Beware of bad economics: The Urban Institute's Solution to the Expiring QM GSE Patch

> *In the department of economy, an act, a habit, an institution, a law, gives birth not only to an effect, but to a series of effects. Of these effects, the first only is immediate; it manifests itself simultaneously with its cause — it is seen. The others unfold in succession — they are not seen: it is well for us, if they are foreseen. Between a good and a bad economist this constitutes the whole difference — the one takes account of the visible effect; the other takes account both of the effects which are seen, and also of those which it is necessary to foresee. Frédéric Bastiat,1850*[1]

The Urban Institute's (UI's) solution to the expiring QM GSE Patch is a classic case of bad economics:

> We recommend a QM safe harbor standard based on a loan's overall riskiness as opposed to the DTI ratio, or who insures or guarantees the mortgage. Under this structure, the 43 percent DTI cap and GSE patch would be dropped from the CFPB's QM rule. Restrictions on risky products, loan terms, and points and fees would remain unchanged, as would the statutory exemption for portfolio lenders with less than $10 billion in assets. With no DTI cap or the patch, this framework would provide safe harbor status to first-lien mortgages as long as their annual percentage rate is no more than 150 basis points over the APOR [Annual Percentage Offer Rate]. The underlying premise is that loans priced under the 150 basis point rate-spread threshold would be less risky than loans priced above this threshold.… Mortgage rates reflect credit risk more holistically than DTI ratios."[2]

At the time the QM GSE Patch was announced in January 2013 by the Consumer Financial Protection Bureau (CFPB), I wrote an op-ed that took into consideration the seen, the unseen, and the foreseeable:[3]

1. Rather than banning the irresponsible underwriting practices of the FHA…, they are grandfathered for up to seven years or until these agencies issue their own rules codifying their irresponsible lending practices.
2. The GSEs and their automated underwriting systems are also grandfathered for up to seven years, notwithstanding that the GSEs and their systems were instrumental in the housing market collapse.
3. The CFPB has codified HUD's view that the way to distinguish a prime loan from a subprime one is by the interest rate charged, not risk [the 150 basis point APOR provision relied on in UI's recommendation].

I further noted: "The rule is made pursuant to the Dodd-Frank Act's provision calling for minimum mortgage standards. It is being touted as making sure 'prime' loans will be made responsibly. Yet true to the government's long history of promoting excessive leverage, it sets no minimum down payment, no minimum standard for credit worthiness, and no maximum debt-

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[1] That Which is Seen, and That Which is Not Seen; by Frederic Bastiat

[2] What, If Anything, Should Replace the QM GSE Patch? | Urban Institute

[3] CFPB's new 'qualified mortgage' rule: The devil is in the details - AEI

to-income ratio. Under its tortured definition of "prime", a borrower can have no down payment, a credit score of 580, and a debt ratio over 50% as long as approved by a government-sanctioned underwriting system. This opens the door to politicized lending at its worst."

I concluded by noting what was clearly foreseeable: "Booms are fueled by excessive leverage. This rule not only does little to limit borrower leverage, it greases the slope for the next bust."

The first half of my twin predictions has already materialized. It is now 7 years after the Patch was announced and Nobel laureate Robert Shiller noted last December, [The Housing Boom Is Already Gigantic. How Long Can It Last?]

Let's evaluate UI's recommendation using Bastiat's advice. UI recommends the use of a loan pricing standard (the seen) that cannot possibly work to constrain risk (the unseen). UI's APOR suggestion will therefore promote higher risk, rather than constrain it (the foreseeable).

To state the obvious; in order for a loan's pricing to reflect risk, the loan must be priced for risk. As I noted back in 2013, FHA, the riskiest lender in the market place, does not price for risk. Thus its loans, no matter how risky, will easily and conveniently meet the APOR plus 150 basis point test. How about the GSEs: Fannie Mae and Freddie Mac? Here the plot thickens. The APOR is based on the current offer rate for conventional, conforming mortgages with 20% down. These are precisely the mortgages that the GSEs purchase in huge quantities. But government policy effectively requires the GSEs subsidize higher risk loans by charging higher rates on lower risk ones. This amounts to about $5 billion per year. In the process the APOR is raised and most, if not all, subsidized higher risk loans are under the APOR plus 150 basis point test. The result? Nearly all, if not all, of government insured loans (about 85% of the home loan market), will pass the APOR test regardless of risk. This is the test touted by UI as "reflect[ing] credit risk more holistically."

This is not the first time UI has been guilty of bad housing economics. In 1999 UI submitted a study to HUD about the state of GSE underwriting, noting:[4]

> In 1997, the U.S. Department of Housing and UI Development (HUD) commissioned the UI Institute to conduct an exploratory study of Fannie Mae and Freddie Mac's single-family underwriting and appraisal guidelines, in response to HUD's statutory responsibility to review and comment on the guidelines. HUD requested that the exploration provide information about the effects government-sponsored enterprises' (GSEs') guidelines have on the funding of loans on properties affordable to lower-income people and in underserved areas, and the impacts automated underwriting and credit scoring technology have on low- to moderate-income and minority borrowers. HUD also requested that this exploration include information about lenders' perceptions about the effects of the GSEs' guidelines on minority mortgage applicants, since minorities' lower average incomes and wealth mean that underwriting guidelines are likely to disqualify higher proportions of minority applicants.

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[4] A Study of the GSEs' Single-Family Underwriting ... - Urban Institute

> Almost all the informants said their opinion of the GSEs has changed for the better since both Fannie Mae and Freddie Mac made substantive alterations to their guidelines and developed new affordable loan products with more flexible underwriting guidelines. These developments, according to informants, have made it easier for many low- to moderate-income applicants to obtain mortgages. This review of the underwriting guidelines also indicates that the GSEs explicitly prohibit lenders from taking a borrower's race or ethnicity into account in making loan decisions. Informants did express concerns about some of the GSEs' practices. The GSEs' guidelines, designed to identify creditworthy applicants, are more likely to disqualify borrowers with low incomes, limited wealth, and poor credit histories; applicants with these characteristics are disproportionately minorities."

In 2000 HUD, citing UI's report, increased the GSEs affordable housing mandates from 42% to 50%.[5] On a proportional basis the Special Affordable Goal pertaining to low- and very low-income borrowers was increased the most--from 14% to 20%.

HUD made special mention of the following findings in UI's study:

> It is very difficult for applicants with low credit scores to be approved for a mortgage, according to the lenders interviewed by the UI Institute.
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> From UI's discussions with lenders, it was revealed that primary lenders are originating mortgages to lower-income borrowers using underwriting guidelines that allow lower down payments, higher debt-to income ratios and poorer credit histories than allowed by the GSEs' guidelines. These mortgages are originated to a greater extent to minority borrowers who have lower incomes and wealth. From this evidence, [UI] concludes that the GSEs appear to be lagging the market in servicing low- and moderate income and minority borrowers.

It is common knowledge that the radical loosening of the GSEs' underwriting standards in the 1990s and 2000s was the result of government mandates and that this was a major cause of the house price boom, crash, and the ensuing Great Recession.

UI's APOR recommendation to the CFPB is as dangerous to the welfare of low- and moderate-income borrowers as its report to HUD was in 1999. As noted in 2013, booms are fueled by excessive leverage. UI's APOR recommendation not only does little to limit borrower leverage, it further greases the slope for the next bust. The solution is to let the Patch sunset expire in January 2021 as originally planned by the CFPB ([Dear CFPB: Let the QM 'patch' expire | American Banker]). Now is the time to take measured counter-cyclical steps to slow the unsustainable home price growth plaguing entry-level buyers.

Let's not allow history to repeat itself.

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[5] HUD's Affordable Lending Goals for Fannie Mae and Freddie Mac, http://www.huduser.org/publications/pdf/gse.pdf