Too "Qualified" or Not "Qualified" Enough?

Criticism and Suggested Reforms to the Currently Ineffective "Qualified Mortgage" Standards

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I. Introduction

The Mortgage Reform and Anti-Predatory Lending Act of 2010[1], is one of the latest regulations enacted by the Consumer Finance Protection Bureau ("CFPB"), as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] ("the Dodd-Frank Act").[3] The Mortgage Reform and Anti-Predatory Lending Act ("the Act") also functions as Title XIV of the Dodd-Frank Act, and the Act became effective on January 10, 2014.[4] This highly influential mortgage underwriting rule significantly updated existing provisions of the Truth In Lending Act[5] ("TILA") and principally requires residential mortgage lenders to thoroughly determine through vigorous verification that prospective borrowers have the financial ability to repay their home loans.[6]

The general topic of this article is past and present predatory lending practices by financial institutions in the residential mortgage context. More specifically, it will address the sub-topic of mortgage safety and soundness standards under the recently imposed "qualified mortgage" regime of the new regulatory environment created by the Mortgage Reform and Anti-Predatory Lending Act of 2010. As related to the general topic and sub-topic, the article will set forth and analytically develop the theme that in its current state, the Act's "qualified mortgage" standards will likely provide ineffective results, rather than fulfilling its intended purpose of accurately assessing the creditworthiness and financial "ability to repay" of applicant consumer borrowers.

The Mortgage Reform and Anti-Predatory Lending Act was passed in response to growing concern that bold action needed to be taken to combat system-wide predatory lending practices and protect consumer borrowers nationwide, with the hope of stimulating and reviving the entire United States economy and financial markets.[7] Excessive predatory lending in residential mortgage loan transactions, along with gross oversight and regulatory failure, served as the root of the Global Financial Crisis, which ultimately caused and contributed to the Great Recession.[8] Counteracting these negative consequences of the predatory lending of the past is crucially important because the United States mortgage market has roughly $9.9 trillion in mortgage loans outstanding, making it the largest single consumer market for consumer financial products and services.[9] When the securitized housing mortgage market imploded in 2008, the rest of the economy collapsed along with it because of its overwhelming size and influence.[10]

The Mortgage Reform and Anti-Predatory Lending Act specifies the requirements for and defines the term "qualified mortgage."[11] Lenders prefer to have their residential mortgage loans deemed "qualified" because it serves to protect them in the future in the event that a consumer borrower should default and attempt to sue the lender for rescission under TILA due to alleged predatory lending practices.[12] Also, lenders desire to extend "qualified mortgages" because they can repackage them through securitization and sell them for higher prices than non-qualified mortgages because "qualified mortgages" are a safer investment associated with less risk, which makes them more valuable.[13] While the Act was an important, good faith first attempt by the CFPB to fulfill its duty assigned by the Dodd-Frank Act of battling predatory lending tactics, the Act has many loopholes and inconsistencies. The Act does impose more significant requirements for lenders to comply with than existed in the critical years leading up to the Global Financial Crisis, but the Act is inadequate in its current form to sufficiently guard consumer borrowers against some residential lenders that seek to conceal their predatory behavior under the guise of a "qualified mortgage."[14] Many provisions that seem strict at first glance need only be complied with for the first few years of a home loan.[15] After the initial years, a lender is free to impose excessive interest rates or raise the consumer borrower's monthly payment to an unsustainable level, which would likely lead the borrower into default and inevitably foreclosure.[16]

The Mortgage Reform and Anti-Predatory Lending Act of 2010[1], is one of the latest regulations enacted by the Consumer Finance Protection Bureau.

Although there is still considerable room for improvement, the CFPB's recent statutory standards and regulations on lending in secured residential credit transactions have reached levels of specificity never before seen in federal lending regulation.[17] However, the criticism should mostly outweigh the admiration, in large part because the Act contains significant gaps in coverage and is not as groundbreaking as one might originally think.[18] This is partly due to the fact that after being burned by the financial meltdown that took place starting in 2008 because of their prior predatory lending behavior, lenders naturally altered their practices and procedures to become more conservative and less risky, even before the Act was finalized, let alone made official.[19] The "qualified mortgage" standard is a step in the right direction by the CFPB, but as it currently stands, it needs meaningful revision to accomplish its underlying purpose.

Part II of this article sets the stage with a historical background and development of the egregious predatory lending that occurred in the residential mortgage industry in the context of the Global Financial Crisis. Part III examines the Dodd-Frank Act in relation to residential mortgage loans and predatory lending, while Part IV critiques provisions of the substantive "qualified mortgage" standards of the Mortgage Reform and Anti-Predatory Lending Act of 2010. Finally, Part V provides the author's conclusion that the current CFPB "qualified mortgage" standards are inadequate to completely satisfy the Act's underlying purpose, and offers recommendations and reforms to the existing regulations.

II. The History of Predatory Residential Mortgage Loans in the Global Financial Crisis

The Global Financial Crisis was a systemic crisis that affected the entire world, the first of its kind in the United States since the 1930's.[20] Entire segments of the credit and lending markets all over the world ceased to function for longer than one month.[21] The Global Financial Crisis ultimately unraveled in 2008, and its devastating consequences altered the course of the financial markets, the securities and derivatives markets, and especially the economic futures of its survivors all around the world forever.[22] The Global Financial Crisis was fundamentally the product of the increasing aggregate effect of poorly made decisions and unwise business strategies.[23] Some of the key origins of the failure included "excessive borrowing, excessive lending, and excessive investment incentivized by a series of significant economic and regulatory factors."[24]

A. Securitization

In addition to the excessive borrowing and excessive lending to mass numbers of unworthy debtors, securitization was another key factor affecting predatory lending in the Global Financial Crisis.[25] Securitization is a "transaction structure in which loans (such as loans secured by residential real estate – i.e., mortgages) are pooled together ("repackaged") as collateral underlying the issuance of securities, predominantly debt securities."[26] "Pooling" works by helping to achieve a greater level of diversity for any particular investor's portfolio of assets when the risks of each loan collected and put into the pool are uncorrelated.[27] These pooled groups of mortgages were used to back securities called collateralized debt obligations ("CDOs")."[28] Basically, these mortgage-backed securities were combined in special purpose vehicles[29] ("SPVs") that were divided into slices or "tranches" based on the level of their exposure to default.[30] The predatory borrowing and lending tied into securitization based on the underlying fact that the securitization affected all kinds of asset classes, but it most directly occurred in the market for subprime residential mortgages in the United States, where it produced and led to overwhelmingly destructive systemic results.[31] "Systemic risk" is defined as: "the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy."[32]

B. Subprime Mortgages

These "subprime mortgages" were associated with higher interest rates than a prime rate and were extended in extremely large quantities to low-income borrowers, associated with higher risk, who sought to purchase residential property to become a homeowner, often for the first time.[33] The borrowers were deemed "subprime" due largely in part to their exceedingly poor credit and below average credit histories.[34] Correspondingly, a "subprime mortgage" is defined as a loan to a borrower of either questionable, undetermined, or unsatisfactory credit quality.[35]

Subprime mortgages were residential mortgages either guaranteed, issued, and/or purchased by the Federal National Mortgage Association ("FNMA" also known as "Fannie Mae") and the Federal Home Loan Mortgage Corporation ("FHLMC" also known as "Freddie Mac"), which essentially function as government-created secondary markets for commercial banks and other mortgage lending institutions of many variations to sell residential mortgages.[36] Leading up to the financial credit crisis of 2008, Fannie Mae and Freddie Mac purchased, packaged, securitized, and resold residential mortgages in the form of mortgage-backed securities with a federal guarantee that the principal and interest payments would be repaid to investors, therefore, earning a profit on the difference between the price of the mortgage-backed securities and their original cost of funding.[37] At the heart of the issue here is the fact that FNMA and FHLMC predatorily decreased their underwriting and due-diligence standards for qualifying mortgages and mortgage-backed securities.[38] But the blame was not on these agencies alone.[39] After the dust settled, the Federal Housing Finance Agency ("FHFA"), the conservator of FNMA and FHLMC, sued seventeen of the country's largest banks to recoup $196 billion that Fannie Mae and Freddie Mac had spent purchasing mortgage-backed securities from these large banks.[40]

Subprime mortgage-backed securities, with their relatively simple securitization and sale processes, were not the only problematic structured finance tool responsible for the Global Financial Crisis.[41] Increasingly, financial engineers continued to develop complex financial investment structures known as structured investment vehicles ("SIVs") and conduits, collateralized loan obligations ("CLOs"), synthetic securitizations, CDO squared ("CDO^2"), and synthetic CDOs.[42] These structured finance tools were made possible through the use and technology of off-balance sheet accounting structure, capital markets funding, over-the-counter derivatives, and credit-default swaps ("CDSs").[43] A "CDS" is:

> [A] bilateral derivative transaction, which may be seen as a type of protection against default of a synthetic loan. In essence the seller of a CDS agrees to pay the buyer if a credit event occurs, typically some sort of default by an unrelated borrower. The buyer of the CDS agrees to pay the seller a stream of payments roughly equivalent to the payments that would be made by the identified but unrelated borrower. As such, the seller of the CDS receives a stream of payments which mimic a loan.[44]

Another way to look at a CDS is that it is a form of debt insurance.[45] The entire financial derivatives investing market, especially with the mass amounts of the pooled and securitized residential mortgage-backed securities distributed, became an alphabet soup of confusion to potential investors.

C. The Bubble Finally Pops

Near the end of 2006, the culmination of the financially engineered mortgage-backed securities was gearing up to become the perfect economic storm.[46] At this time, the United States, along with several other Western hemisphere countries, was enjoying the many benefits of high real estate prices that turned out to be unsustainable over the long term.[47] It was a time period of unparalleled low and stable inflation rates.[48] Some economists and other experts on the Great Recession[49] have even classified the Global Financial Crisis as "an accident waiting to happen."[50] During this period, there were uncharacteristically low risk spreads for most classes of assets, the volatility of the market was unusually low and stable as well, [51] and the United States housing real estate prices were steadily increasing, creating an unyielding, widespread belief that home prices would likely continue to appreciate forever without limit and would undoubtedly never depreciate in value.[52]

It seems as if the major banks that were selling the pooled mortgage-backed securities chose to take advantage of this conjecture and decided they could afford to become extraordinarily leveraged. These decisions were deemed reasonable at the time because even if some unworthy borrowers would almost certainly default on their home mortgages, there would always be more "homeowners" to take out additional residential home loans in pursuit of the American dream. The bank could continue making money on the interest by perpetuating this cycle. This scene set the perfect stage for a strong period of growth and prosperity, cultivated by complacency, ignoring many of the warning signs, and dangerous risk-taking.[53] The heads of the national banks reassured themselves that their strategy would produce positive results overall because the individual property markets in America would rise and fall independently of each other, but that proved to be entirely untrue.[54] Instead, beginning in 2006, the United States began to suffer a nationwide housing price slump.[55]

When the national financial system finally caught up with the compounding of the numerous poor decisions, industry-wide complacency, and unsustainable amount of leverage that banks were attempting to carry in a domino effect catastrophe, the stock market crashed, and the residential housing market bubble inevitably popped.[56] For a bank to be highly leveraged[57], it means that the bank is employing the use of credit to enhance its speculative capacity, or that it is using borrowed capital for an investment, while expecting and betting that the amount of profits made on the underlying investment is greater than the amount of interest payable on the borrowed capital.[58] If the opposite ends up being true, meaning that the profits (or losses) made on the underlying investment is less than the amount of interest payable on the borrowed capital, the bank is in trouble and has probably attempted to sustain a level of leverage beyond its means.[59] This

extremely unfortunate underwater situation was agonizingly real for millions of "homeowners."[60] The investment banking institutions could have eased the epic downfall of the market, or quite possibly prevented it altogether, if they had lowered their maximum loan-to-value ("LTV") ratio by requiring a higher percentage down payment from consumer borrowers when they were applying for a mortgage.[61] The regulators also could have required that the banks set aside more capital for a rainy day emergency fund and maintain greater percentages of fractional reserves.[62] But neither did.

This triggered a downward spiral and led to record high numbers of unemployment and the loss of many hard-working Americans' life savings, which they intended to rely on for support during their retirement years.[63] It is safe to say that the worldwide credit crisis of 2008 produced long-lasting consequences for the future of global and international finance and permanently reshaped the world of investing.[64] Another key factor surrounding the Global Financial Crisis was that the industry leaders in asset investment ratings firms misclassified the subprime mortgage-backed securities and other structured financial derivatives as being much "safer" and less risky than they actually were.[65] It is often assumed that at least part of the misclassification was due to ignorance and part was due to failure to adequately monitor.[66] The ratings agencies have been widely criticized for slow reaction to deteriorating credit risks, rapid reappraisals, and an asymmetric view of credit improvements and declines.[67]

D. Oversight Failure By the Ratings Agencies

Investors purchased these mortgage-backed securities and other CDOs that they associated with less risk because they trusted in the fact that they had "AAA" credit ratings assigned by the most dependable credit ratings agencies with the longest-standing historical accuracy and the best reputations.[68] Standard and Poor "AAA," meaning "prime" and having an "extremely strong capacity to meet financial commitments" is the highest credit rating an asset, security, or option can receive from this agency.[69] "BBB-" designates the lowest possible rating that is still considered "investment grade" by market participants.[70] Any class of assets that does not meet the standard to be considered "investment grade" is instead referred to as "junk."[71] Also, it is important to note that any rating from "AA" to "CCC" may be modified in rating slightly up or slightly down with the addition of a plus (+) or (-) sign displayed within the major rating categories.[72] However, Standard and Poor reminds potential investors that their credit ratings are not indicators of investment merit.[73] "Ratings are not buy, sell, or hold recommendations or a measure of asset value."[74] They are not intended to recommend the suitability of an investment because it depends on the individual investor's portfolio and desired risk premium.[75] The central ratings agencies involved in this disaster were Moody's and Standard and Poor.[76]

These credit ratings agencies, commonly known as Moody's and S&P, were paid directly by the banks that created and financially engineered the mortgage-backed securities in question.[77] Therefore, many of the executives at the credit ratings agencies felt compelled and obligated to provide a positive and confident assessment of these creatively engineered financial derivatives because the banks were essentially their customers.[78] These agencies rated the mortgage-backed securities and other structured finance tools as prime or "AAA," which is the same rating as many bonds and investments issued by the United States Treasury or state and local municipal bonds that are thought of as being completely risk free, when in reality the mortgage-backed securities could have been more accurately rated as very risky and "subprime" or "junk."[79] The prime ratings gave investors a very false sense of security when spending significant portions of their savings on these securities that ended up being not only extremely risky but entirely worthless.[80] Investors even went so far as to seek out these "prime" mortgage-backed securities because of the higher than average returns that they were associated with.[81] Investors probably should have known that this arrangement was too good to be true when they were receiving higher than average returns with supposedly less risk. But the possibility of substantially higher profits trumped reason.

Following the unraveling of the many aspects of the interconnected financial markets and the stock market crash, many Americans were left with their retirement accounts and mutual fund accounts virtually depleted, creating widespread panic.[82] After every crash of the United States economy, slowly but surely the market eventually recovers, but some of the ones hit hardest in this particular recession were the elderly who did not have the years necessary to wait for their financial holdings to recover.[83] Because of the panic multiplying exponentially each day, many elderly Americans pulled their money out of their investments in an attempt to hoard cash as the stock market was still on its way down, which is a grave common mistake of casual investors.[84] This drove the stock market further and further down in value as trust in the system rapidly declined and nearly disintegrated.[85]

E. Major Financial Institution Failures

In March 2008, the first major casualty of the economic meltdown was Bear Stearns, the fifth largest United States investment bank and "the one with the least diversified business and the greatest direct involvement in debt capital markets."[86] Its fundamental problem centered on severe but disguised liquidity issues, even though Bear Stearns appeared to be fully liquid because it was actually well capitalized.[87] On March 14, 1998, the Federal Reserve Bank of New York provided emergency funding to Bear Stearns through the intermediary of J.P. Morgan.[88] The bailout was not enough to prevent Bear Stearns from preparing to file for bankruptcy on March 17, 2008.[89] However, on March, 16, 2008, J.P. Morgan agreed to buy out Bear Stearns for

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parts.[90] Later on October 25, 2013, J.P. Morgan was ordered to pay $5.1 billion to settle allegations of misleading FNMA and FHLMC about the quality of the residential mortgage derivatives that it sold the housing agencies during the upward slope of the national real estate boom.[91] Bear Stearns' failure was previously unprecedented for an investment bank of such great magnitude.[92] Once the bank's clients began to lose faith, counterparties, other clients, and the entire industry of lenders refused to participate in transactions with Bear Stearns in any capacity, and this avoidance ensured the downward spiral of Bearn Stearns and sealed its fate.[93] After trust, "the ultimate glue of all financial systems," in the once world-renown investment bank dissolved, it was deemed poisonous, and "nobody trusted anybody, so nobody would lend."[94]

The next casualty in the lineup of the Great Recession was Lehman Brothers, the fourth largest United States investment bank.[95] On September 15, 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection, "with $680 billion in assets, $650 billion in liabilities, and over 100,000 creditors around the world."[96] The Lehman Brothers bankruptcy constituted the largest and most complex bankruptcy that the United States and the modern business world have ever seen.[97] The downfall of Lehman Brothers would later come to be regarded as "the straw that broke that camel's back" and ultimately led to the record-breaking stock market plummet and subsequent systemic credit crisis.[98] It is widely believed that declining to bail out Lehman Brothers and allowing the investment bank to be disassembled in bankruptcy proceedings was the federal regulators' "most dramatic error."[99] Many economists opine that the decision by the United States government to forgo bailing out Lehman Brothers and allowing it to fail in an attempt to avoid meddlesome government intervention, ironically ended up resulting in more government intervention, rather than less.[100] During the same week, Bank of America acquired and purchased the remaining assets of Merrill Lynch, which was formerly the third largest United States investment bank.[101] Uncertainty and insecurity were on the rise rapidly because after this historic collapse, the market participants contemplated for the first time, "if Lehman [Brothers] failed, [then] anyone could fail."[102] The prior common perception that some of these financial giants were "too big to fail," was now simply a remnant of the prosperous past.[103]

The Dodd-Frank Act is the most comprehensive financial reform since the 1930's.

Lastly, what should have been another epic casualty of the Global Financial Crisis was American International Group ("AIG").[104] At the time of the Great Recession, AIG was the largest insurance company in the world with over $1 trillion in global assets.[105] AIG's predominant form of business consisted of writing and selling credit default swaps on corporate and residential mortgage debt.[106] During the course of ordinary business, at any given time AIG's equity was only a fraction, around one-fifth, of its potential liability, measured in the full notional amount.[107] Therefore, when residential "homeowners" began defaulting on their mortgages, the mortgage-backed securities entered default, and AIG could not pay the notional amount, also known as par value, that was now due to the credit default swap holders.[108] It was soon obvious that if the United States Treasury allowed AIG to fail, it would trigger systemic catastrophic results, causing other institutions around the globe to fail as well, due to their intimate relationships and interconnectedness.[109] Trying to face reality, AIG clumsily and possibly illegally asked the Federal Reserve for a massive loan needed in order to survive[110] On September 16, 2008, the United States Treasury guaranteed a two year $85 billion loan from the Federal Reserve, which protected AIG's creditors and counterparties.[111] This resulted in a 79.9 percent equity stake for the Federal Government in AIG.[112] The implications of the Global Financial Crisis are still being felt deeply, and without the government intervention and fiscal stimulus, there likely would have been a massive global depression, rather than a recession.[113] It is unclear whether the Great Recession is entirely over, but it is imperative that regulators, bankers, and investors learn from the mistakes of the past in the hope of a better financial tomorrow.

III. The Dodd-Frank Wall Street Reform and Consumer Protection Act

A. The Dodd-Frank Act and Predatory Lending

The purpose of enacting the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act")[114] was to provide some accountability for the Global Financial Crisis and the loss of eight million jobs.[115] The Dodd-Frank Act is the most comprehensive financial reform since the 1930's.[116] It was the supposed solution[117] by Chris Dodd, a former Connecticut senator, and Barney Frank, a former Massachusetts representative,[118] to a plethora of past regulatory failings and oversights,[119] or a "sweeping legislative package designed to prevent another spectacular financial collapse."[120] The Dodd-Frank Act is often viewed as a bailout bill, meant to salvage the remnants of the devastated United States financial industry.[121] Unfortunately, the current status of the Dodd-Frank Act today remains uncertain, with many vital sections still unfinished or unimplemented.[122] Since the effective date of January 10, 2014, however, the Dodd-Frank Act speaks to predatory lending in the residential mortgage setting.[123]

Predatory lending occurs when "money lenders use unfair, deceptive, or fraudulent practices to entice borrowers," usually the consumer borrowers most in need of cash, into taking out a loan from them, regardless of the purpose of the loan.[124] Dodd-Frank triggered a major shift in accountability and deviated from traditional credit principles by obliging lenders to attempt to determine whether the borrower has the ability to repay the loan.[125] This shift assumes that consumers are unable to understand the complexities of the loan process, cannot be trusted to provide reliable application information, and are incapable of acting in their best own interests.[126] Looking at the Global Financial Crisis from this perspective completely blames the downfall of the residential mortgage market on lenders and financial institutions that "preyed" on the " victim" consumers.[127] In addition, the "ability to repay" requirement allows consumer borrowers to sue their lender if it later becomes evident that the lender overestimated their financial ability to fulfill the obligations of their home loan.[128]

However, from the lender's perspective, there is only so much that can be done to verify financial fitness.[129] For example, if a consumer has a steady income during the initial years of the repayment schedule but then loses his job or becomes subject to extraordinary medical bills pertaining to an accident, the consumer could quickly default on his mortgage.[130] This is one reason why the Dodd-Frank Act offers a "safe harbor" for lenders to protect them from potential liability if they exercise due diligence in the application review process.[131] If the lender satisfies all the requirements of approving a "qualified mortgage" to the borrower, the requirements of which are discussed further in Part VI, the lender is protected from consumer recourse.[132] This "hastily crafted" regulation greatly oversteps the appropriate remedy because it inhibits the freedom of borrowers and lenders to agree to a considerable amount of mortgage options, and it will lead to an increase in mortgage rescission litigation and less credit availability for borrowers seeking a residential home loan.[133]

The central rule within the Mortgage Reform and Anti-Predatory Lending Act implements sections 1411 and 1412 of the Dodd-Frank Act, which mandate that lenders "must make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms."[134] This means that the lender must actually verify the consumer loan applicant's income and previously existing debt obligations, rather than merely relying on the applicant to be honest and forthcoming about his financial status.[135] This rule imposed on lenders applies quite broadly in "any consumer credit transaction secured by a dwelling."[136] In general, prior to the adoption of the Act, lenders could partake in loose underwriting practices that quickly approved consumer borrowers that had an obvious lack of an ability to repay.[137] While this "reasonable and good faith determination" regulation imposes a greater burden on the lender than before, it benefits the lender as well by preventing the lender from imprudently approving a loan applicant that will furnish the lender with an undesirably risky mortgage that will be difficult to securitize and sell and will cause problems in the future through a likely inevitable consumer borrower default.[138]

B. The Creation and Role of the CFPB

The Consumer Finance Protection Bureau was created[139] as part of the original framework of Dodd-Frank for regulating and monitoring systemic risk and its harmful effects.[140] The CFPB was established as an inner segment of the Federal Reserve System, and it is considered by some to be one of the most powerful federal agencies ever created.[141] The CFPB regulates all financial activity related to consumer products and services without meaningful checks on its authority from Congress or the President.[142] One of the CFPB's most recent regulations, the Mortgage Reform and Anti-Predatory Lending Act ("the Act"), took effect on January 10, 2014, and it is the central piece of the CFPB's new mortgage scheme.[143]

The intent behind the role and formation of the CFPB was to protect ordinary consumers from deceptions and schemes by Wall Street investment banks and other financial institutions involving mortgages, credit cards, securities, and any other related product.[144] The CFPB is the federal agency responsible for enforcing TILA[145], which allows consumers to pursue rescission of their home mortgage against the lender under certain circumstances.[146] This view of the CFPB presumes that many large financial institutions and investment banks are like predators, preying on and devouring the helpless, innocent, victimized consumers.[147]

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IV. The Mortgage Reform and Anti-Predatory Lending Act

A. Residential Mortgage Safety and Soundness

Maintaining safety and soundness in the financial sense signifies that a consumer withdraws precisely the same quantity and quality of what he previously deposited with a financial institution.[148] Economic safety and soundness is often assessed with a "CAMELS" rating.[149] "CAMELS" is an acronym that stands for "capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk."[150] Safety and soundness of financial institutions is also frequently evaluated by the "5 C's of Credit: Character, Capacity, Collateral, Capital, and Conditions."[151]

Surprisingly, safety and soundness in the mortgage context is not a new concept.[152] As far back as 2001, safe and sound banking practices required lenders to ascertain that there was adequate evidence that a consumer borrower possessed sufficient resources and the financial ability to make all required payments on home loan obligations before the lender granted the loan.[153] The factors that banks were already supposed to consider within the mortgage application process were: the interest rate on the loan, the credit score of the applicant borrower, the current liquidity of the lender overall, the price of the dwelling to be secured by the loan, the current foreign exchange rate, the particular transaction in general, compliance with existing applicable regulations, strategic risks, reputational risks, and the effect of approval on the particular lender as a whole.[154] However, these existing requirements failed to prevent the mortgage market meltdown in 2008 because both consumers and lenders are naturally greedy.[155] Some unscrupulous lenders anticipated that they could continue to capitalize on this business plan through the large commissions associated with approving loans to low and mid-income borrowers who did not have the financial fitness necessary to repay their loan obligations, and then selling and repackaging residential mortgages into mortgage backed securities.[156] Regarding the events surrounding the complete overleveraging of the financial markets that led up to the Great Recession, prudent underwriting and the denial of unworthy applicant borrowers by residential mortgage lenders could very well have kept the mortgage markets safe and sound.

B. "Qualified Mortgage" Standards

The Dodd-Frank Act linked predatory lending with the idea of mortgage safety and soundness for the first time, connected by the system-wide abuse that took place in underwriting housing loans and the unsustainable practices that provided almost effortless access to credit.[157] More narrowly, the Mortgage Reform and Anti-Predatory Lending Act ("the Act"), sets forth strict criteria of how a lender can achieve "qualified mortgage"[158] status on a loan secured by a dwelling.[159] The general foundation of the newly implemented regulation indicates that no creditor is permitted to make "a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance, and assessments."[160] Before 2010, this requirement that is now universal, applied only to certain high-cost and high-risk mortgages.[161]

Furthermore, a "qualified mortgage" designates that the regular periodic payments for the loan may not include an increase in the principal balance, known as negative amortization, or allow the consumer debtor to defer repayment of the principal through means of an interest only loan.[162] Additionally, the loan payments shall not contain a "balloon payment," which is a scheduled payment that is more than twice as large as the average of the previous payments.[163] To satisfy the "qualified mortgage" test, creditors must also intensely and diligently verify that the evidence of consumer income and financial resources relied upon to qualify for the obligation is reliable and property documented.[164] For mortgages with fixed interest rates, the underwriting process merely must be based on a payment schedule that fully amortizes the loan over the loan term and adequately takes in to account all the applicable taxes, insurance, and assessments that pertain to the loan.[165] For mortgages with adjustable interest rates, the underwriting process must be based on the maximum rate allowed under the loan during the first five years, including a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments.[166] Any residential mortgage loans meeting the definition of a "qualified mortgage" must comply with any and all CFPB regulations and guidelines about total monthly debt to monthly income.[167] Specifically, the CFPB passed a regulation that mandates that at the time of consummation of the loan a consumer borrower's overall monthly debt to income ratio cannot exceed 43 percent, in order for a lender to achieve "qualified mortgage" protection.[168] This includes debt completely unrelated to residential real estate.[169] Moreover, a "qualified mortgage" cannot have total points and fees payable that exceed three percent of the total amount of the loan or have a term that exceeds a maximum of thirty years.[170] Lastly, the regulation provides that a reverse mortgage can achieve "qualified mortgage" status as long as it fulfills all of the same requirements.[171] These elements in combination are supposed to sufficiently inhibit creditor financial institutions from engaging in predatory lending.[172] However, in their current state these rules may work to inefficiently approve some financially unstable consumers and deny many creditworthy consumers.

C. Criticism of the "Qualified Mortgage" Requirements

The Mortgage Reform and Anti-Predatory Lending Act ("the Act") contains many inconsistencies and significant gaps in coverage. As it stands, the Act is inadequate to sufficiently guard consumer borrowers against some lenders attempting to hide their predatory behavior behind a "qualified mortgage."[173] For example, many provisions that seem strict at first glance need only be complied with for the first five years of the home loan.[174] After the initial five years, the lender is free to impose excessive interest rates or raise the borrower's monthly payment to an unreasonable level, which would likely lead the borrower into default and inevitably foreclosure.[175] It is essential that this part of the statute become more comprehensive, so the Act should be reformed to mandate that any requirements imposed during the initial years of the residential mortgage be enforced throughout the entire term of the loan. This alteration would properly and meaningfully expand the accountability of the lender to the full length of the loan period.

Correspondingly, the Act is not ideal for lenders either. The Act imposes an undue burden on lenders because in addition to their existing responsibilities and obligations, they must now worry about exceptionally precise and minute procedures, covering activities from communications with borrowers to general business practices, etc.[176] This overstepping of regulatory boundaries impairs both lender and borrower freedom of choice, confuses consumer protection with consumer control, and fosters an unhealthy dependence on government intervention, which impairs the positive effects of the free market on the economy. In total, bare minimum compliance with the Dodd-Frank Act could cost financial institutions about $50 billion annually, or 12 percent of overall operating expenses.[177] Plus, this incredibly sizable amount of money does not include the litigation fees that lenders will undoubtedly incur in connection with the borrower right to sue under the "ability to repay" requirement.[178] Even if a lender prevails in court through a finding of due diligence in pursuing a good faith verification that the borrower had a reasonable "ability to repay," the lender will be left to pay the litigation costs suffered through defense.[179] Rather than being able to offer residential mortgages to the largest amount of qualified consumers, lenders will be too busy spending their limited funds on trainings for upper level management and employees to comply with the new regulations.[180] To combat these severe compliance costs, the CFPB should conduct an extensive review of the existing rules in light of their cost versus their benefit to eliminate any provision with a price that outweighs its worth. This will prevent unnecessary compliance measures that do not provide substantial value.

Further, the Act is over inclusive, unnecessarily restricting certain financing options across the board that a lender could previously choose to offer, such as balloon payments.[181] The formerly accepted various financing options were designed to fit the needs of a myriad of borrowers.[182] Of course, some borrowers cannot handle the risk or responsibility that comes with a mortgage loan with a balloon payment. However, some borrowers can. Balloon payments and other irregular residential mortgage plans should be approved on a limited basis as "qualified mortgages" if they satisfy the remainder of the obligations and as long as the specific borrower in question has a reasonable "ability to repay" the irregular mortgage structure. On the other hand, the Act is also under inclusive, in the sense that it will allow some non-creditworthy borrowers to slip through the cracks to approval, if they merely satisfy arbitrary requirements, such as the 43 percent maximum debt to income ratio.[183]

History, time, and statistics have demonstrated that a maximum debt to income ratio is not the best predictor of loan repayment performance.[184] It is an inefficient tool to use in distinguishing whether a borrower is creditworthy.[185] One of the main reasons this is true is because "income" is difficult to analyze. For example, a young adult with a residential mortgage, a trust fund, and zero income would fail the "qualified mortgage" test, along with a retiree with a residential mortgage, a large bank account of life savings, and zero income. These applicant borrowers would be excluded from the benefits and protection of having a mortgage deemed "qualified," even though they may be quite creditworthy.

Instead of the current maximum debt to income ratio, the misguided, but extremely necessary "qualified mortgage" standard should require creditor lenders to focus on loan to value ratio and/or credit score, along with applicant income, economic climate, etc. Imposing a maximum loan to value ratio and/or a minimum credit score would vastly increase the efficiency of the Act, and it would better predict the likelihood that the consumer borrower has reasonable "ability to pay" and would fulfill the obligations under the residential loan. However, neither criterion could be looked at in a vacuum. They each must be considered in relation to each other and any other pertinent application information.

In order to obtain an official credit score, a consumer must have borrowed money in the past. If a particular consumer has never gone into debt because he has always had enough wealth to pay for items in cash, this should not make the consumer less creditworthy or undeserving of the protections associated with a "qualified mortgage." To remedy this potentially unclear characteristic, the loan to value ratio and the credit score of the applicant borrower should be evaluated on a sliding scale. If an applicant is willing to offer a large down payment, for example 70 percent, has verified stable income or funds to repay, but has no credit history or credit score, it should be apparent that this borrower is still creditworthy. Likewise, if an applicant has an outstanding credit score, has verified stable income or funds to repay, but can only offer a 12 percent down payment, this borrower is likely still creditworthy as well. Although a firm tightening up of the loan underwriting process is arguably warranted, imposing arbitrary rigid regulations, without regard to the applicant's criteria as a whole is unjustified.

As it stands, there are significant problems and inconsistencies inherent in the Mortgage Reform and Anti-Predatory Lending Act. Nonetheless, it is a step in the right direction because unfortunately, it is not economically possible for everyone who desires to own a home to do so. To fully recover from the predatory lending practices, system-wide fraud, and loose residential mortgage underwriting that led up to the Global Financial Crisis, these recommendations should be implemented into the Act, which would benefit both lenders and borrowers ultimately.

V. Conclusion and Recommendations

For all of these reasons, the current CFPB "qualified mortgage" standards under the Mortgage Reform and Anti-Predatory Lending Act, as a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, are inadequate to effectively satisfy the intended purpose or underlying objectives of the regulation. For the Act to accomplish its desired goals, substantial reforms must be adopted. First, the CFPB should amend the Act to require that all "qualified mortgage" beneficial borrower protection provisions required for the initial years of the residential mortgage loan be applicable to all years of the loan term, not merely the first five years. This obligation would protect consumers in general, by precluding lenders from raising the interest rate or the monthly payment on mortgages to unsustainable levels that the consumer borrowers cannot afford. Similarly, this requirement would help to reduce the number of defaults and foreclosures because of inability to repay, and it would rightfully hold residential lenders accountable for the credit that they extend to consumers.

Moreover, the CFPB should conduct an exhaustive review of the existing "qualified mortgage" standards in regards to analyzing their cost versus their benefit. This will eliminate unnecessary compliance measures that do not provide substantial value. As the Dodd-Frank Act currently stands, even bare minimum compliance would impose an undue burden on lenders through the exceptionally meticulous procedures. In litigation costs alone, residential mortgage lenders will incur significant expenses defending suits associated with alleged "ability to repay" violations, even if the lender complied with making the requisite good faith verification. These costs will likely be passed on to the consumer in the form of additional fees. To ease the heavy burden of these compliance costs, the CFPB should reevaluate the new standards in relation to their realized benefits.

In addition, irregular mortgage structures should not be completely excluded from the realm of "qualified mortgages" in all circumstances. These irregular loan repayment schedules should be available as "qualified mortgages" on a very limited basis, but only if all other "ability to repay" requirements are met. Many consumers cannot maintain the discipline and postponed responsibility that often comes with a mortgage with a large balloon payment at the end of the loan term, but some consumers can. The existing "qualified mortgage" standards under the Act will inhibit the positive effects of the free market on the financial system and will impair lender and borrower freedom of choice in extending and obtaining residential mortgages. This dangerously confuses consumer control with consumer protection. The Act is both overinclusive and underinclusive because it not only unnecessarily restricts certain mortgage financing options categorically but also can improperly approve particular noncreditworthy borrowers if they satisfy arbitrary requirements.

Lastly, rather than requiring a maximum debt to income ratio, it should be mandatory for lenders to evaluate the creditworthiness of applicant consumers through the analysis of a maximum loan to value ratio and a minimum credit score, on a sliding scale of importance. This would decrease the chance that the borrower would default on the mortgage. Loan to value ratio and consumer credit rating have been proven to be significantly better indicators of future loan repayment performance by history and statistics. Focusing on loan to value ratio and credit score and factoring in these numbers along with income, market conditions, etc., will drastically improve the efficiency of the Act in approving creditworthy applicants and denying noncreditworthy applicants.

In conclusion, the CFPB has already made meaningful strides towards demanding that lenders comply with strict residential loan underwriting criteria, but there is still much room for reform and improvement. Consumer protection in general requires protection that is tailored to meet the needs of a variety of differently situated consumers. Currently, the Mortgage Reform and Anti-Predatory Lending Act is both overinclusive in some ways and underinclusive in others. By applying the reforms, improvements, and recommendations suggested herein, the Act will become more efficient and more effective.

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