New Lending Rules Announced With Big Loopholes - Could Harm Self Employed and Taxpayers in General

January 10, 2013 - The CPFB has announced a series of new lending rules for home mortgages that are due to go into effect next year. The rules are the latest round of one-size-fits-all regulatory action that is supposedly being put in place to protect consumers and the economy. But as currently structured, they will actually put pressure on Fannie Mae and Freddie Mac to loosen their lending standards, are likely to hurt people who are self-employed, and could expose taxpayers to significant financial risk.

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The rules announced today are as a result of the Frank-Dodd financial reform bill passed by Congress. They are supposed to ensure that borrowers can actually pay back the money that they owe.

Now you might think that banks would have a vested interest in seeing to it that borrowers would repay them. But if you look at what happened in the financial crisis, banks were more concerned with lending than they were with repayment. There were a lot of reasons for this but one of the biggest was because any loan with a federal guarantee protected the banks from most losses. Ironically, the new rules are likely to make that problem even worse.
Here is a brief run down on what is in the rules:

- No more interest only loans

- No more no-doc or low-doc loans

- Lenders can no longer base loan affordability on initial or teaser repayment rates. They must now base this calculation on expected payments once the teaser rate expires.

- Qualified mortgages can't exceed 30 years to repay.

- Qualified mortgages can't have negative amortization or a large balloon payment on principle

- The borrower's debt to income ratio must be 43% or less

The new rules give lenders 8 factors that lenders must review before issuing a "qualified mortgage" - meaning that the loan meets the CPFB's lending standards. Lenders can continue to issue non-qualifying mortgages but they probably won't because under the new rules, borrowers can no longer sue lenders if the loan meets the standard for being "qualified". To be a qualified loan, the lender must look at current income and assets along with future projections for these items, current employment status, the monthly payment on the mortgage, monthly payments for items related to the mortgage (insurance payments, taxes, etcâ€¦), other debts, overall debt to income ratio and the borrower's credit history.

That may sound like a very comprehensive list of items but the CPFB is actually telling banks to look at these items and not to substitute other factors even if those other factors prove to me more reliable. This means that if the CPFB doesn't know as much about lending as the banks, they could be putting the entire lending system at risk.

Regardless of that, there is a huge loophole in the evaluation criteria. Only loans that have been evaluated on the 8 factors listed will be considered "qualified" with one exception. Any loan that meets Fannie Mae or Freddie Mac standards will automatically be considered qualified. This means that there is going to be a lot of pressure on both Fannie and Freddie to loosen their lending standards. If they do, lenders will follow their lead and taxpayers will be on the hook for any of these mortgages that go into default. At the same time, the banks involved will be completely insulated from any law suits as a result of their lending practices on these loans.

From the banks' perspective, the easiest thing they can do to protect themselves from a law suit is to run every loan application they get through Fannie Mae's Desktop Underwriting (known as DU) program. Any loan that is approved this way would appear to be protected from borrower law suits.

And finally, because of the approach taken by the CPFB to these regulations, anyone who is self-employed is going to find it much harder to qualify for a loan. The reason for this is that people who are self-employed have a lot more in the way of tax deductions. Because of this, even if they have very good cash flow and ample assets, their gross adjusted income could be very low. Using a 43% debt to income ratio with no exception for the borrowers' source of income, and no accommodation for their overall assets will make it much more difficult for them to borrow. And when they do get a loan, lenders are likely to lend them less and charge them more.

byJim Malmberg
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