

How Bank-Defeated 'Plan-Vanilla' Mortgage Requirements Live On

by [Joe Adler](#)

WASHINGTON — Before there was much talk about "qualified mortgages," "living wills" and the "Volcker Rule," the two words that perhaps scared bankers the most were "plain vanilla."

Industry advocates demanded those two words — which would have forced all lenders to offer customers a standardized, low-risk mortgage product — be removed from early legislative drafts of what became the Dodd-Frank Act, and it was hailed as an industry victory when the phrase was expunged.

But years later, the outcome of implementing "QM" and the related "qualified residential mortgage" standard — provisions that survived in the final law and incentivize banks to make standardized, low-risk loans — has forced a rethinking about whether "plain vanilla" died at all.

"Overwhelmingly the effect of QM and QRM is to anchor the financial system in a safer, fairer product, and that was the point of the plain-vanilla approach," said Michael Barr, a University of Michigan law professor.

Barr should know. After proposing the plain-vanilla idea in academic work with two co-authors, he helped champion it in the Obama administration's initial regulatory reform proposal as a senior Treasury Department official. The plan would have required lenders to offer a plain vanilla product — to be defined by regulators — "prominently" to allow borrowers to easily compare it with more complicated and potentially riskier products. But the idea appeared dead-on-arrival for the industry.

"People who were opposed to the Consumer Financial Protection Bureau were looking for different kinds of hooks or arguments against the bureau. One of the arguments was that it would go too far — that it would be too intrusive in the marketplace," Barr said. "Because I was really strongly pushing for the Consumer Financial Protection Bureau, and I had authored these papers about 'plain vanilla' and the importance of using behavioral economics as a regulatory tool, it became an easy target."

Yet as the bill evolved, other ideas emerged with a similar objective, he said. The proposed CFPB would require new procedures to verify borrowers' "ability to repay." But the agency would also define which ultrasafe loans would get the "QM" stamp of approval for legally safe compliance with the underwriting rules. Meanwhile, "QRM" would set a similar high bar to determine which securitized loans are exempt from new risk retention requirements.

"Others, in the Congress, and who were independent of my view, also had the idea of anchoring the system in a safer, fairer product," Barr said. "They didn't think about the problem in precisely the same way but they, together with Treasury, came up with an approach that had the same basic effect."

Observers said the potential of QM and QRM to focus lenders' attention on the safest products is reminiscent of the initial idea behind requiring "plain vanilla" products. An overwhelming view is that the regulatory and legal incentives for meeting QM and QRM are so appealing that they will dominate the mortgage market. That argument was bolstered when the CFPB's final rule sought to broaden the definition to cover more loans than had previously been discussed. (Regulators have proposed making QRM identical to QM in their plan to implement the law's risk retention provisions, but that plan is still pending.)

"Having a broad definition shuts out anything that is not a QM. There is not enough incentive to develop a robust non-QM market," said Edward Mills, policy analyst at FBR Capital Markets. "When you look at a QM, it's very plain vanilla. ... The vast majority are going to be 30-year fixed-rate mortgages and any of the innovation that had occurred in the past in the mortgage market is not going to be there as we standardize the product."

Others, particularly those who believe a non-QM market will emerge, are not so sure that the plain-vanilla idea survived through to Dodd-Frank's enactment. They say the distinction — that plain-vanilla products would have been required to offer as an option, whereas lenders can choose not to meet QM and QRM standards if they have an alternative approach — is significant.

"QM is actually quite different from plain vanilla. The concept behind plain vanilla was to require anyone who was offering a non-plain vanilla product to also offer a plain vanilla product to the borrower," said Adam Levitin, a Georgetown University law professor. "No one is required to offer a mortgage that is QM. The whole comparison baseline concept just isn't built into QM."

Raj Date, a former deputy director at the CFPB, who later founded a firm specializing in non-QM loans, said while the "plain-vanilla" approach is conceptually similar to those provisions that will soon be reality for the mortgage market, there are key differences.

"There is a product defined both by Congress and a regulatory agency for which there is a certain established incentive to offer that product. But there is a difference in purpose," said Date, managing partner of Fenway Summer.

For example, he said, "The purpose of the QRM and risk retention framework was to reintroduce the discipline of holding residual risk to discourage terrible underwriting. That is different from giving the consumer a chance to choose a product that is more prudent for them."

Date said if Dodd-Frank had ultimately required all lenders to offer such a standardized product, it could have proven a significant obstacle for a firm like his.

"I don't know that we're going to be especially competitive in offering a GSE-eligible 'qualified mortgage,' " he said. "That's a commodity product, and it's hard to make our cost of capital with a commodity product, competing against banks a million times our size. ... It just won't be a focus for us."

Barr, a former assistant Treasury secretary for financial institutions, said the plain-vanilla approach is not "identical" to the standards that remained in the law, particularly since lenders are not technically required to make QM or QRM loans. But, "conceptually," he said, they are "the same basic thing."

"We were open during the whole legislative process to try and reintroduce ideas and develop new compromise positions that would make the set of proposals that we had put forward as strong as we possibly could in the final legislation," he said. "We succeeded in a number of areas, and one of those areas is with plain-vanilla. We didn't go screaming around saying, 'Hey, we're sticking plain vanilla back in.' We were attentive to the way in which QM and QRM could anchor the market in a safer, fairer product, in the way that we had proposed under this earlier rubric. ... It was coming from some of the people who had opposed plain vanilla."