Lenders Compliance Group

Monday, September 26, 2011

Riding the Horse Backwards

At a DC conference, dauntingly titled Mortgage Regulatory Forum, Barney Frank, the Congressman from Massachusetts whose name eponymously joins Dodd in the landmark Dodd-Frank Act, spoke about a "revolt" against the risk retention regulations embodied in the Qualified Residential Mortgage rules required by that Act.

We've heard about this risk retention requirement by its euphemistic cognate, rather barbarically described as to "keep skin in the game." I will be publishing a comprehensive article soon about the Act's provision regarding this "skin in the game" mandate. And I will see that you get a copy of the article. For the time being, though, maybe we should reflect a bit on Congressman Frank's worries.

But first, before speculating on Frank's musings about a revolution, let's begin with a story.

Snideley Whiplash and Dudley Do-Right

You might remember the cartoon character Dudley Do-Right of the "Dudley Do-Right of the Mounties" series, a part of the Rocky and Bullwinkle show. Dudley was forever saving Nell Fenwick, Mountie Inspector Fenwick's beautiful daughter, from the machinations of the evil Snideley Whiplash and Tuque, his equally nefarious sidekick. Whereas Dudley is garbed in the bold red uniform with shiny gold buttons of the Royal Canadian Mounted Police, Snidely wears black on black: suit, cape, stove pipe hat, boots - even a black, twisted, handlebar moustache.

Snidely was bent on doing naughty things to the hapless Nell, like tying her to a railroad track. And Snideley's arrogance was only exceeded by his sheer joy when conniving some evil exploit to be perpetrated on the innocent.

But Dudley would save Nell, usually just by dumb luck, free her from the railroad tracks, and boldly stand before her in a puffed-up, prideful "my hero" pose. And then Nell would thrillingly come running into Dudley's open arms, thanking him profusely for saving her!

Actually, no. Nell never did run into Dudley's arms. That just never happened. Not even once!

In fact, Nell would show her gratitude not to Dudley but to Dudley's horse, aptly named Horse, also dressed up like a Mountie. Dudley often rode Horse backwards, galloping boldly to the scenes of Snideley's pernicious schemes.

Even when Dudley had freed Nell from the chains holding her to the railroad tracks, she would hardly notice him. Instead, she gently stroked Horse's snout and elicited his big, charming, toothy smile. For the most part, Nell ignored Dudley, even when he saved her from Snideley's perilous plans.

Poor Dudley Do-Right! He really never did get the grateful recognition he thought he deserved. He never did win Nell's hand in romance. And yet Dudley never gave up on seeing himself as the bold hero responding with courageous alacrity to Nell's call of distress!

"Skin in the Game"

In a proposed rule issued by federal financial regulators, and pursuant to Dodd-Frank, there will soon be a requirement for sponsors of certain asset-backed securities to retain at least 5% of the credit risk of the assets underlying the securities. For "asset-backed securities" read mortgage securitizations. This is being referred to as "risk retention," or that "skin in the game" phrase I mentioned above.

According to those in favor of risk retention, the purpose of this rule is to coalesce underwriting guidelines into an incentivized alignment with securitizers and investors, through promoting a certain set of underwriting standards. The risk retention provision would exempt asset-backed securities that are collateralized exclusively by residential mortgages that are eligible as "qualified residential mortgages," now known, of course, as QRMs.

Many regulators have signed on to the QRM and risk retention provisions, since their view essentially is that "credit risk retention," the name given to the QRM concept, should be required because they believe it encourages prudent underwriting and securitization.

However, consider this: it is simply not known if 5% is even the appropriate amount of risk to be retained in order to align incentives! Indeed, there is scant statistical support for any such percentage whatsoever.

From a Distance

From a high altitude of consideration, the composite criteria of a QRM are the "plain vanilla" variety perfectly familiar to residential mortgage loan originators: 80% LTV; 20% down payment plus closing costs; 28% front-end ratio, and 36% back-end ratio.

Underwriting to the QRM guidelines means that securities backed by QRMs will not require securitizers to retain credit risk. Of course, there's far more to what constitutes a QRM and how it is structured.

Recently, I spoke with a supervising prudential regulator, an old friend, and asked if QRM will crowd out the development of other products that could serve the consumer. His view was that the QRM criteria allow for innovation and, in any event, if they adversely affect a consumer's access to credit, then QRM standards may need to be changed. I must admit, I do not find that response very satisfying.

Markets are active, not passive. Much too often, though, regulatory requirements tend to be reactive, rather than responsive, mostly due to politicians catering to their constituencies and lobbyists. Since when did politicians and regulators so fully replace market action or override underwriting models that lenders undertake as part of making a market, pricing in risk, and developing loan products that respond to consumer needs?

"Revolt"

Congressman Frank seems to have concluded that the recent economic meltdown was largely caused by the housing bubble - presumably, that would be the housing bubble that he declared would never take place. So, "credit risk retention" is now being advanced as a policy that can help to avoid another housing bubble.

Here's the prevailing narrative: in 2008 and 2009, we went into the Great Recession, and now we're experiencing high unemployment and weak growth. Was the housing bubble the ultimate cause?

Most people seem to think so. They believe that the housing bubble burst in 2006 and led to a severe financial crisis in 2008, intensifying a recession that had begun in December 2007. And the Fed did what it could, through targeting inflation to prevent the crash, but could not stem the tide.

Here's another narrative, one actually supported by facts: the housing crash did not lead directly to a recession or high unemployment, although it seems to have been a proximate cause.

More than two-thirds of the decline in housing construction happened between January 2006 and April 2008. During that period, though, the unemployment rate rose only slightly, from 4.7% to just 4.9%. And statistics demonstrate that most of the workers who lost jobs in housing construction were subsequently reemployed in other fields. It wasn't until October 2009 that unemployment soared to 10.1%, with job losses spread out across almost all sectors of the economy.

Indeed, the financial crisis did have its roots in the housing bubble, and there were consequent systemic failures of financial institutions, yet for some odd reason this situation did not set off alarm bells at the Fed until much too late.

There is a world of difference between a proximate cause and the ultimate cause.

Bottom Line: monetary policy failed to predict the problem and the Fed did not respond soon enough.

Fallacy of the "Blame Game"

The assumptions of the first narrative have dominated politics and have led to the QRM remedy.

Thus it is that we have this statement from Mr. Frank:

> "I am disappointed at this **revolt against risk retention** that was so clearly at the center of this."
>
> "All the other problems we had ... they all centered on the system for selling to other people loans that shouldn't have been made in the first place."
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> "It's simply not possible with any conceivable number of regulators to monitor every loan. If the people making the loans do not have an incentive not to lend to people who can't repay, there is no way we will prevent those kinds of loans from being made." (My emphasis.)

That sweeping statement is certainly not supported by the facts. I have discussed this fallacy of the "blame game" in detail elsewhere, for instance in my three-part series on the Dodd-Frank legislation.

Yet the "revolt" is not just coming from lenders. Consumer advocacy groups want to ensure homeownership for qualified borrowers among low and middle income families, without having to be turned away due to a market that has been deincentivized from lending to them.

Nell and the Horse

Maybe there was a really good reason why Nell preferred to show her gratitude to the Horse, rather than to drape herself around Dudley Do-Right's neck in gleeful appreciation and unbounded thanks.

I wonder if you could suggest what Nell's reason might have been.

What do you think?

Please feel free to comment!

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Labels: "Housing Bubble", "Skin in the Game", Barnie Frank, Credit Risk Retention, Dodd-Frank Act, QRM, Qualified Mortgage, Qualified Residential Mortgage, Risk Retention

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