International Journal of Social Science and Economic Research

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

DODD-FRANK AND ITS IMPACTS ON MORTGAGE LENDING

Sali Bakare

University of the People, Business Administration Division

ABSTRACT

The financial crisis of 2008 was caused partly by reckless lending practices. Lenders strayed from traditional underwriting standards in order to meet mortgages demand from consumers with sub-prime credit because Wall Street firms were paying high fees and premiums on no income documentation loans. The damage that resulted from these reckless underwriting practices in the mortgage industry has been a catastrophe on the US economy. If the housing market is made productive again, the US economy will come back to normal. This spurs the Obama administration to implement Dodd-Frank Act in 2010.

Keywords: Dodd-Frank, Reckless lending, Financial crisis, Lax underwriting

INTRODUCTION

The 2008 financial crisis was brought about by unscrupulous underwriting practices, which almost damaged global financial system. During the 2008 financial crisis, losses experienced by many large financial institutions because they held portfolios of troubled assets threatened their sustainability (Bailey, Klein, & Schardin, 2017). Millions of Americans lost their homes to the financial crisis. Brokers who originated mortgage loans with high interest rates earn higher fees; which is an inducement to continue making risky loans. In 2004, No-doc loan accounted for 52% of Alt-A loans (loans that fall between prime and sub-prime loans); by 2006, this type of loan has risen to 78%. By 2009, sub-prime mortgages have delinquency rates of 48%. There are uncertainties in the rules governing housing finance.

There was panic in the market that several other institutions might hold portfolios of the troubled assets and that their viability was at stake. Because of the inter-connections among financial institutions, the failure of one institution caused the failure of others. Due to the panic, the inter-bank funding market shut down, putting the U.S. financial system in jeopardy. That problem spread quickly globally. The global financial system almost collapsed in 2008.

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

In 2010, the Obama administration (in the US) implemented Dodd-Frank Act to correct the damages caused by the reckless underwriting practices in the mortgage industry; which created a catastrophe on the US and global economy. It was this situation that gave rise to a widespread call for changes in the regulatory system. In 2010, Congress passed the Dodd-Frank Act, which increased the federal government's role in the markets. The U.S. policymakers were then faced with an option of bailing out the failing financial institutions or leaving them to fail.

There was need for a formal procedure to deal with the failure of important financial institutions. The government launched a committee to evaluate systemic risk, executive compensation, and restrict U.S. banks from making certain kinds of investments. Banks have to maintain a minimum level of unsecured long-term debt that can be converted to equity in case of failure. Dodd-Frank helped to facilitate mortgage terms and paperwork for consumers and stopped high commissions for loans with high fees and or high interest rates. However; Dodd-Frank critics argued that the Act created slow-downs in lending, which prevented some consumers from getting personal and small business loans. The critics also argued that the legislation created a lack of liquidity in the market, which in turn resulted in the U.S. businesses losing ground to foreign competition.

Dodd-Frank Act

Dodd-Frank Wall Street reform and consumer protection Act is a financial reform legislation passed by the Obama administration in 2010 as a response to the 2008 financial crisis to reduce various risks in the financial system. It is the most extensive financial regulatory bill since the 1930s as it released about 400 rulemakings in the financial sector (Nobert & Furth, 2017)). It was named after Senator Dodd and US Representative, Barney Frank.

Some new government agencies were established to oversee various components of the financial system. One agency, the Financial Stability Oversight Council (FSOC) with the Orderly Liquidation Authority (OLA) provision, monitors companies whose failure could have a major negative impact on the economy, for financial stability. This agency has the authority to break up banks that are considered too large and pose a systematic risk. The agency could force the banks to increase their reserve requirements. The Consumer Protection Bureau is to ensure that mortgage lenders make consumers understand the terms of a mortgage before finalizing the paperwork and not charge high closing costs or interest rate. The Volker rule restricts banks on how they invest and do speculative trading.

Dodd-Frank required greater disclosure to enhance transparency in the markets. It established the *SEC* Office of Credit Ratings, because credit rating agencies were accused of giving misleadingly favorable ratings that contributed to the financial crisis. Dodd-Frank attempted to

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

find long-term solutions to pre-crisis problems by instituting higher prudential standards (based on global Basel III capital standards) including higher capital requirements for all bank holding companies with more than $50 billion in assets. Unite State regulators in some cases mandated standards that go beyond Basel III such as bank stress-testing (Tracy, 2018); while global regulators agreed on a minimum level of unsecured long-term debt that can be converted to equity in case of failure.

Volcker Rule

Volcker Rule is section 619 of Dodd-Frank Act. Volcker Rule was proposed by the American economist and former Federal Reserve Bank Chairman, Paul Volcker, to prohibit US banks from making certain kinds of speculative investments that do not benefit bank customers. Mr. Volcker noted that, some speculative activities played a key role in the 2007-2008 financial crises. The Rule was scheduled to be implemented as part of Dodd-Frank Act on July 21, 2010; but because some community banks filed a law suit against the Rule's provisions, it did not come into effect until July 21, 2015.

Regulation Z

Regulation Z was prepared by the *Board of Governors of the Federal Reserve System.* It was designed to promote the informed use of consumer credit by requiring disclosures about its terms and cost. It is otherwise known as The Truth in Lending Act (TILA). TILA includes substantive protections for consumers. For example, the act and regulation give consumers the right to cancel certain credit transactions that involve a lien on their principal dwelling. Regulation Z also prohibits specific acts and practices in connection with an extension of credit secured by a consumer's dwelling. It also prohibits unfair compensation to loan originators.

Consumer Financial Protection Bureau (CFPB)

Consumer Financial Protection Bureau was created under Dodd-Frank to work with bank and non-bank lenders, industry participants, consumer groups, and policymakers in order to regulate consumer banking products such as credit cards, payday loans, and mortgage rules in an attempt to stop oppressive lending practices. The major cause of the 2008 financial crisis was the dishonest and unfair mortgage lending practices among non-bank mortgage providers. There were a lot of fragmented oversights among regulatory agencies which led to weaknesses in supervision due to the gap between the regulatory and supervision agencies (Financial Crisis Inquiry Commission 2011, 22, as cited by Bailey, Klein, & Schardin, 2017). The CFPB removed misleading financial products from the marketplace and monitors mortgage lending and money

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

transfers. The bureau has provided enhanced protection for consumers, which resulted in greater financial stability.

Derivatives

Derivatives are a useful tool for managing risk. Derivatives are used to transfer risk from those who are afraid of it to those who are willing to assume it but did not understand it. An example of derivatives is when the airlines lock in the price of fuel oil by buying financial instruments. About 95% of derivatives were either interest rate or foreign exchange, which performed well during the crisis. Before the crisis, derivatives were complex to understand due to lack of transparency. Title VII of Dodd-Frank requires that most derivatives be traded on open exchanges and centrally cleared.

Criticism of Dodd-Frank

Proponents of Dodd-Frank believe the act will prevent the US economy from experiencing another financial crisis. The critics of the Act on the other hand believe that if financial institutions are restricted from taking risks, their profit-making ability and competitiveness to foreign financial institutions are also restricted. With restrictions, there will be high unemployment, low wages, and low standard of living, which will eventually lead to low economic growth.

Critics of Dodd-Frank also claim that the Act is too burdensome for small banks because it unnecessarily increases compliance costs, reduces lending and non-interest fee income. Because of regulation, small business lending is negatively affected (Bettencourt, 2014); which in turn resulted in high unemployment and slow business activities. Dodd–Frank did little to address the root causes of the crisis and simply expanded the federal safety net for financial institutions. According to Michel and Furth (2017), one macroeconomic model predicts that removing a 22-basis-point investment wedge associated with Dodd–Frank would increase income by 1% and generate $340B in revenue.

IMPACTS OF DODD-FRANK ON BANKS AND THEIR CUSTOMERS

Positive Impacts

Dodd Frank requires all banks to have a shutdown process in place in case if the institution becomes insolvent; this way, taxpayers will not have to bail out financial institutions. There is a limit to fees that banks can charge on loans. Increased capital requirements for financial institutions resulted in increased safety (Bailey, Klein, & Schardin, 2017). Higher capital

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

requirements imposed on financial institutions increased their ability to withstand or recover quickly from financial stress events and crises. Dodd-Frank Act increased transparency of major financial transactions. Dodd-Frank improved protections for consumers. The Act helped to facilitate mortgage terms and paperwork for consumers and eliminated high commissions for loans (in fees and interest rates).

Dodd-Frank instituted a new failure-resolution procedure that helps to reduce the risk of losses resulting from bad management decisions that could cause a financial collapse. The Federal Deposit Insurance Corporation (FDIC) established standard procedures to safely wind down failed institutions. Regulators and investment managers now pay more attention to risk. Title II of the Act outlines a plan to resolve large institutions under FDIC direction; while Title I requires that all systematically important financial institutions (SIFIs) prepare resolution plans for how they could be resolved in the event of a business failure and submit the plan to Federal Reserve Bank and FDIC.

Before Title II, there was a lack of procedure for resolving SIFIs, which caused a major instability during the crisis. Although the Basel Committee on Banking Supervision issued guidelines on how to resolve multinational banks, Title II of Dodd-Frank Act provided an Orderly Liquidation Authority (OLA) for the FDIC to resolve SIFIs in order to protect the operations of domestic subsidiaries. The single point of entry (SPOE) facilitated the issue of resolving a global bank with foreign subsidiaries. The (SPOE) can resolve and recapitalize large insolvent financial institutions effectively without requiring taxpayer funds as Dodd-Frank expressly prohibits taxpayer losses from the use of Title II authority. Since its announcement, SPOE has gained acceptance as a viable strategy for resolving SIFIs. Though it is not perfect, SPOE is a progress towards a safer financial system.

Negative Impact

Many Wall-Street investors feel that Dodd-Frank hurts economic growth because of the overly strict new rules. FDIC is required to seek and obtain a joint resolution from Congress before providing temporary liquidity guarantees to financial institutions on certain kinds of debt. These requirements may reduce financial stability during periods of stress, which may negatively affect economic growth. Higher capital requirements resulted in financial activities been moved out of banks into the non-bank sectors. The Volcker Rule prohibits commercial banks from engaging in proprietary trading; and the Lincoln Amendment prohibits firms that engage in swaps from receiving federal assistance. Critics argued that Volcker Rule is complex, ambiguous, and expensive; which makes it difficult for banks to adhere to its requirements and for regulators to

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

implement and oversee it. Some critics also argued that Lincoln Amendment is redundant as its main goals can be achieved by Volcker Rule.

Although increased capital requirements and strict regulation and supervision have created a safer financial industry, bankers believe that Dodd-Frank Act inhibited lending to some households and businesses. Bankers also believe that regulators and supervisors have taken over their (bankers') jobs. According to Bailey & Klein (2014), most legislations are followed by amendments; but Dodd-frank is not, because of political chaos. Dodd-Frank eliminated the regulatory tools that were used successfully during the financial crisis. The FDIC's ability to provide debt assurance to depository institutions is subject to support of the Congress; which may be a problem if time is a constraint. Waiting for Congress before issuing guarantee to depository institutions could cause unnecessary and potentially costly delay as destabilization can begin and spread quickly; which may threaten the financial system.

The financial stability oversight council (FSOC) lacked transparency in both public and private proceedings. Some of the mandates are in conflict; limiting their ability to "ring the alarm bell" for future crises. Financial institutions were able to adhere to the new capital requirements by accepting a small return on assets, cutting their net interest margins, and reducing their operating costs

The Glass-Steagall (!932), which repealed the key sections of the Banking Act, contributed significantly to the financial crisis (Bailey, Klein, & Schardin, 2017). Prohibiting the Federal Reserve from making emergency loans to single institutions could worsen moral hazard. Requiring that Fed be transparent in its actions may be harmful, although there are situations where the Federal Reserve should be more transparent.

Impact on Mortgage Lending

Dodd-Frank Act introduced some changes to the mortgage lending practices. The two most important changes that Dodd-Frank Act introduced are the ability to repay and the standards to qualified mortgage (QM) as they form the foundation of mortgage lending. Under the first alternative, the creditor does not have to verify the borrower's employment status, credit history, or debt-income ratio. The second alternative requires that lenders follow Dodd Act rules and the ability to repay standards, which provides little incentive and little legal certainty for lenders.

Some opponents of Dodd-Frank Act believe that the Act is too complex. Lenders argue that the QM requirements are complex and may prevent potential borrowers in rural areas and low income earners from accessing needed loans. Although consumers deserve to be protected,

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

hastily drafted legislation would tend to hurt those it was intended to protect and perhaps drive some lenders out of the mortgage market.

Some Texas banks have stopped making mortgage loans because of the new compliance requirements. Lending in some small bank declined; which means a decline in loans to small businesses. And small businesses are crucial contributors to economic growth. On the other hand, the big banks' market share rose from 43% in 2006 to 56% in 2011.Although Dodd-Frank has addressed most of the major problems that caused the mortgage crisis, the Act must be balanced so that it will not harm the borrowers that it is supposed to protect and at the same time, create a strong legal safe harbor for lenders.

Regulation Z is confusing regarding loan originators' compensation. A lot of banks had to increase their fees to account for litigation risk, which may arise from the qualified mortgage loans rule (43% debt-income ratio). Customers may interpret qualified mortgage loans to mean discriminatory lending; and therefore, file a suit against lenders. And litigation may wipe out many years of mortgage-related profits. While it is crucial to avoid lax underwriting, care should be taken not to over-regulate the lending marketplace so as to make affordable credit available for middle and low income earners.

Debt-to-Income Rule

Loan performance and the ability to repay do not change at 43%; so why the debt-to-income (DTI) of 43%? If the borrower's DTI is 43% or less, the loan is QM and no further test is required. If not, the borrower's mortgage must be 31% or less of monthly income. Borrower must have liquid financial reserve available to meet mortgage-related obligations. Borrower's residual income must be above the threshold established by the CFPB. The interest rate cannot be adjusted more than once a year. The loan term must not be over 30years. Payment cannot be interest payment only.

Dodd-Frank reduces investor buy-back claims and borrower litigation. Reduced exposure to buy-back claims is a huge benefit to lenders and should not be under-estimated. If Title XIV of Dodd-Frank Act was in place in 2006-7, there might not have been the crisis. If mortgage lending is not regulated, it will disrupt the economic well-being of the Americans.

Facts & Solutions

Until private capital is returned to the lending market, federal housing administration (FHA) and government-sponsored enterprise (GSE) (Fannie Mae and Freddie Mac) will continue to dominate the market. Provisions in Dodd Act may lead to less competition in the lending

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

marketplace, reduced loan access to potential borrowers, and expensive loans. Some Texas banks opt out of making mortgage loans because of the new strict compliance requirements (The impact of Dodd-Frank, 2013). This is a problem because families depend on their local banks for loans. Therefore, the authorities need to balance between consumer protection and consumer access to credit.

Loan originators must retain an economic interest in the credit risk transferred to investors through mortgage backed security. Residential QM is exempted from securitization. This provision will make mortgage more expensive. Regulators implement rules and regulations with no regard to Congressional intent because regulators are in a hurry to impose restrictive guidelines on originators and consumers (The impact of Dodd-Frank, 2013).

Quality mortgage loan rule of 43% DTI may create problem for lenders. Customers may take qualified mortgage loans as discriminatory lending; and therefore file a suit against the lenders. Litigation may be very expensive. Two alternatives exist under QM standards. The first one is the legal safety harbor, which protects the originator against legal suits. Suits can be filed only if the originator did not comply with the QM standards. The second one is the rebuttable presumption of compliance, which means evidence could be provided that originator introduced standards beyond that which is in the QM standards. Quality mortgage must therefore be broadly defined to create a strong legal safe harbor for lenders.

The fee limit introduced by the Home Ownership and Equity Protection Act (HOEPA) gives incentive to creditors to inflate loan amount and the fees. Compensation from selling a home should not be included in the points and fees cap. The outlined limit (3% cap) will make it difficult for lenders to recoup costs associated with issuing small loans. If originator compensation, title fee, escrow, etc. are included in the 3% cap on points and fees, borrowers will have difficulty in finding lenders willing to issue loans less that $250000. This is because an originator will make 3% on a $50000 loan and a $500000 loan. Three percent on $50000 is $1500 and $15000 on $500000. Lenders will not want to issue small loans. Therefore, there is need to regulate small and big banks differently.

Debt-to-income (DTI) rate alone cannot be used to predict delinquency rate. It is unclear if sellers of manufactured homes are classified under the systems to avoid fraud effectively (SAFE) Act regarding registration and licensing. Also, there is no secondary market for manufactured home loans (The impact of Dodd, 2013). Manufacturing homes industry is a crucial source of affordable homes; it provided over 51000 housing in 2011 for low income earners (The impact of Dodd, 2013). These elements need to be clarified so lenders would know how to comply.

CONCLUSION

Because of the reckless lending practices that led to the financial crisis of 2008, Dodd-Frank Act put a lot of tight rules on underwriting. The too strict restrictions in the Act may limit credit availability to some credit-worthy borrowers. Tight requirements make credit availability harder for low income earners. Between 10% and 20% of potential home buyers are currently locked out of the mortgage market (The impact of Dodd, 2013). Dodd-Frank may negatively change the landscape of homeownership due to its strict restrictions. Some small lenders in the rural areas have stopped issuing mortgage loans (The impact of Dodd, 2013).

A narrow QM rule limited loan availability. Quality mortgage must be broadly defined to create a strong legal safe harbor for lenders and not lock potential home buyers out of the mortgage market. The strict restrictions may cause more lenders to opt out of the mortgage loan business, some may charge high interest rates, and some may set stricter standards. Although Dodd-Frank has addressed most of the key problems that caused the mortgage crisis, the Act must be adjusted so that it will not inadvertently harm borrowers and should at the same time, create a strong legal safe mortgage lending environment for lenders. If mortgage lending is not regulated, it will disrupt the economic well-being of the Americans.

REFERENCES

1. Bailey MN, Klein AD, Schardin J. The Impact of the Dodd-Frank Act on financial stability and economic growth. The Russell Sage Foundation Journal of the Social Sciences. 2017; *3*(1), 20–47.

2. Bettencourt BD. The Dodd-Frank Act and its impact on agricultural lending. 2014; Retrieved from https://repository.asu.edu

3. Financial Crisis Inquiry Commission 2011, Retrieved from https://fcic.law.stanford.edu/report

4. Gilmartin B. Dodd-Frank and its impact on big banks' revenue. 2016; Retrieved from https://seekingalpha.com

5. Jacobius A, Appell D, Bradford H, Barry B, Diamond B, Diamond R. Assessing the impact of Dodd-Frank 5 years later. 2015; Retrieved from www.pionline.com/article/20150727

6. Lux M, Greene R. Dodd-Frank is hurting community banks. 2016; Retrieved from https://www.nytimes.com/

ISSN: 2455-8834

Volume:03, Issue:12 "December 2018"

7. Michel N, Furth S. The Macroeconomic impact of Dodd Frank. 2017; Retrieved from https://www.heritage.org

8. The impact of Dodd-Frank's home mortgage reforms: Consumer and market perspectives. 2013; Retrieved from https://www.gpo.gov/fdsys/pkg/CHRG-112hhrg76115/html

9. Tracy R. Banks Failing Stress Tests? Not for Much Longer. 2018, June 26; Retrieved from https://www.wsj.com/articles/banks-failing-stress-tests-not-for-much-longer-1530005400?mod=searchresults&page=1&pos=2

