The Effect of New Mortgage-Underwriting Rule on Community (Smaller) Banks' Mortgage Activity

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The Consumer Financial Protection Bureau (CFPB), government agency created through the Dodd Frank Act, enacted the Ability-to-Repay (ATR) and Qualified Mortgages (QM) rule in January 2014. Using a new survey on Community banks from 2014 and Home Mortgage Disclosure Act Data (HMDA) for the years 2011-2014, I look at the effect of the ATR/QM rule on mortgage origination. From the survey responses, we infer that community banks in the sample expected and increase in compliance costs, and a possible decrease in mortgage origination. However, analysis of the HMDA suggests that the ATR/QM rule has not disrupted community banks mortgage origination.

INTRODUCTION

In the aftermath of the financial crisis the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was signed into law. The new regulatory framework has as one of its main goals to tighten mortgage-underwriting standards and in theory prevent the lending practices that characterized the mid 2000s. A case in point, the Consumer Financial Protection Bureau (CFPB), government agency created through the Dodd Frank Act, has issued rules that aim to "protect consumers from irresponsible lending". One of the most significant reforms implemented by the CFPB: the Ability-to-Repay (ATR) and Qualified Mortgages (QM) rule (henceforth ATR/QM rule) went into effect in January 2014. One goal behind this new rule is to make sure that creditors issue loans where they have verified the ability to pay by the borrower. In fact, the new mortgage rule aims to reduce among other things the size of the low-doc loan market, which was a significant ingredient in the recent mortgage crisis. Several arguments were brought up against the implementation of the ATR/QM rule, both pointing out additional burden on community (small) banks, and credit rationing against certain borrowers (Marsh & Norman (2013)). Beyond the cost to banks, given the stringent requirement on income reporting, it is possible that the new rules could also ration credit against self-employed (Bassett & Driscoll (2015)).

Another important aspect of the new rule is further standardization of the products that could affect community and small banks business model based on relationship lending. The business model followed by community banks relies on repeat business within a limited population, which provides a strong economic disincentive to predatory lending and other practices that exploit consumers (Marsh & Norman (2013)). The ATR/QM would put community banks then at a disadvantage compared to other lenders in the market (larger banks) that already rely on standardized products and less on relationship lending. Furthermore, since some of the rules could make it more expensive for smaller/community banks to enter or stay in the market, "Dodd-Frank furthers the trend toward too big to fail because it will lead to greater asset concentration in a smaller number of financial institutions" (Marsh & Norman 2013). That is, one of the unintended consequences of the new rules, if onerous to smaller banks, is to reduce the market share of smaller institutions and subsequently increased the market share of large financial institutions, thus potentially increasing systemic risk.

It is important to emphasize that according to the FDIC the implementation of the rule entails some benefits for small banks vis-à-vis other creditors such as: (a) Small creditors have much broader "safe harbor" for QMs than other creditors (b) They are not required to meet a specific Debt To Income ratio (DTI) as long as the determination of the ATR is reasonable (c) Small banks may continue to write balloon loans with QM status. [1]

Using a new survey on Community banks from 2014 and Home Mortgage Disclosure Act Data (HMDA) for the years 2011-2014, I look at the potential effect of the ATR/QM rule on mortgage origination from community banks during the first year when the rule became effective. From the survey responses, we can infer that community banks in the sample expected and increase in compliance costs, and a possible decrease in mortgage origination. However, analysis of the HMDA suggests that the ATR/QM rule has not disrupted community banks mortgage origination.

BACKGROUND ON THE ABILITY-TO-REPAY (ATR) – QUALIFIED MORTGAGE (QM) RULE

According to Truth in Lending (Regulation Z) the Ability-to-Repay (ATR) establishes that "(A) creditor shall not make a loan that is a covered transaction unless the creditor makes a reasonable good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms." [2]

Creditors can comply with the ATR rule in two ways: (a) consider and verify eight underwriting criteria before extending a loan. The eighth criteria are: income or assets, employment status, monthly payment on the subject loans, monthly payment on any simultaneous loans, mortgage related obligations, current debts, credit history, monthly debt-to-income ratio. (b) Originate a qualified mortgage.

A Qualified Mortgage (QM) is a consumer credit transaction, secured by a residential structure containing one to four units (i) that calls for regular (fully amortizing) periodic payments; (ii) that has a loan term that does not exceed thirty years; (iii) in which the points and fees do not exceed a certain threshold (typically, three percent of the loan amount); (iv) that is underwritten using the maximum, fully amortizing payment based upon the maximum interest rate that can apply to the loan during the five-year period following consummation; (v) for which the creditor considers and verifies the consumer's current or reasonably expected income and assets as well as current debt obligations, in each case, using a highly-detailed new Appendix Q to Regulation Z; and (vi) for which the consumer's debt-to-income ratio does not exceed forty-three percent at consummation. By writing a Qualified Mortgage the creditor obtains presumption of compliance with ATR rule.[3]

DATA

We will rely on two sources of data The 2014 Community Banking in the 21st Century National Survey data and The Home Mortgage Disclosure Act (HMDA) for years 2011 through 2014.

Community Banking National Survey data

First we provide the relevant background on the Community Banking Nation Survey data. The Conference of State Bank Supervisors (CSBS) and state bank regulators conducted the national survey of community banks on a variety of topics. The survey data covered 884 community banks.[4] Although not a random sample the responses from the survey provide a representative overview of the community banks involved in real estate lending. Along the same lines the qualitative value of the survey can further motivate the analysis of the impact of the rules. The survey included several topics such as: line of business (entering and exiting), participation in the market for family mortgages, effects of new technology and new regulation, changes in competition and consolidation (acquiring a bank or becoming a target bank).

The Home Mortgage Disclosure Act (HMDA)

The Home Mortgage Disclosure Act (HMDA) was enacted by Congress in 1975 and was implemented by the Federal Reserve Board's Regulation C. Since 2011 Consumer Financial Protection Bureau (CFPB) holds rule-writing authority of regulation C. The HMDA provides public loan data that is used by regulators to, among other things, assess mortgage lending patterns and possible discriminatory lending practices by creditors.

For the empirical analysis, we rely on the Transmittal Sheet that aggregates information from each creditor. The Transmittal Sheet includes a series of fields identifying the lending institution: the reporting lender's name, the lender's HMDA and tax identification numbers, and the regulatory agency; it also contains the reporting lender's address and telephone number. The Transmittal Sheet also includes the number of loans each lender submits on the Loan Application Report (LAR) file and lender's parent total assets.

In order to determine the effect of the new rules on community smaller banks we rely on the criterion set by the FDIC to determine which banks are considered small in the sample. According to the FDIC a small creditor meets the following two criteria: (a) Asset Test Less than $2.0 billion in assets as of prior year’s end (adjusted annually for inflation and set at $2.028 billion for 2014). (b) Originations Test: Originates no more than 500 closed-end first-lien “covered transactions” a year, together with affiliates.

EMPIRICAL ANALYSIS AND RESULTS

Summary Statistics

The Community Banking National Survey collected information from 884 community banks. It included an important number of questions on the effect of ATR/QM rule. For example Figure 1 shows the response of com-munity banks to the question “Will you make non-Qualified Mortgage loans in 2014?” The distribution of the answers indicates than more than half of the respondents are “undecided” (29%) or will make Non QM loans on “an exception basis”. A potential explanation is the uncertainty in regards to the ATR/QM rule at the time of the survey. As for the change in the dollar value of mortgage loans in 2014, figure 2 shows that 28% of the respondents expect a decrease compare to the values in 2013. More than half of the banks in the survey have at least more than 30% of their portfolio in mortgage loans (figure 3).

The survey answers also provide a first pass on the expected effect of ATR/QM rule. For example, banks were asked what fraction of the mortgages in 2013 would not have qualified under the ATR rule. As Figure 4 shows about 62.9% of the respondents would have expected 21% to 30% of the mortgages not to qualify under the ATR rule. Only a small fraction of respondents (13.2%) would have expected a very small fraction of the mortgages not to qualify under the ATR. The respondents list “unaffordable debt to income (DTI) ratio” as the main reason why mortgage would not qualify un-der ATR (see table 1). Figure 5 shows that about half (49.8%) of the banks in the survey would have expected 21% to 30% of the mortgages originated in 2013 not to meet the QM criteria. Also in this case, the DTI ratio would have been the main issue (see table 2).

In terms of cost of compliance, 95% of banks in the sample (see figure 6) report to have experienced an increased in cost. Similarly community banks in the sample report the following as top 3 drivers of compliance cost: Increased personnel costs (37%), Increased time allocation (26%), Increased costs for 3rd party vendor services (23%) (see table 3).

To determine what the actual effect of the ATR/QM rule in 2014 we rely on the HMDA Transmittal Sheet files that aggregate information yearly from creditors for 2011 to 2014.[5] Figure 7 is a visual of the data, where we plot the main variable of interests Loan Applications reported (LAR) against Assets both in logarithmic scale. A simple linear regression suggests a positive correlation between Loans Applications reported and total Assets.

Since the ATR/QM rule was expected to be burdensome for community (small) banks we divide the sample into community banks and other banks, using the FDIC asset size threshold. Any bank with total assets less or equal to $2.028 billion (as of 2014) and less than 500 loan origination in the previous year are coded as a community (small) bank. Table 4 presents the summary statistics for the entire sample, community banks and other banks. The panel data includes 10,663 institutions of which the majority are community banks (10,202). As shown in table 4b, the average size of community banks is about $331 million, and the average community bank reports about 334 loan applications. Both the size of the other banks in the sample as well as the number of loan applications reported is much larger (see table 4c).

Analytical Methods

In this section we present an empirical model to assess the effect of ATR/QM on the number of loan applications reported (mortgages) by commercial banks vis-à-vis other banks. The main approach is akin to a Difference in difference estimation where the goal is to capture the "differential effect" of the legislation on community banks. The main equation is:

$$\begin{aligned} y_{it} = \beta_0 + \beta_1 \text{community bank indicator}_i + \beta_2 \text{dummy}_{2014} \\ + \beta_3 \text{community bank indicator}_i * \text{dummy}_{2014} + \phi_i + \delta_s + \epsilon_{it} \end{aligned} \quad (1)$$

Where y_{it} is the natural log of loan applications reported by bank i in year t; community bank indicator is set to one if the bank fulfills the size criteria set forth by the FDIC in determining if a bank is a small creditor (we use the asset cut off of $2.028 billion for 2014); dummy_{2014} is a dummy set equal to 1 if the mortgage is loan is reported in 2014. Since the rule came into effect in 2014, the coefficient of interest is β_3 which will capture the differential effect of the ATR/QM rule on loan applications reported by community banks vis-à-vis other banks in the sample during the year 2014. The model also includes a banks fixed effect ϕ_i and state fixed effect δ_s; and additional time dummies for the years 2011 and 2012. ε_{it} is the error term for bank i in year t.[6]

Results

Table 5 shows the results from estimating model 1. For robustness, three different estimators are presented, Pooling, Fixed effect and Random effect estimator.[7]

The results suggest that community banks tend to report on average less loan applications than other banks. This suggests that larger banks, those above the $2.028 billion asset threshold, tend to report more mortgage loan applications. This is consistent with the positive correlation between bank assets and loan applications. However, the coefficient of main interest, the interaction term between the community bank indicator and the 2014 dummy albeit positive is statistically insignificant across estimators. These results hold across the three different model specifications.

CONCLUSION

Using survey data on Community banks for 2014 and Home Mortgage Dis-closure Act Data (HMDA) for the years 2011-2014, I look at the potential effect of the Ability-to-Repay (ATR) and Qualified Mortgages (QM) rule on mortgage origination from community banks.

From the survey responses, we infer that community banks in the sample expected and increase in compliance costs, and a possible decrease in mortgage origination. However, analysis of the HMDA TS files suggests that the ATR/QM rule has not disrupted mortgage origination from community banks.

It is important to point out that 2014 is the first year of the ATR/QM rule; it is possible that the increasing burden on compliance (claimed by community banks in the survey) may have an effect in subsequent years.

ENDNOTES

1. For details see FDIC Directors' Resource Center at https://www.fdic.gov/regulations/resources/director/technical/atr.html
2. For details see the Federal Regulation 12 CFR 1026 at http://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title12/12cfr1026_main_02.tpl"
3. There are in fact two types of QMs: a "Safe Harbor" Presumption QM and a Rebut-table Presumption QM. The latter were available to creditors however the former, "Safe Harbor" Presumption QM, are part of the new rules. The two type QMs are identical in every respect except in the APR; "Safe Harbor" Presumption QM has a lower APR. For small creditors, this applies to QMs with APR 3.5% less than the APOR (average prime offer rate).
4. The survey collected answers from 1008 banks, but only 884 reported mortgage loans in their portfolio.
5. To avoid repeated observations in the same year we relied on the data from creditors that are supervised by the FDIC.
6. One of the few studies on this topic is Bhutta & Ringo (2015) who also look at the effect of the ATR/QM rule. They estimate a similar model using a HMDA-LAR report les and obtain similar findings.
7. The Hausman test yields a p-value of 2.2e-16, which suggests that the random estimator is superior.

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TABLE 1
PRIMARY REASON WHY MORTGAGE WOULD NOT HAVE QUALIFIED UNDER ATR?

	N	%
Unaffordable debt-to-income (DTI) ratio	262	29.64
Other	208	23.53
Inability to verify income or assets	181	20.48
Weak or non-existent credit history	112	12.67
Other borrower debts	46	5.2
Unaffordable monthly mortgage payment	27	3.05
Unaffordable property taxes and insurance5	24	2.71
Inability to verify employment status	15	1.7
Unaffordable payments on loans secured by the same property	9	1.02

Source: 2014 Community Banking National Survey data

TABLE 2
PRIMARY REASON WHY MORTGAGE WOULD NOT HAVE MET QUALIFIED MORTGAGE STANDARDS?

	N	%
Loan exceeded the debt-to-income ratio	360	40.72
Loan had a balloon payment within the rst 60 months	307	34.73
Other	141	15.95
Loan had interest-only payment features	28	3.17
Loan exceeded the limits on points and fees	23	2.6
Bank exceeded the small creditor originations threshold (less than 500 mortgages)	18	2.04
Loan terms exceeded 30 years	4	0.45
Bank exceeded the small creditor asset threshold	2	0.23
Loan had negative amortization features	1	0.11

Source: 2014 Community Banking National Survey data

TABLE 3
PRIMARY REASON FOR INCREASE IN COMPLIANCE COST

	N	%
Increased personnel costs	327	36.99
Increased time allocation	226	25.57
Increased costs for 3rd party vendor services	203	22.96
Loss of efficiency	40	4.52
Other	26	2.94
Loss of pro table business lines	7	0.79
Loss of customers due to increased paperwork and/or disclosure burdens	7	0.79
Loss of customers due to increased time between loan application and final loan approval	4	0.45

TABLE 4
SUMMARY STATISTICS OF HMDA (TS) 2011-2014

(a) All Banks

Statistic	N	Mean	St. Dev.	Min	Max
Assets ($ thousands)	10,663	580,645.600	6,459,669	10,000	467,000,000
Loan Applications	10,663	457.471	1,544.491	1	46,916

(b) Community Banks

Statistic	N	Mean	St. Dev.	Min	Max
Assets ($ thousands)	10,202	331,766	338,183	10,000	1,999,518
Loan Applications	10,202	334.221	978.052	1	25,320

(c) Other Banks

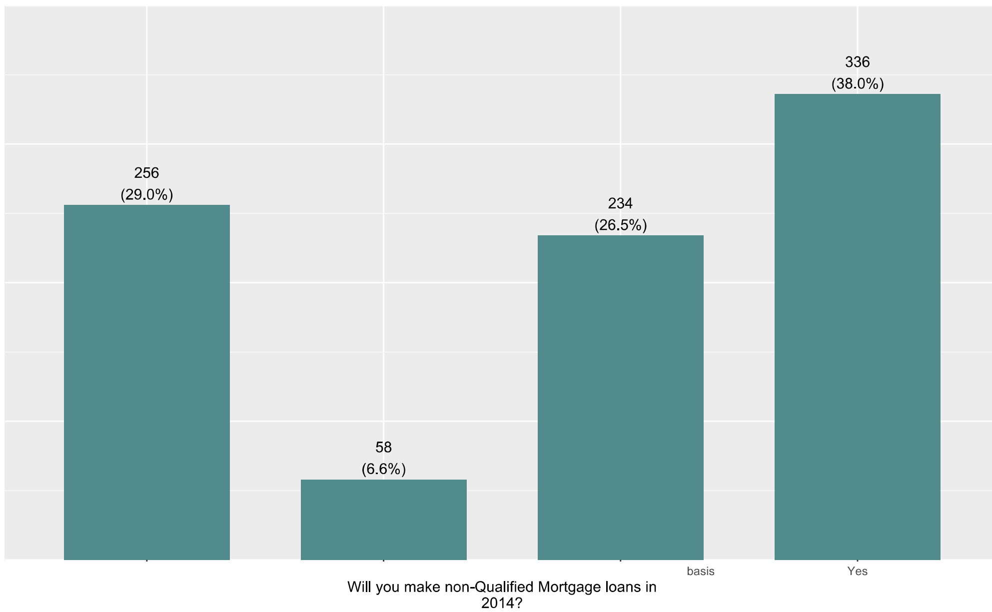
Statistic	N	Mean	St. Dev.	Min	Max
Assets ($ thousands)	461	6,088,388	30,542,688	2,001,416	467,000,000
Loan Applications	461	3,184.998	5,126.877	3	46,916

Source: HMDA TS files 2011-2014

TABLE 5
EFFECT OF ATR/QM RULE ON MORTGAGE ORIGINATIONS

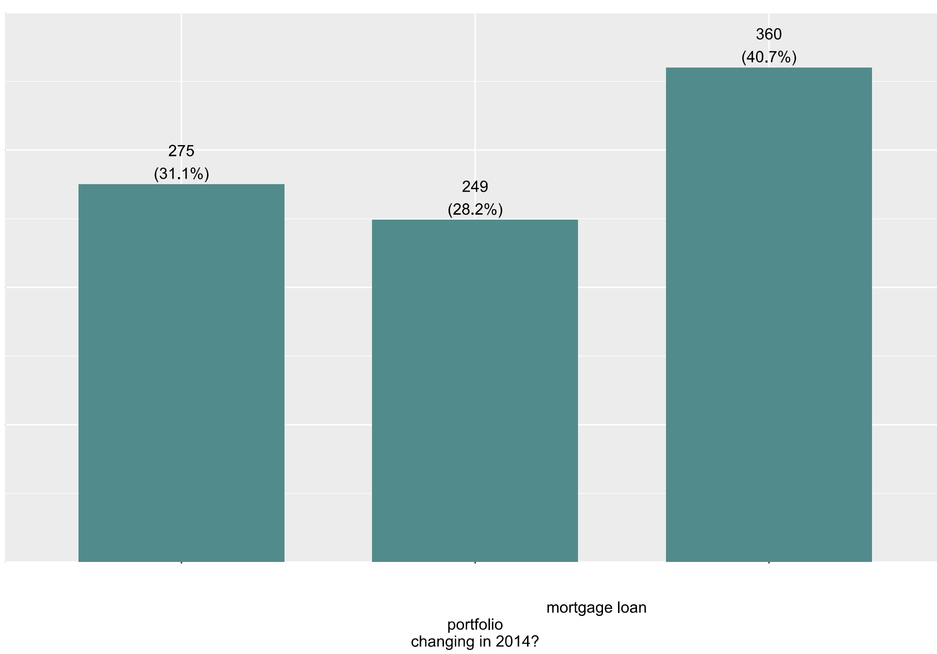
	Dependent variable:		
	Logarithm of LAR		
	Pooling (1)	Fixed effect (2)	Random effect (3)
Community bank indicator	-2.338***	-2.264***	-2.326***
	(0.081)	(0:093)	(0:081)
$dummy_{2014}$	-0.216	0.442	-0.206
	(0.151)	(1.576)	(0.151)
Community bank indicator*$dummy_{2014}$	0.072	0.054	0.065
	(0.153)	(0.177)	(0.152)
Observations	10,663	10,663	10,663
Adjusted R^2	0.241	0.139	0.235
Note:	*p<0.1; **p<0.05; ***p<0.01		

FIGURE 1
NON QUALIFIED MORTGAGES



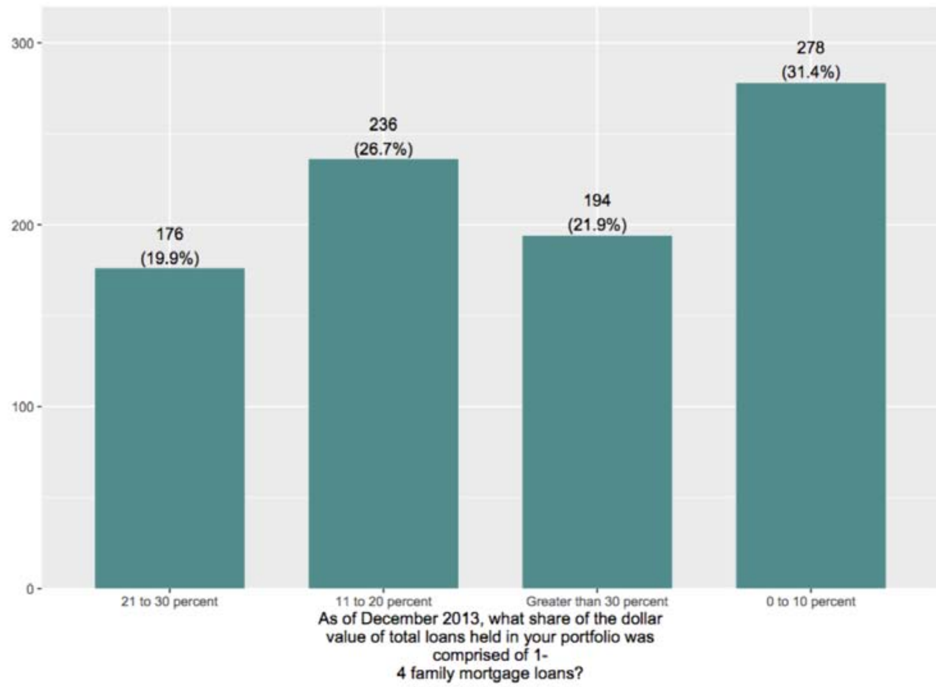
Source: 2014 Community Banking National Survey data

FIGURE 2
EXPECTED CHANGE IN MORTGAGES IN 2014



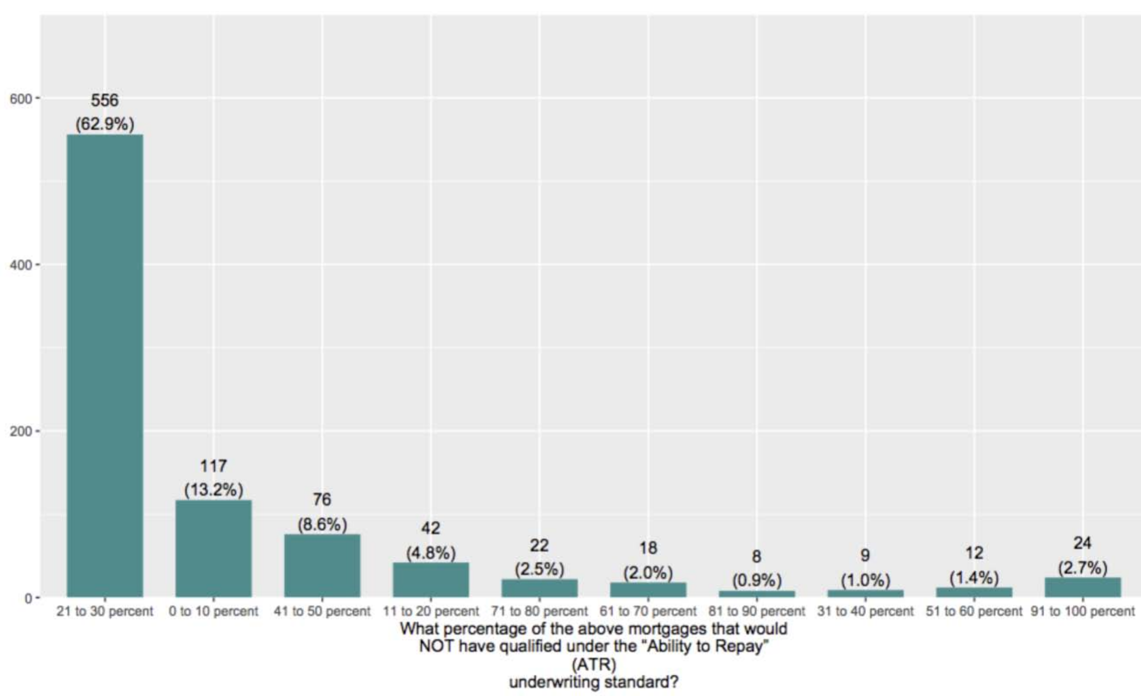
Source: 2014 Community Banking National Survey data

FIGURE 3
DOLLAR VALUE SHARE OF MORTGAGES IN 2013



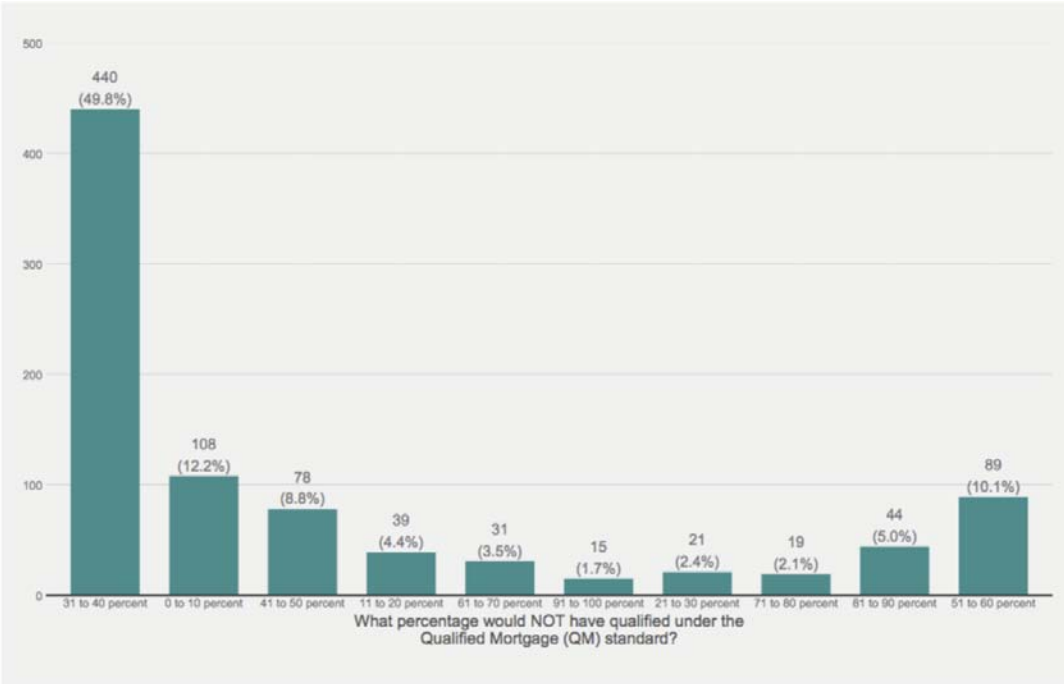
Source: 2014 Community Banking National Survey data

FIGURE 4
ESTIMATED SHARE OF NON ATR MORTGAGES IN 2013



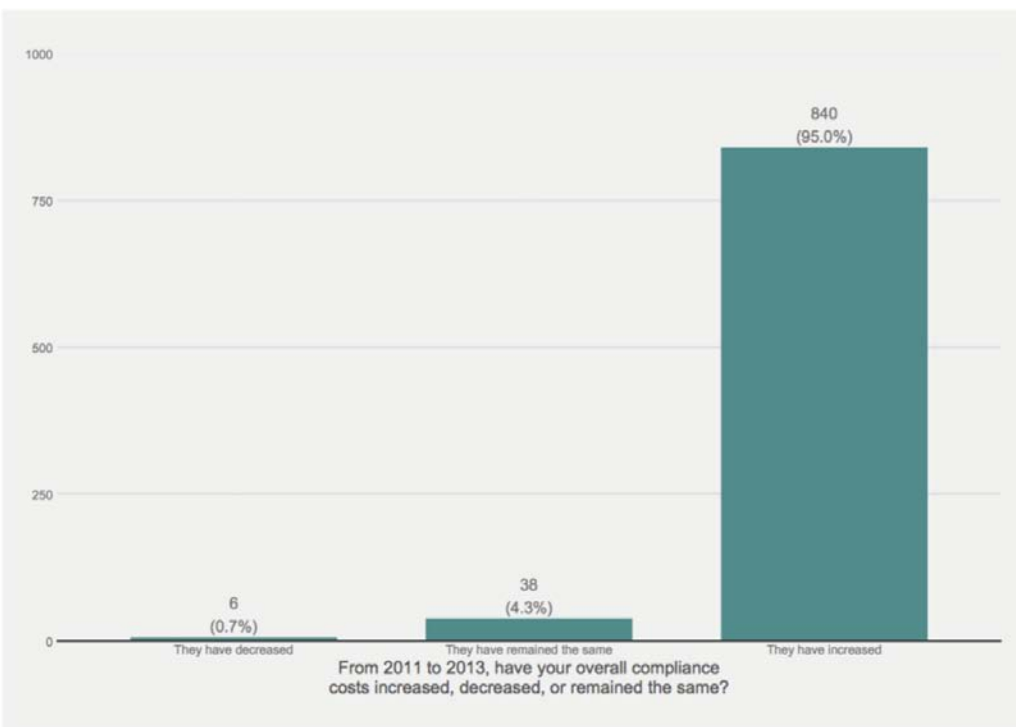
Source: 2014 Community Banking National Survey data

FIGURE 5
ESTIMATED SHARE OF NON QUALIFIED MORTGAGES (QM)



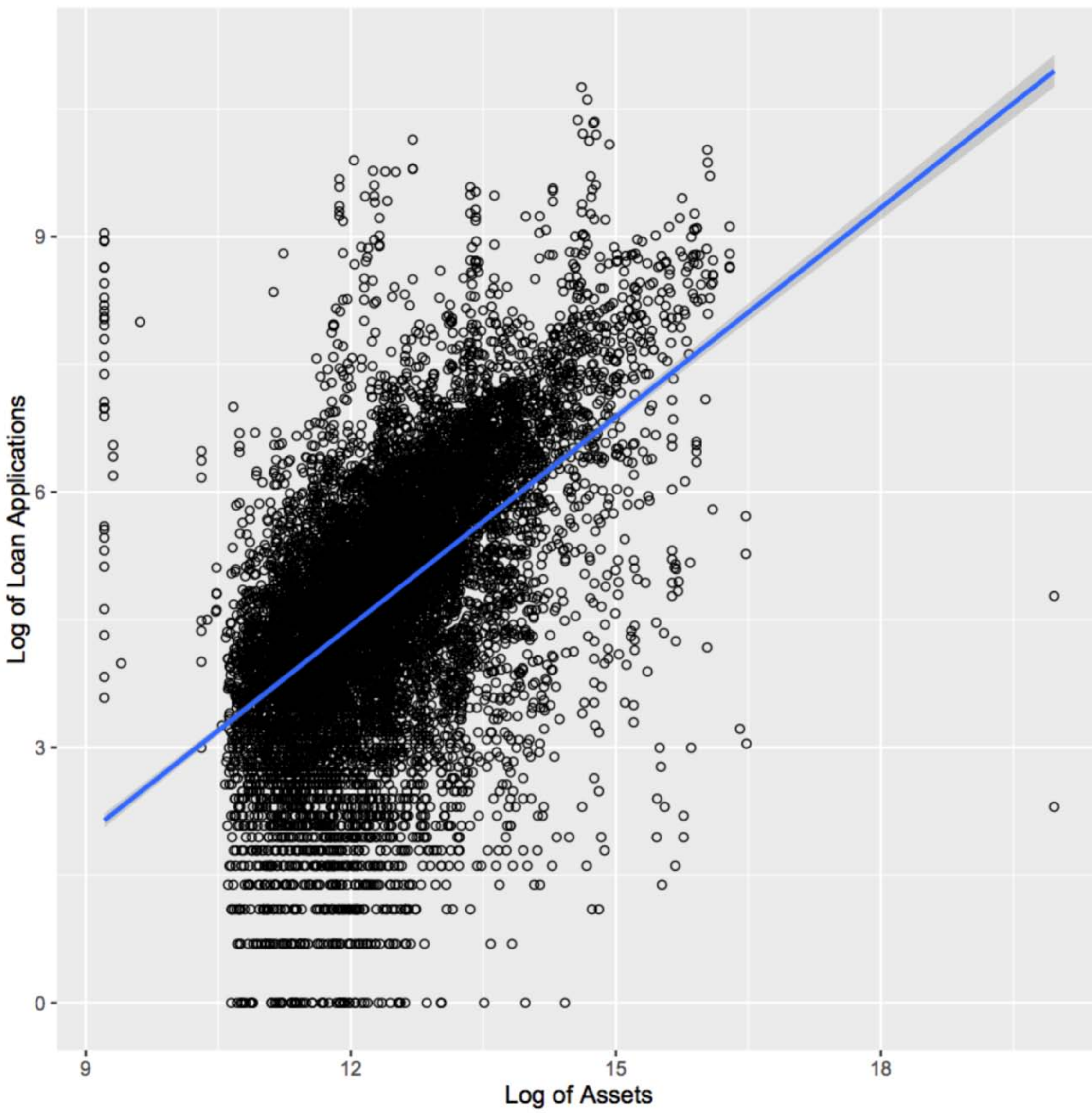
Source: 2014 Community Banking National Survey data

FIGURE 6
CHANGE IN OVERALL COMPLIANCE COST IN THE PAST 3 YEARS



Source: 2014 Community Banking National Survey data

FIGURE 7
BANKS IN THE SAMPLE (2011-2014)



Source: HMDA, TS files 2011-2014