Testimony of Eric Stein
Senior Vice President, Center for Responsible Lending

Before the House of Representatives Committee on Financial Services
Subcommittee on Financial Institutions and Consumer Credit

The Impact of Dodd-Frank's Home Mortgage Reforms: Consumer Market Perspectives

July 11, 2012

Chairman Capito, Ranking Member Maloney, and Members of the Subcommittee, thank you for inviting me to testify at today's hearing.

I am Senior Vice President of the Center for Responsible Lending (CRL). CRL is affiliated with Self-Help, a nonprofit community development lender that creates ownership and economic opportunity, for which I also serve as Senior Vice President. Self-Help has provided $6 billion in financing to 70,000 homebuyers, small businesses and nonprofits and serves more than 80,000 mostly low-income families through 25 retail credit union branches. CRL is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. In between two periods of employment at CRL and Self-Help, I served as Deputy Assistant Secretary for Consumer Protection at the U.S. Department of the Treasury from 2009 to 2010.

The ongoing foreclosure crisis is dramatic in its reach and is a constant reminder of why we need the reforms in the Dodd-Frank Wall Street Reform and Consumer Protection Act, including regulatory reforms to better protect consumers from harmful financial practices and the mortgage market reforms in Title XIV. According to a CRL analysis, from early 2007 through the end of 2011, approximately 10.9 million homes had started the foreclosure process.[1] Millions more Americans are current on their mortgage but owe more than the home is worth as a result of decreased property values. While today's hearing is not focused on the foreclosure crisis itself, the reforms in Title XIV and the establishment of the Consumer Financial Protection Bureau (CFPB) are crucial to preventing future turmoil in the housing and financial markets similar to the experience of recent years.

In addition to providing further context to the mortgage market improvements made in Dodd-Frank, my testimony today will also touch on the Ability-to-Repay and Qualified Mortgage

[1] CRL calculation based on MBA National Delinquency Survey from 2007q1 through 2001q4, scaled to reflect market coverage. As per MBA's claims, we assume 85% market coverage for 2007a1-2010q2 and 88% coverage for 2010q3 and after.

(QM) rulemaking currently being conducted by CFPB. In the years before the crisis lenders often failed to determine whether a borrower had an ability to repay their mortgage – in addition to offering mortgages with harmful features. Dodd-Frank now requires lenders to assess a borrower's ability to repay their mortgage. Additionally, the Qualified Mortgage concept was included in Dodd-Frank to establish default mortgage standards that lenders can use to demonstrate a borrower's ability to repay the mortgage. Along with The Clearing House Association[2], which is owned by banks comprising a significant share of the mortgage market, the Consumer Federation of America, and The Leadership Conference on Civil and Human Rights, CRL submitted joint recommendations to the CFPB on designing this rulemaking. These joint recommendations are attached as an appendix to this testimony.

In discussing the QM rulemaking, I will touch on three inter-related recommendations:

- **Qualified Mortgage should be broadly defined:** We recommend a broad definition that includes the current conventional mortgage market, because creditworthy borrowers should benefit from the substantial protections – fees no greater than 3 percent, prohibiting balloon payments, interest only payments, negative amortizations, and unaffordable teaser ARMs – that are included for QM loans. Additionally, a broad QM definition will protect against shrinking the current conventional mortgage market.

- **Qualified Mortgage should include the use of clear, bright line standards:** The Qualified Mortgage definition should also use clear, bright line standards instead of guiding principles that provide less clarity about whether an individual mortgage should count as a Qualified Mortgage. Bright line standards will provide easy-to-understand rules of the game so everyone will know if a loan is a QM or not. This is good for both lenders and borrowers.

- **Rebuttable presumption standard, not a lender safe harbor:** A broad Qualified Mortgage definition using clear, bright line standards should also have a rebuttable presumption and not a safe harbor. Putting in place a rebuttable presumption hurdle for borrower litigation gives lenders a considerable litigation advantage but allows a borrower to bring a case when there is a rare, starkly unaffordable QM loan and strong evidence available at the outset.

[2] The Clearing House Owner Banks are: Banco Santander, Bank of America, The Bank of New York Mellon, BB&T, Capital One, Citibank, Comerica, Deutsche Bank, HSBC, JPMorgan Chase, KeyBank, PNC, RBS Citizens, UBS, U.S. Bank, Union Bank, and Wells Fargo.

1. **Harmful mortgage features and lending practices were prevalent in the pre-crisis mortgage lending market and led to massive foreclosures.**

In the fallout of the foreclosure crisis, the alphabet soup of harmful lending products and practices – such as YSPs, IOs and NINJA loans – is now well known. Many of these features and practices were at one time touted as innovations to serve borrowers. As the foreclosure crisis has made plain, such rhetoric has failed to match reality.

Over the last ten years, CRL has produced research highlighting the increased foreclosure risk posed by abusive lending practices. In 2006, which pre-dated the worst of the foreclosure crisis, CRL released a report estimating that abusive and predatory lending would lead to approximately 2.2 million foreclosures among subprime mortgages.[3] At the time, our report was denounced by the mortgage industry as absurdly pessimistic. As we all now know, the system was loaded with much more risk than CRL originally reported.

At the end of last year, CRL released a report entitled *Lost Ground* that builds on our pre-crisis research and confirms the link between risky mortgage features and foreclosure rates. For mortgages originated between 2004 and 2008, this research shows that loans originated by a mortgage broker, containing hybrid or option ARMs, having prepayment penalties, and featuring high interest rates (i.e., subprime loans) were all significantly more likely to be seriously delinquent or foreclosed upon than a 30-year fixed-rate mortgage without a prepayment penalty.

CRL's research also demonstrates that African-American and Latino borrowers were much more likely to receive mortgages with these harmful features. For example, African-American and Latino borrowers with FICO scores above 660 were **three times** as likely to have a higher interest rate mortgage than white borrowers in the same credit range.[4] Although the majority of foreclosures have affected white borrowers, *Lost Ground* confirms that African- American and Latino borrowers have faced a disproportionate number of foreclosures and delinquencies than white borrowers within every income range.

The foreclosure crisis could have been prevented, but it wasn't, and it bears revisiting in more detail the kind of harmful lending practices that fueled the crisis still affecting communities across the country.

- **2/28s and other ARMs:** Adjustable rate mortgages (ARMs) – including "2/28s" where starter rates reset after the first two years – were widespread in the years leading up to the foreclosure crisis. These 2/28s and other ARMs led to payment shocks for many

[3] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Costs to Homeowners*, (December 2006), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf
[4] *Id.*

households who were unprepared for higher monthly payments once the interest rates increased. As of 2009, subprime mortgages with short-term hybrid ARMs had serious delinquency rates of 48 percent compared to 21 percent for subprime fixed-rate mortgages and 36 percent for the total universe of active subprime mortgages.[5] In fact, were it not for the Federal Reserve lowering interest rates to historically low levels following the financial crisis, it's easy to imagine the payment shock from expiring teaser rates leading to an even higher number of foreclosures than has occurred so far.

A related product called interest-only (IO) ARMs let borrowers make interest only payments during an introductory period, which jeopardized any ability to build equity as well as leading to payment shock for borrowers once the loan started amortizing over a reduced loan life. Going even further, payment option ARMs (POARMs) allowed borrowers to make monthly payments where the amount paid could vary from month-to-month, including payment amounts that did not cover the full interest due. This resulted in negative amortization. Too many lenders structured these loans so that the payments would substantially increase in five years or less when borrowers hit their negative amortization cap, underwrote the loans only to the very low introductory teaser rate, and failed to document income.

- **Prepayment penalties:** Many borrowers facing payment shock from increased interest rates once an introductory period ended also faced penalties when trying to exit into a new mortgage or to sell the property. These prepayment penalties are a feature associated with a higher likelihood of default,[6] and were present in the great majority of subprime mortgages, and increasingly in Alt-A mortgages (which generally consisted of limited documentation mortgages to higher credit score borrowers), during the mortgage boom.[7] To avoid default, the typical subprime borrower had to sell or refinance before the rate reset. This produced prepayment penalties, generally equal to six months' interest—typically 3.5 percent to 4 percent of the loan balance. Because the average borrower did not have the cash on hand sufficient to cover the prepayment penalties and refinancing fees, they had to pay them from the proceeds of the new loan. This produced ever-declining equity even when home prices were rising. Once home prices declined, foreclosure risk climbed catastrophically.

---

[5] *See GAO Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources*, at 12-13 (August 2010) (available at http://www.gao.gov/assets/310/308845.pdf).

[6] *See, e.g.*, Lei Ding, Roberto G. Quercia, Wei Li, Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, at 49 (Working Paper: May 17, 2010) (stating "[w]e also found that subprime loans with adjustable rates have a significantly higher default rate than comparable CAP loans. And when the adjustable rate term is combined with the prepayment-penalty feature, the default risk of subprime loans becomes even higher.") (available at http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf).

[7] See *Report to Congress on the Root Causes of the Foreclosure Crisis*, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, at 23 (January 2010) (citing Demyanyk, Yuliya, and Otto Van Hemert. 2008. Understanding the Subprime Crisis. Working paper. St. Louis, MO: Federal Reserve Bank of St. Louis.) (available at http://www.huduser.org/Publications/PDF/Foreclosure_09.pdf).

- **No-doc or low-doc loans:** The practice of failing to document a borrower's income and assets was also prevalent in the subprime and Alt-A market. For example, low-doc loans comprised 52 percent of Alt-A originations in April 2004 and rose to 78 percent at the end of 2006.[8] By 2006, no-doc or low-doc loans made up *27% of **all** mortgages*.[9] These loans without proper documentation were frequently underwritten with inflated statements of the borrower's income.[10] Lawyers representing borrowers in predatory lending cases often found the borrower's tax returns included in the file of those who were nevertheless given "no doc" or "low doc" loans. Unbeknownst to these borrowers, they paid higher interests rate for the "privilege" of receiving a no-doc loan, even where they provided full documentation to the broker.

- **Yield Spread Premiums:** The proliferation of mortgages with these harmful features was driven in significant part by the use of yield spread premiums (YSPs) as a way to compensate mortgage brokers. Because YSPs paid mortgage brokers higher payments when a mortgage had a higher interest rate than the borrower qualified for, these YSPs gave mortgage brokers incentives to steer borrowers into loans that were more expensive and less stable than they qualified for. And, by 2006, mortgage brokers accounted for 45 percent of all mortgage originations and 71 percent of all non-prime mortgage originations.[11] In fact, most borrowers who received subprime loans could have qualified for better, more sustainable loans. Many qualified for lower-cost prime loans[12]; those who did not often would have qualified for sustainable, 30-year fixed-rate subprime loans for at most 50-80 basis points above the introductory rate on the unsustainable

---

[8] Rajdeep Sengupta, *Atl-A: The Forgotten Segment of the Mortgage Market*, Federal Reserve Bank of St. Louis *Review*, January/February 2010, 92(1), pp. 55-71 at 60 (available at http://research.stlouisfed.org/publications/review/10/01/Sengupta.pdf).

[9] *See* Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* at 165 (Jan. 2011) [hereinafter *FCIC Report*], available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

[10] Over ninety percent of a sample of stated income loans exaggerated income by 5 percent or more and almost 60 percent exaggerated income by over 50 percent. Mortgage Asset Research Institute, Inc, Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association at 12 (April 2006), (available at http://www.mortgagebankers.org/files/News/InternalResource/42175_Final-8thAnnualCaseReporttoMBA.pdf)..

[11] Ren S. Essene & William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans* at 8 (Joint Center for Housing Studies, Harvard University Apr. 25, 2007) (citing Mortgage Bankers Association, *MBA Research Data Notes: Residential Mortgage Origination Channels* (2006) (available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/mm07-1_mortgage_market_behavior.pdf).

[12] For example, a *Wall Street Journal* study found that 61 percent of the subprime loans originated in 2006 that were packaged into securities and sold to investors "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms." *See* Rick Brooks & Ruth Simon, "Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market," *Wall Street Journal* at A1 (Dec 3, 2007). Freddie Mac estimated in 2005 that more than 20 percent of borrowers with subprime loans could have qualified for prime. *See* Mike Hudson & E. Scott Reckard, "More Homeowners With Good Credit Getting Stuck With Higher-Rate Loans," Los Angeles Times (Oct. 25, 2005), available at http://articles.latimes.com/2005/oct/24/business/fi-subprime24.

"exploding" ARM loans they were given.[13] This 50-80 basis point increase is modest compared with the 350 to 400 basis point prepayment penalty (plus additional refinancing fees) that the borrower had to pay to refinance the typical 2/28 loan before the end of the second year.

- **No Escrows for Taxes and Insurance:** Subprime lenders commonly did not escrow for taxes and insurance, attracting borrowers with the deceptive lure of lower monthly payments. This practice increased the risk of default twice a year when the tax and insurance bills came due and produced further equity-stripping cash-out refinancings where the borrower had the equity to cover the bills and refinancing fees and penalties.

On top of these harmful loan features and lending practices, many lenders also failed to determine whether a borrower had an actual ability to repay their mortgage. Proper underwriting is particularly important for mortgages with resetting interest rates or negative amortization or interest-only payments (or all of the above) to ensure that borrowers can afford the larger monthly payments when they kick in down the road. However, for many mortgage originators, this straightforward underwriting never happened. For example, at the time when Federal regulators proposed that lenders fully underwrite mortgages with ARMs, interest-only and negative amortization features at the fully indexed rate and payment, Countrywide estimated that 70% of their recent borrowers would be unable to meet this standard.[14] This recklessness set borrowers up for failure and, as a result, caused a foreclosure crisis.

2. Regulatory failures leading up to the crisis demonstrate the need for the Consumer Financial Protection Bureau.

Federal regulators should have been able to reign in the worst practices in the private market in the years leading up to the burst of the housing market bubble and the beginning of the foreclosure crisis. Instead, federal regulators aided and abetted the lending binge, ignoring the inherently risky practices in the marketplace. The agencies responsible for protecting depositors, shareholders, taxpayers, borrowers, and the general financial market stood by as predatory practices and dicey lending became commonplace, ravaging the mortgage market and setting off a chain reaction of financial devastation.

During these years of lax regulation, the private market essentially engaged in a failed experiment on conducting wide scale mortgage lending outside of government oversight. From

[13] January 25, 2007 letter from the Coalition for Fair and Affordable Lending ("CFAL") to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3. CFAL was an industry group representing subprime lenders.
[14] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," Oct. 26, 2007.

mortgage brokers to bankers on Wall Street to credit ratings agencies acting as rubber stamps, the private-market created a securitization system for private label mortgage-backed securities that was designed for failure and largely unregulated.

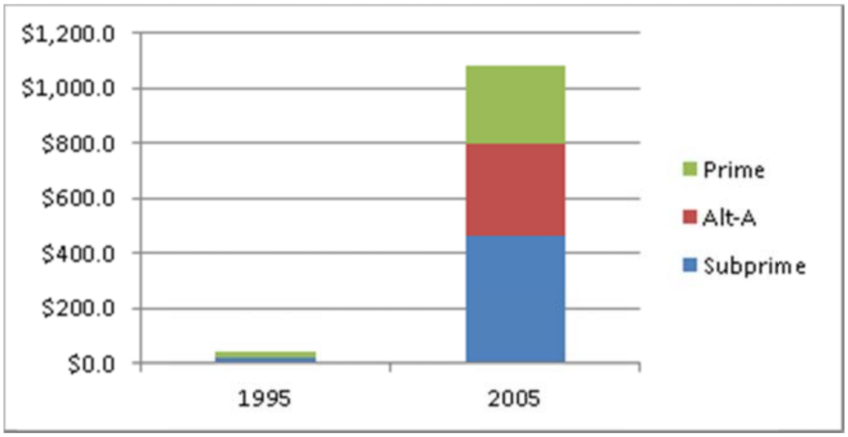
The private label securitization (PLS) chain started with originators that were often steering borrowers into higher cost and riskier loans than they qualified for. This included an increasing number of mortgage brokers incented by yield spread premiums. CRL released a study in 2008 showing that brokered loans, when compared to direct lender loans, cost subprime borrowers additional interest payments ranging from $17,000 to $43,000 per $100,000 borrowed over the scheduled life of the loan.[15] Even over a fairly typical four-year loan term, the subprime consumer paid over $5,000 more for brokered loans.[16]

Market participants readily admit that they were motivated by the increased fees offered by Wall Street firms in return for riskier loans. After filing for bankruptcy, the CEO of one mortgage lender explained it this way to the *New York Times*, "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans…What would you do?"[17] Beginning in 2000, subprime lender New Century implemented a plan that "concentrated on 'originating loans with characteristics for which 'whole loan buyers' [i.e., Wall Street firms] will pay a high premium,'" and increased its sale of loans from $3.1 billion in 2000 to $20.8 billion in 2003.[18]

These unsustainable mortgages helped expand the housing bubble and primed the financial system for the 2008 financial crisis. Leading up to the foreclosure crisis there was a substantial and rapid increase in the volume and share of non-prime mortgage originations. As the chart below illustrates, the growth in the PLS market was heavily driven by subprime loans, which increased from $17.6 billion to $464 billion between 1995 and 2005, and Alt-A loans, which though virtually non-existent in 1995, reached $333.6 billion by 2005.

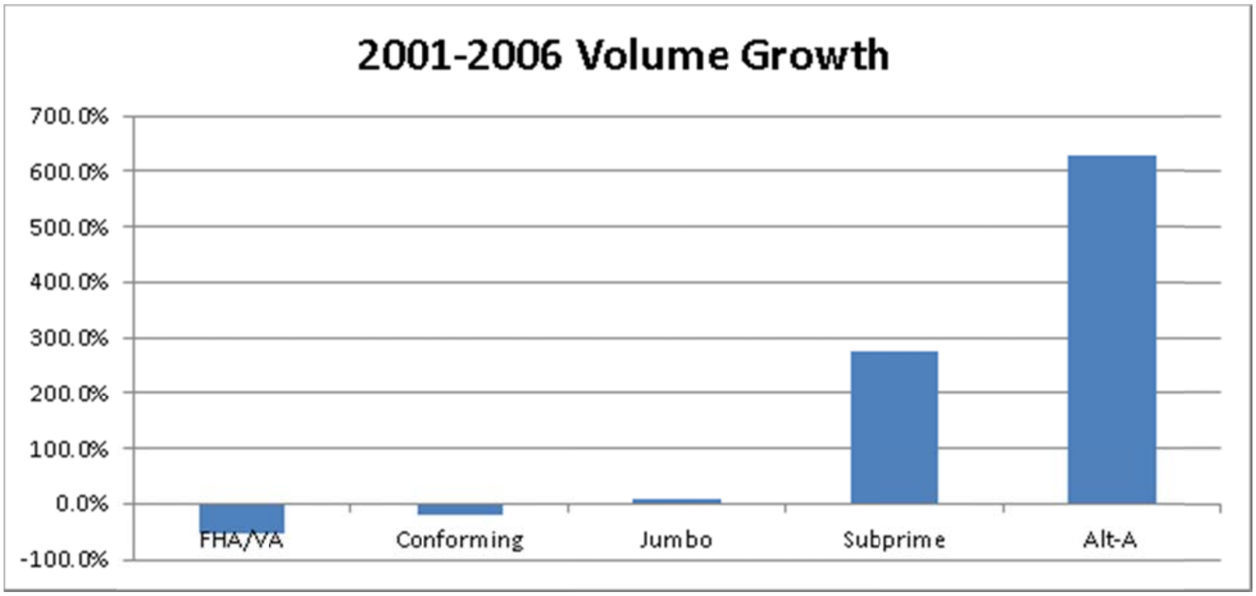
[15] *See generally* Keith Ernst, Debbie Bocian & Wei Li, *Steered Wrong: Brokers, Borrowers, and Subprime Loans*, (Center for Responsible Lending Apr. 8, 2008), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/steered-wrong-brokers-borrowers-and-subprime-loans.pdf.
[16] *Id.* at 14 (explaining that a typical subprime borrower who received a brokered loan paid $5,222 more in interest during the first four years of a $166,000 mortgage compared to a similar borrower who did not use a broker).
[17] Vikas Bajaj & Christine Haughney, "Tremors at the Door: More People with Weak Credit Are Defaulting on Mortgages," *New York Times* (Jan. 26, 2007), (available at http://www.nytimes.com/2007/01/26/business/26mortgage.html).
[18] *FCIC Report* at 89 (citing *In re: New Century TRS Holdings, Chapter 11*, Case No. 07-10416 (KJC) (Bankr. D.Del. February 29, 2008) (Final Report of Michael J. Missal, Bankruptcy Court Examiner at 42)).

Non-Agency Issuance of Mortgage Backed Securities (in $billions)



Source: CRL calculations based on data from
http://www.fdic.gov/bank/analytical/regional/ro20063q/na/2006_fall01_chart02.html

Additionally, as the subprime and Alt-A markets rapidly grew in size from 2001-2006, the volume of conforming (i.e., loans purchased by Fannie Mae or Freddie Mac) and government-backed mortgages actually decreased.



Source: CRL calculations of data from Inside Mortgage Finance's
2008 Mortgage Market Stastistical Annual, Volume 1.

The subprime and Alt-A originations bundled into private label mortgage-backed securities have failed at much greater rates than GSE-backed mortgages – even the ill-advised GSE Alt-A mortgages that have caused their greatest losses. While the GSEs generally required strict underwriting (until they followed the private market in to the no-doc fray by purchasing Alt-A loans), and used standardized forms, documents and financial models to provide stability and liquidity in the secondary market, subprime originators, backed by private securitizations, did not have such standards or homogeny. And, private label securitization was responsible for 42% of all serious delinquencies through 2009, despite accounting for only 13% of all outstanding loans. In contrast, Fannie Mae and Freddie Mac, which had a combined share of 57% of loans outstanding, accounted for only 22% of serious delinquencies.[19]

Although the failure of toxic subprime and Alt-A mortgages bundled in private-label mortgage-backed securities sparked the foreclosure crisis, the wider economic impacts of the 2008 financial crisis, particularly widespread unemployment, led to an increase in delinquencies for other mortgages as well, including prime fixed-rate mortgages.[20]

It was in the context of these massive federal regulatory and private market failures that Congress enacted Dodd-Frank, which included the creation of an independent CFPB. By establishing the CFPB, Congress wisely consolidated the consumer protection functions of the federal prudential regulators into an independent agency with a mission to protect borrowers from abusive financial practices. These consolidated consumer protection responsibilities include broad rule-writing authority as well as supervision and enforcement authority. Although its supervision authority only extends over depositories with more than $10 billion in assets, it also supervises payday lenders, mortgage-related companies, private student lenders, and other large non-bank entities.

Creation of the CFPB was the correct response to the regulatory failures that permitted these destructive mortgage lending practices to continue. Subprime abuses first developed in the non-bank sector with large subprime lenders, which had no federal regulator to mind the store. The same was true with mortgage brokers and servicers. A race to the bottom ensued, where bank practices progressively deteriorated as banks struggled to compete. Instead of stepping in, safety and soundness regulators failed to prioritize consumer protection and looked the other way. In addition, no federal regulator was charged with using its research capacity to look across the financial system and identify emerging risks to consumers such as the rapid build-up of subprime and Alt-A lending. CFPB has just this charge, along with the responsibility to supervise non-bank and large bank mortgage lenders. Going forward, we will need this capability.

---

[19] James B. Lockhart, "FHFA's First Anniversary and Challenges Ahead," Speech before the National Press Club, July 30, 2009. (available online at http://www.fhfa.gov/webfiles/14715/FHFA1stAnnSpeechandPPT73009.pdf).

[20] *See, e.g.*, *FCIC Report* at 216 ("Prime fixed-rate mortgages, which have historically been the least risky, showed a slow increase in serious delinquency that coincided with the increasing severity of the recession and of unemployment in 2008.)

3. **Dodd-Frank reforms will help prevent reckless mortgage lending from returning to the mortgage market.**

The Mortgage Market Reform and Anti-Predatory Lending Act, which is Title XIV of Dodd-Frank, is an important step forward in reigning in harmful lending practices. These are basic reforms to ensure that the mortgage market remains focused on sound underwriting and sustainable lending.

As a result of the new law, loan originators such as mortgage brokers can no longer receive more compensation for putting borrowers in higher rate loans than they qualify for – compensation cannot vary according to the terms and conditions of the loan (except for principal balance). Prepayment penalties that lock borrowers into bad loans are significantly restricted. No-doc lending is prohibited. Escrows of taxes and insurance are required for higher interest rate loans (except for rural community banks). Up-front fees are limited to 5 percent or the loan becomes a disfavored HOEPA loan (though interest rates can rise to 6.5 percent over conventional rate without the loan hitting these limits). Loans must be underwritten to the fully indexed rate.

If Title XIV had been in place earlier, there never would have been a crisis, and millions of Americans would not have lost trillions of dollars of wealth or their jobs. Rather than stifling legitimate lending, these reforms will provide a level playing field and sensible rules of the road so that we will avoid the constriction of credit we're facing now that invariably follows a crisis. These are reforms for the long-term to prevent future abusive lending and foreclosure waves from resurfacing. If Congress were to reverse or weaken Title XIV, we could return to a marketplace where short-term gains prevail over the long-term financial stability of both our markets and household balance sheets.

The costs of the current crisis confirm that such a reversal would be a mistake. CRL's *Lost Ground* analysis shows that as of February 2011, about 3.6 million homeowners with mortgages made between 2004 and 2008 were delinquent or already in foreclosure. This is in addition to the millions who have already lost their homes to foreclosure, and the over 16 million homeowners who are currently underwater on their mortgage.[21] In other words, those who suggest that Dodd-Frank is unnecessary are being shortsighted.

[21] Tiffany Hsu, *Zillow: 31.4% of U.S. homeowners are underwater on mortgages*, Los Angeles Times (May 24, 2012) (available at http://www.latimes.com/business/money/la-fi-mo-zillow-underwater-20120524,0,165710.story); Stan Humphries, *Despite Home Value Gains, Underwater Homeowners Owe $1.2 Trillion More than Homes' Worth*, Zillow Real Estate Research (May 24, 2012) (available at http://www.zillow.com/blog/research/2012/05/24/despite-home-value-gains-underwater-homeowners-owe-1-2-trillion-more-than-homes-worth/).

One of the main reforms in Title XIV is a straightforward and good one. Section 1411 requires lenders to make a reasonable and good faith determination on whether the borrower has an ability to repay the offered mortgage. Said a different way, this section requires lenders to do the basic underwriting that so often failed to happen in the years leading up to the crisis. In making its determination on whether the borrower has an ability to make the monthly payments, this section requires the lender to look at a fully amortizing payment schedule.

It's important to highlight that the Ability-to-Repay section does *not* require lenders to predict the future. By this I mean that Dodd-Frank only states that lenders must determine whether *at the time the loan is consummated* there is an ability to repay and make the monthly payments. This means that lenders are not responsible for predicting whether widespread layoffs are going to happen several years in the future or whether a borrower might become ill and have to cut back his or her hours.

Additionally, I want to emphasize that the Ability-to-Repay requirement does not prevent lenders from also – and separately – considering whether borrowers have a willingness or propensity to repay a mortgage. In other words, the ability to repay factor is just one part of a lender's underwriting decision making process. Lenders may use other, although non-discriminatory, factors to determine whether to offer a borrower a mortgage, and this is not restricted by the Ability-to-Repay requirement in Dodd-Frank.

Dodd-Frank also establishes a category of mortgages called Qualified Mortgages (QM), which is a default standard that lenders can use to demonstrate that the borrower has an ability to repay the mortgage. This designation has benefits for lenders and borrowers. For lenders, it makes it significantly easier to demonstrate compliance with their Ability-to-Repay determination and substantially reduces the risk of investor buy-back claims and borrower litigation. Reduced exposure to buy-back claims is a substantial lender benefit that should not be underestimated. For borrowers, the QM category means they can avoid a list of risky mortgage features that are either prohibited or restricted, including interest only loans, loans with negative amortization, and balloon payment loans. Additionally, lenders must underwrite all ARMs by looking at the maximum interest rate that could apply during the first five years of the mortgage and fully amortize the remaining payments. The allowable points and fees that lenders can charge on QM loans are also limited to 3 percent.

These Ability-to-Repay and Qualified Mortgage reforms will lead to improvements in the mortgage market's long-term stability by reducing the likelihood of unaffordable and predatory mortgages.

4. **The CFPB should establish a broad Qualified Mortgage definition using clear, bright lines that also includes a rebuttable presumption and not a safe harbor.**

The Consumer Financial Protection Bureau is currently engaged in the rulemaking process to define what counts as a Qualified Mortgage and to implement the overall Ability to Repay requirements in Title XIV. The CFPB recently took the prudent step of reopening the comment period on this rulemaking to get additional data analysis to assist in defining a Qualified Mortgage, and this comment window closed earlier this week on July 9, 2012. As the CFPB recognizes, it is much more important for them to get this rulemaking right, using the best data available, than to finish it six months earlier. This reopened comment period does not interfere with the January 2013 deadline established in Dodd-Frank. When finalized, this rulemaking will have the ability to ensure that homeowners have broad access to 30-year, fixed-rate or long-term ARM fully-amortizing loans with limited fees instead of products with high fees and deceptive terms that borrowers cannot afford.

There are three aspects to how CRL – along with the Consumer Federation of America, The Clearing House Association, and The Leadership Conference on Civil and Human Rights – believe that Qualified Mortgage should be defined. First, we support creating a broad definition that will encompass the entire currently constrained market with room for additional lending beyond today's levels. Second, we support using clear, bright line standards – on issues such as back end debt-to-income ratio and cash reserves – in delineating this broad definition. Third, we support establishing a rebuttable presumption for borrowers to contest the presumption in the limited situations where a lender should have reasonably known at the time the loan was made that a borrower could not afford the mortgage.

For the rule to function as a whole, each of these three prongs must be present. I address each in more detail below.

A. Qualified Mortgage should be broadly defined.

On the issue of whether the CFPB should use a broad or narrow definition of Qualified Mortgage, we strongly support a broad definition that includes the current conventional mortgage market. More specifically, we support establishing a broad QM definition where lenders can use a number of well-established underwriting factors.

A broad QM definition is key to this rulemaking. First, creditworthy borrowers should benefit from the substantial protections included in QM mortgages. These protections include fees no greater than 3 percent, prohibiting balloon payments, interest only payments, negative amortizations, and unaffordable teaser ARMs. A narrow QM definition that uses an unnecessarily low debt-to-income ratio would push creditworthy borrowers, including many low-income borrowers and borrowers of color, into the non-QM market. This would harm borrowers – and potentially recreate a dual mortgage market – because non-QM mortgages could still have harmful features in addition to likely being more expensive.

Second, without a broad QM definition, the overall size of the lending market is likely to shrink. Lenders are likely to scale back lending for mortgages that do not qualify as QM, because of increased litigation risks, including possible buy-back claims, for non-QM loans. Therefore, if creditworthy borrowers are pushed out of the market for QM loans, the non-QM market is not likely to pick up the slack. This will needlessly leave creditworthy borrowers with restricted access to credit. This problem is avoidable, however, if a broad QM definition is adopted.

B. Qualified Mortgage should include the use of clear, bright line standards.

The Qualified Mortgage definition should also use clear, bright line standards instead of guiding principles that provide less clarity about whether an individual mortgage should count as a Qualified Mortgage. Bright line standards will provide easy-to-understand rules of the game so everyone will know if a loan is a QM or not, and they can be set in a way that does not overly restrict the QM market. This is good for both lenders and borrowers.

Using bright line standards requires creating some cut off points, and we think this can be done in a nuanced way that incorporates traditional underwriting techniques. Our joint proposal with the Consumer Federation of America, The Clearing House Association, and The Leadership Conference on Civil and Human Rights recommended a two-step process for evaluating a borrower's total debt-to-income (DTI) ratio. In step one, the borrower meets the DTI test if they fall below an initial DTI limit, which we stated should be 43 percent and is the Federal Housing Administration's current manual underwriting limit. In step two, lenders can review a list of compensating factors like cash reserves, low housing payment, lack of payment shock with demonstrated payment history, and residual income for those borrowers above the initial DTI limit. If the borrower meets one of the compensating factors, then they meet this part of the QM definition.

This above approach strikes the right balance in creating a QM standard. It will be straightforward for lenders to implement since it uses common underwriting factors. In addition, it does not create the problem of having a narrow QM definition where the DTI threshold is too low and unnecessarily excludes creditworthy borrowers from the QM market.

C. A broad Qualified Mortgage definition using clear, bright line standards should also have a rebuttable presumption and not a safe harbor.

On the last issue, the CFPB should establish a rebuttable presumption that borrowers would need to overcome in order to raise a challenge about the affordability of a QM loan. Not only does this structure follow the statutory language, but it also makes sense when creating a broad Qualified Mortgage that is defined using clear, bright line standards. In this structure, lenders get considerable benefits from a broadly defined QM market even though we know that some loans will be unaffordable for some borrowers, not least of which is reduced liability exposure from investor buy-back claims. If QM is defined narrowly, then lenders will retain extensive buy-back risk on all non-QM loans, to the extent that they make non-QM loans at all. The prospect of buy-back risk with a narrow QM definition far exceeds the borrower litigation risks that lenders would face with a broad QM definition and rebuttable presumption standard.

Putting in place a rebuttable presumption hurdle for borrower litigation gives lenders a considerable litigation advantage but allows a borrower to bring a case when there is a rare, starkly unaffordable QM loan and strong evidence available at the outset. With all three pieces in place, the Qualified Mortgage system will provide the market with widespread access to affordable and safe credit, lenders will have certainty due to the bright line standards and reduced litigation risk, and borrowers will have access to good loans with the ability to raise claims in rare, extreme cases. This overall system is one that will work for the entire market, and one supported by major lenders in the joint recommendations attached as an appendix to this testimony.

Straying from these inter-related recommendations will be harmful for the market and for borrowers. If the QM market is narrow, not broad, a safe harbor would be of limited use to lenders. If QM is defined fuzzily rather than with bright lines, there could be significant litigation over whether a loan is QM or not. Additionally, a safe harbor standard would prevent borrowers from bringing any claim concerning an unaffordable QM loan even in situations where the lender has acted in bad faith.

Thank you for the opportunity to testify today, and I look forward to answering your questions.

Appendix

Ability-to-Repay ("ATR") Analysis and Qualified-Mortgage ("QM") Determination

DISCUSSION DRAFT

by

Center for Responsible Lending
The Clearing House Association
Consumer Federation of America
Leadership Conference on Civil and Human Rights

For a Meeting With

Consumer Financial Protection Bureau
on

March 7, 2012

This document represents consensus recommendations concerning the ability-to-repay ("**ATR**") and qualified-mortgage ("**QM**") requirements of Dodd-Frank. These recommendations are interrelated and dependent upon each other.

1.0 Qualified Mortgage

Congress intended QMs to comprise the vast bulk of the mortgage market, and they should. QM loans by statute have safer features associated with responsible lending and lower default rates than loans without those features, such as limited fees, full amortization, and limited terms. Congress gave loans with these features a litigation advantage precisely to incent lenders to make QM loans.

If the QM definition is construed narrowly, it will be more difficult for low-income and minority families to qualify for safer loans, and, to the extent that mortgage credit is available to them at all, many of these borrowers will be left to the part of the market where they will be significantly more vulnerable to equity stripping through high fees and bad practices. A large non-QM market would not by its size alone protect consumers, and the broad availability of loan features that experience has shown to entail greater risks for consumers and investors will add to costs without providing commensurate consumer benefits.

By contrast, a broad definition of QM would combine prudent lending with less litigation, benefiting homeowners, investors and lenders alike. It would also support access to credit, since secondary market standards are very likely to require loans to be QM.

2.0 Ability-to-Repay Determination

2.1 General standards

Statutory requirement

The statute states that "no creditor may 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 (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(1).

The ability-to-repay analysis should be based on factors that reflect capacity to repay as of the time of consummation, not willingness or propensity to repay.

- The determination of ability to repay is separate and distinct from the underwriting decision, which properly includes factors other than just ability to repay.

- The regulations and accompanying commentary should clarify that:

  - the statutory ATR analysis concerns the borrower's capacity (the statute uses the term "ability") to repay a loan through current income, assets (other than the home), and funds available, not the propensity to make such payments.

  - other factors unrelated to ATR that influence the credit decision (e.g., credit score, LTV, appraisal) should not be used by creditors in establishing the borrower's ATR or in challenging a creditor's determination of ATR.

  - while the statute refers to a consumer's "credit history," this reference was intended to ensure only that a lender obtained a consumer's credit report (which contains the consumer's credit history) to verify the consumer's debts and associated monthly obligations,[1] not that lenders should use the credit history or credit report to otherwise determine the borrower's ability to repay. Otherwise, it would make no sense that QM establishes a rebuttable presumption of ATR when QM does not discuss creditworthiness.

- The CFPB should adopt the portion of proposed commentary Paragraph 43(c)(1)-1, which clarifies that a creditor is required to "determine that a consumer will have a reasonable ability *at the time the loan is consummated* to repay the loan" (emphasis added). A change in a consumer's circumstances after consummation of the loan is not relevant to determining compliance with the rule, unless such events are documented in the consumer's application or by information provided by the consumer reasonably prior to consummation of the loan. For example, the creditor must consider the potential impact of a consumer's impending retirement and the consumer's ability to repay if the consumer's application contains a notation that the consumer plans to retire six months after the loan is made. However, a significant reduction in income due to a job loss that occurs after consummation or a significant obligation arising from a major medical expense arising after

---

[1] The proposal would require, as part of an ability-to-repay determination, a consumer's credit history. Proposed Regulation section 226.43(c)(2)(vi); Proposed Commentary Paragraph 43(c)(2)(viii). This improperly conflates the full underwriting analysis that all lenders must undertake in order to ensure safe and sound underwriting practices—which includes assessing creditworthiness, loan-to-value ratios, and other factors—with the statute's requirement to consider the borrower's capacity to repay. An analysis of a borrower's ability to repay a debt is simply one important part of a lender's full underwriting analysis.

the loan is consummated would not be relevant to an ability to repay challenge. *See* Paragraph 43(c)(1)-1.

The regulation and commentary should require creditors to verify and document income, assets, and debts using third-party sources.

- **Income or assets:** The final rule should adopt the proposed regulatory provisions and commentary that require verification of income or assets using third-party documentation that provides reasonably reliable evidence of the consumer's income or assets and that permit creditors to consider expected income if it is reasonable and documented. Proposed Rule section 226.43(c)(4); Proposed Commentary Paragraph 43(c)(2)(i)-1; Proposed Commentary Paragraph 43(c)(2)(i)-3. Dodd Frank requires that income and assets be appropriately documented and verified. However, this requirement can pose barriers to obtaining credit for some borrowers who have non-traditional or alternative income sources, such as boarder income and informal self-employment income, which is more difficult to document and verify. Since CFPB will have to confront and resolve these issues in issuing the final regulations, the parties would like to work with the CFPB to develop standards that specifically address how such non-traditional or alternative income sources can be considered by the creditor in the underwriting process and verified, including working through parties that work closely with borrowers, such as HUD-approved housing counselors.

- **Debts:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-1, which provides that creditors may look to widely accepted governmental and nongovernmental underwriting standards to define debts, and a creditor may, for instance, look to credit reports, as well as statements for student loans, auto loans, credit cards, etc., to determine a consumer's outstanding debts. However, see the discussion below regarding expenses not on a credit report or the consumer's application.

- **Reconciling different information:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-2, which provides that the creditor must consider debts in the credit report that are not listed on the consumer's application. The credit report is deemed a reasonably reliable third-party record under § 226.43(c)(3). "For debts not listed in the credit report, but offered by the borrower through the application process, the creditor need not verify the existence or amount of the obligation through another source. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source."

Ability to repay—when the creditor must consider expenses not listed on the credit report or the borrower's application

- The commentary should clarify that the lender must consider additional information that the borrower provides [in writing] a reasonable time before consummation about regular/recurring expenses that would have a material impact on the borrower's ability to repay the loan. However, the borrower would have the burden of proving that she had offered such information [in writing] reasonably prior to the consummation of the loan and that it would have a material impact on her ability to repay the loan. **[Note to CFPB: The parties disagree about whether this information must be provided in writing.]**

[There is agreement that the borrower needs access to information that describes how the lender conducted the ability-to-repay determination. The parties will attempt to propose a solution at a later date.]

2.2 Payment used to qualify the borrower—treatment of ARMs

For all ARMs, the ATR standard should require the following:

- The contract interest rate and payment *cannot*:
    - adjust more frequently than annually;
    - increase by more than 200 basis points in any annual rate adjustment; or
    - adjust by more than 500 basis points over the life of the loan.

- The borrower must be qualified based on the *maximum* rate and payment that could occur in the first 6 years of the term of the loan (that is, the rule would not allow the creditor to ignore the first rate and payment adjustment on a 5-1 ARM in the ATR analysis).

[**2.3** Potential ATR Carve-Out for Certain Streamlined Refinancings: There is agreement that an exception to the ability-to-repay and qualified-mortgage requirements should be established for certain streamlined refinancings. The parties will attempt to propose such an exception at a later date.]

3.0 QM Definition

All items below must be met in order for the loan to be a designated as a qualified mortgage:

3.1 Loan Terms

A qualified mortgage cannot have terms that provide for:

- an increase of the principal balance as a result of negative amortization based on regular required payments
- interest-only payments
- balloon payments
- a term greater than 30 years
- points and fees that exceed the greater of $3,000 or 3 percent of the total loan amount so long as the loan is not a HOEPA loan
- the contract interest rate and payment to:
    - adjust more frequently than annually;
    - increase by more than 200 basis points in any annual rate adjustment; or
    - adjust by more than 500 basis points over the life of the loan
- In addition, the borrower must be qualified based on the *maximum* rate and payment that could occur in the first 6 years of the term of the loan (that is, the rule would not allow a creditor to ignore the first rate and payment adjustment of a 5-1 ARM in the ATR analysis).

3.2 Documentation Requirements

The following documentation requirements would be required for QM loans:

- Verification of borrower income;
- Verification of employment ("**VOE**") status, if applicable (either written or oral VOE);
- Documentation of current debt obligations (based on credit report and borrower application); and
- Documentation of payments on simultaneous seconds and any other subordinated loans in place at origination.

3.3 Additional QM Underwriting Requirements

In order to be a qualified mortgage, a loan must meet at least one of the "waterfall" tests described below. However, the fact that a mortgage might qualify under one of these tests does not imply an obligation on the creditor's part to make the loan or to otherwise forego the underwriting process. All references to housing debt, housing obligations, and housing payments below would include principal, interest, taxes, insurance, condominium association fees and other housing-related obligations.

- If the borrower's total debt-to-income ratio ("TDTI") is 43 percent or less (with a bona fide error cushion), the loan would meet QM requirements. No other tests would be required.
- If the borrower's TDTI is more than 43 percent, the following tests could be applied:
  - *Front-End Ratio*: Is the borrower's housing debt-to-income ratio 31 percent or less of the borrower's gross monthly income and is TDTI 50 percent or less?
    - ➢ If yes, the loan meets QM requirements; no further test required. If no, continue.
  - *Previous Housing Payments*. Has the borrower had stable income for the past six months and made timely mortgage or rental payments over a specified period of time (TBD), and will her new monthly housing obligations be no more than 5 percent higher than her current housing expenses? [Parties are still discussing the appropriate definition and timeframe for establishing a history of "timely" payments.]
    - ➢ If yes, the loan meets QM requirements; no further test required. If no, continue.
  - *Reserves.* Does the borrower meet one of the following tests: 1) at least 6 months of liquid financial reserves available to meet mortgage-related obligations and a TDTI of 50% or less; or 2) greater than 18 months in liquid financial reserves (i.e., no TDTI cap required)? (Only 60 percent of any reserves with a withdrawal penalty would be allowed to count.) [Parties agree that some degree of seasoning should be required but do not have a specific recommendation.]
    - ➢ If yes, the loan meets QM requirements; no further test required. If no, continue.

– *Residual Income.* Is the borrower's net residual income above the minimum threshold established by the CFPB and/or other government agency (e.g., U.S. Department of Veterans Affairs ("**VA**")?

➢ If yes, the loan meets QM requirements; no further test required. If no, the loan will only be made as a non-QM loan unless one of the prior tests in the waterfall is met.

The residual-income test could be based on tax-adjustment tables and income guidelines prepared by CFPB, VA guidelines, or industry standards.

Even if the loan does not meet any of the QM tests, there is no implication that the loan fails to meet the ability-to-repay test.

4.0 Contesting the Presumption

We propose the following process:

- Borrower rebuts presumption when a borrower demonstrates that the loan fails to meet the basic tests of QM—product type, fee levels, etc.

- If the loan is a QM, the borrower can still assert that the ability-to-repay requirement was not met by demonstrating that the lender failed to take into account information provided to it that, if properly considered, would have prevented a reasonable and good faith finding of a reasonable ability to repay.

  - For example, the borrower shows that she provided information to the creditor before consummation that she owed debt that was not listed on the borrower's credit report. Failure to consider this debt could be grounds for challenging whether the ability-to-repay requirement was met. The lender could still have met the requirement if the existence of the debt did not materially affect a reasonable determination of the borrower's ability to repay.

  - Similarly, if a creditor alters or omits information collected in the course of the application, without reasonable basis, that is relevant to the borrower's ability to repay, the borrower can challenge whether the ability-to-repay standard was met.

  - Absent further information or evidence submitted by the borrower that either contradicts the creditor's records and assertions or documents information that the lender had but did not reasonably consider, the presumption for qualified mortgages should provide a sufficient shield to the lender.

- If the loan is not QM to begin with, the burden of proof that the lender did not appropriately consider the borrower's ability to repay falls on the lender. In this case, the lender will not have the benefit of the presumption of ability to repay when defending borrower claims that the lender failed to consider relevant information provided by the borrower.

- Accordingly, revise proposed Alternative 2 Commentary Paragraph 43(e)(1)-1 as follows [*additions in bold and deletions in strikethrough*]:

In general. Under § 226.43(c)(1), a creditor must make a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations. **A borrower raises a claim or defense of violation of sec 226.43(c)(1) by setting forth specific facts that, at the time the loan was consummated, the creditor did not make a reasonable and good faith determination that the borrower had a reasonable ability to repay the loan based upon information provided by the borrower reasonably prior to closing.** Under § 226.43(e)(1), a creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirement of § 226.43(c)(1) if the terms of the loan comply with § 226.43(e)(2)(i)-(ii) (or, if applicable, § 226.43(f)); the points and fees do not exceed the limit set forth in § 226.43(e)(2)(iii), and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or, if applicable, § 226.43(f)). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must **prove** ~~demonstrate~~ that the loan complies with all of the requirements in § 226.43(c) (or, if applicable, § 226.43(d)). However, even if the loan is a qualified mortgage, the ~~consumer may rebut the presumption of compliance evidence that the loan did not comply with~~ **lender has not necessarily complied with the ability-to-repay requirement** in § 226.43(c)(1). For example, **(1)** evidence of a high debt-to- income ratio with no compensating factors, such as adequate residual income ~~could be sufficient to rebut the presumption~~, **or (2) evidence that the lender did not reasonably consider information provided to it relevant to the borrower's ability to repay could be used by the borrower to establish that the creditor did not meet the ability-to-repay requirement. When a loan is a qualified mortgage, the consumer has the burden of proving that the creditor did not comply with the repayment ability requirement of § 226.43(c)(1).**

The Clearing House Owner Banks
Banco Santander
Bank of America
The Bank of New York Mellon
BB&T
Capital One
Citibank
Comerica
Deutsche Bank
HSBC
JPMorgan Chase
KeyBank
PNC
RBS Citizens
Regions
UBS
U.S. Bank
Union Bank
Wells Fargo
Payments Company
Shared Board Seat:
City National
Fifth Third Bank
First Citizens
M&T