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July 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551

RE: Docket No. R–1417 and RIN No. AD 7100-AD75

Dear Ms. Johnson:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the nation's federal credit unions, I am writing to provide NAFCU's comments on the Federal Reserve Board's (the Board) proposed changes to Regulation Z that impose standards on mortgage lenders to ensure that consumers have the ability to repay their mortgage. NAFCU is supportive of the Board's efforts to ensure that consumers are not placed in mortgage loans that they cannot afford. Indeed, credit unions and virtually any other responsible lender already comply with most – if not all – of the requirements the Board proposes for "qualified mortgages." NAFCU does remain concerned about the regulatory burden this proposal will create. In regards to this proposal NAFCU believes:

- Credit unions that make qualified mortgages should have a clear safe harbor under the rule
- Disclosure of compensation arrangements are counterproductive to providing consumers with meaningful information
- The proposed rule is overly complex in many areas.

In addition, NAFCU would like to note that some of our members operate quite successful, narrowly tailored loan programs with little or no verification of income. Many aspects of this rule will require such institutions to make a sea change in how they operate their lending programs, when there will be little benefit to credit union members.

Qualified Mortgage

The Board proposed two alternatives as to what would constitute a "qualified mortgage." Alternative 1 would set parameters on the terms of the loan, require the lender to consider the ability to repay using certain factors and require verification of income. Lenders who comply with the requirements would be presumed to be in compliance with the rule and would receive a legal safe harbor. Alternative 2 would impose the same requirements as Alternative 1 with additional underwriting requirements. More importantly, Alternative 2 would only provide lenders a rebuttable presumption of compliance. NAFCU supports Alternative 1. NAFCU understands the statutory ambiguity which led the Board to propose two alternatives, which the Board explained in the proposed rule. Regulation Z; Truth in Lending, 76 Fed. Reg., 27,390, 27,453 (proposed May 11, 2011) (to be codified at 12 C.F.R. pt. 226). Alternative 1 is the best and most logical interpretation given the statutory ambiguity. It is well accepted cannon of statutory interpretation to look to the structure of a statute if the text is ambiguous. As the Board itself acknowledges, the structure of the statute implies that Congress intended a "qualified mortgage" to serve as a safe harbor, rather than provide a mere presumption of compliance. The structure of the statute as well as the policy rationale for the provision, weigh in favor of Alternative 1. However, if the Board ultimately discards Alternative 1, NAFCU would recommend it consider a compromise combining the two alternatives, so that lenders that wish to make qualified mortgages would be required to comply with the more strict requirements in Alternative 2, but would then receive the benefit of the safe harbor.

Originator Compensation

The proposal sets up a fairly complicated scheme by which any bonus compensation paid to loan officers must be disclosed to the consumer as "points and fees" that he or she pays. While NAFCU understands this provision is, at least in part, required by the statute, the Board's interpretation is unnecessarily broad. Incentive based compensation schemes can be quite complex. The Board attempted to address some of these complexities in the staff commentary; nonetheless, it will be extremely burdensome in many cases for institutions to accurately discern exactly what portion of a loan officer's compensation should be included. Moreover, there are other cases where the amount to include is easily identifiable, but makes little sense in terms of providing useful disclosures to consumers. For example, in the staff commentary, Paragraph 32(b)(1)(ii)-2(C) explains how the disclosures should be made when a loan officer is not eligible for any bonus until he or she meets a certain minimum threshold. The fact that a loan officer is only eligible for a bonus after reaching a certain minimum threshold illustrates the primary flaw in this portion of the proposal; the bonus compensation is not being paid directly or indirectly by the borrower but is instead being paid by the lender. This sort of micromanagement of the disclosure process is burdensome for lenders and will only drive up the cost of credit for all borrowers. In the same staff commentary discussed above, the tenth and the eleventh borrower would receive different disclosures for identical loans based simply on when the loan closed. Thus the proposal arguably obfuscates the process, rather than clarifying it.

Equally burdensome is the requirement that "hourly pay for the actual number of hours worked on a particular transaction" be included. Id. at 27,488. For institutions that employ hourly employees, this provision creates a considerable new burden. This proposal essentially requires lenders not just to track employee time overall but to track employee time in a way that enables the institution to determine exactly how many hours were dedicated to processing every mortgage loan. That is an incredibly burdensome new requirement. Moreover, it is of questionable value as the exact same loan with the exact same terms at an institution that uses salaried employees would arguably appear cheaper, even if the actual cost to the borrower is identical, as the salaried employee's time would not be included in the "points and fees" section.

NAFCU understands the statutory language may compel inclusion, to some extent, of incentive compensation paid to in house loan officers. The way in which bonus compensation would be disclosed under the rule, however, is incredibly confusing and creates considerable administrative burdens for lenders. Under the proposal, identical loans will appear to contain different costs, which will only complicate the process of price shopping for consumers. Given the considerable administrative burden and financial cost to mortgage lenders as well as the limited benefit to consumers, NAFCU request the Board use its authority to eliminate the more onerous provisions that would require a complicated record keeping system for both incentive schemes and for hourly employees.

Limits on Points and Fees

The Board proposed two alternatives to limit points and fees on qualified mortgages. NAFCU supports Alternative A, as it is much easier to implement from an operational standpoint. While Alternative B would eliminate some anomalies in the points and fees limit, the formula is unduly complex and its benefits simply do not outweigh the burden it would create. Alternative A is straightforward, easy to execute and still provides consumers considerable new protections.

Balloon Mortgages

The Board requested comment on several issues related to balloon mortgages. Specifically, the Board asked about a cap for institutions that issue balloon mortgages. Second, the Board asked about the time horizon that should be employed in making the ability-to-repay determination for balloon mortgages. Third, the Board asked about the impact of the balloon payment provisions on credit availability.

The statute created an exception to the general ability-to-repay requirements for certain balloon-payment mortgages. However, the exception is somewhat narrow in that only certain lenders – primarily those operating in rural areas where credit is often limited – may qualify for the exception. Among other limits, the Board is required to place a threshold on the number or amount of balloon-payment loans that a creditor may make under the exception. The Board asked whether the limit should be based on the total annual amount of loan originations or if it should instead be based on the number of such loan originations. The Board should not choose one option or the other but should instead create a limit for both the total loan amount of originations and for the total number of covered transactions. Lenders should then be entitled to choose between these two options to determine coverage. Understandably, this will allow some lenders to pick and choose the cap that works best for them. However, this would still be a reasonable mechanism for several reasons.

First, the exception is already fairly narrow; allowing lenders two options to comply would provide some flexibility and help ensure a reasonable number of balloon lenders remain in the market. A per transaction cap, for example, would have a disparate impact on lenders who make a large number of very small loans. Presumably, it is these types of lenders and these types of loans that Congress intended to protect when it created the exception. Second, as discussed below, the balloon-payment provisions will reduce credit in rural areas. Allowing lenders to choose the cap that works best will at least partially alleviate that issue. Further, the Board presumably should be able to set a transaction cap and an aggregate loan amount cap at levels that are more-or-less equal. Consequently, providing an alternative would simply provide flexibility for the lender to choose what works best for its mortgage portfolio without permitting the exception to be undercut.

NAFCU supports the proposed five year time horizon for underwriting the maximum payment for balloon-payment mortgages. First, the five year time horizon is consistent with other provisions in the rule regarding qualified mortgages and refinancing of non-standard mortgages. Moreover, the rationale behind much of the ability-to-repay rule is that consumers failed to understand the true cost and the terms of their mortgages. Accordingly, the rule should be designed to clarify those costs or terms in a reasonable manner. The rule should not be designed to discourage using legitimate products that serve niche markets. Balloon-payment mortgages are not typical. Consequently, it is extremely unlikely that a balloon-rate mortgage would be made if the borrower did not understand the fundamental difference between a balloon-rate mortgage and other mortgages; the requirement for a large, balloon-payment. Permitting creditors to underwrite a balloon loan using the maximum payment during the first five years after closing will provide consumers the information they need to make an educated decision regarding the loan. Alternatively, requiring balloon mortgages to be underwritten using some longer time horizon, intended to capture the balloon-payment would only serve to make the loan look more expensive. There appears little reason to require disclosures in such a manner unless the Board wishes to discourage use of this type of lending product.

The proposed balloon-payment provisions will limit credit availability in rural areas. The balloon-payment exception is limited to lenders that: (1) have less than $2 billion in assets: (2) make more than 50 percent of their loans in certain rural counties; (3) keep virtually all balloon-payment mortgages in portfolio and (4) agree to accept limits on the number or aggregate amount of balloon loan mortgages. Further, new escrow requirements for balloon mortgages have already made offering this product less attractive. Finally, these new rules are being put in place even as the housing market continues to falter. Taken together, this aspect of the rule will certainly impede a recovery in the housing market by limiting the availability of credit. NAFCU makes two suggestions that would provide at least some relief.

First, the Board should absolutely adopt the less restrictive of the two options regarding lenders selling balloon-payment mortgages on the secondary market. Under the Board's Alternative 1, any lender that ever sold a balloon-payment mortgage would forever be prohibited from using the exception. Such a harsh rule makes very little sense from a policy perspective. Accordingly, the Board should, at the very least, adopt Alternative 2, which would limit the prohibited period to the preceding and current calendar years. In NAFCU's estimation, even Alternative 2 is unreasonably narrow; however, it is certainly better than the alternative. Ideally, the Board should limit the restriction to only the current calendar year. Adopting this recommendation would still keep the exception quite narrow but it would provide lenders added flexibility to occasionally sell a balloon mortgage loan without being required to exit the market for a prolonged period of time.

Next, NAFCU recommends the Board expand the definition of "rural" areas. The proposal does little to protect lenders operating in large rural counties that may happen to be located adjacent to a metropolitan or micropolitan area. For example, simply because the far eastern edge of a county is adjacent to a micropolitan area does not mean that people living in the far western edge of the county have easy access to the services available in that micropolitan area. The Board should expand the definition of "rural" areas to include all "noncore" counties, as defined by the Economic Research Service (ERS) of the U.S. Department of Agriculture, which would include codes 4, 6, 7, 10, 11 and 12. The proposal will undoubtedly impact the availability of credit in rural areas. These two suggestions would, however, limit – to some extent – the impact of the proposal on credit availability.

Employment Verification for Military Personnel

The proposal would allow lenders to verify employment in the military by using an existing electronic database maintained by the Department of Defense (DOD). Additionally, the Board requested comment on whether it should permit lenders to use other means of verification, such as a Leave and Earnings Statement. NAFCU supports providing this additional flexibility in verifying income. First, there exist several defense credit union members that have considerable expertise in lending to military personnel. Given their experience in this field, if a credit union determines the Leave and Earnings statement is sufficiently reliable, it should be entitled to use it to verify income. Second, the database the proposal would permit lenders to rely upon is not, in our members' experience, completely reliable.

Refinancing Transactions

The proposal includes an exception for certain refinancing loans. Specifically the mortgage holder of a non-traditional mortgage may refinance the loan into a traditional mortgage provided certain conditions are met. One of those conditions is that the new monthly payment must be "materially lower" than the current monthly payment. The proposal indicates that whether a payment is "materially lower" depends on the facts and circumstances of each transaction but, in any case, a reduction of ten percent or more would satisfy the requirement. NAFCU has several thoughts on this portion of the proposal.

First, NAFCU supports a lower safe harbor threshold. A reduction of five percent or more should satisfy the requirement that the new payment be "materially lower" than the current payment. This figure would better serve the policy interest in permitting refinancing transactions while still ensuring the exception applies only to transactions that provide consumers a meaningful benefit. At the same time, NAFCU recommends the Board also permit reductions of a minimum dollar amount to satisfy the rule. This would be particularly helpful in the context of mortgages for which the monthly payment is already low and for which a ten percent reduction is simply not feasible.

Finally, NAFCU also recommends that the Board provide additional guidance regarding the "facts and circumstances" that a lender should examine in determining if the refinancing results in "materially lower" monthly payments. The Board explains that the monthly payments on the new transaction must be "materially lower" but other than the ten percent safe harbor, provides very little direction as to what would satisfy this requirement. Consequently, lenders will be unlikely to use this exception unless the monthly payment is reduced by at least ten percent. If certain facts and circumstances exist that would warrant using the exception in cases where the payment is reduced by less than ten percent, it would be helpful if the Board would provide guidance to that extent.

NAFCU appreciates the opportunity to share our thoughts on the proposal. Qualified mortgages should carry with them the protection of a safe harbor. If the Board merely provides institutions a rebuttable presumption of compliance, many lenders will have little incentive to make qualified mortgages, which would seemingly undercut the intent behind the provision. Further, NAFCU is deeply concerned with the provisions relating to originator compensation. Requiring disclosure of originator compensation in the "points and fees" is potentially very problematic. It will create considerable new administrative burdens and will likely prove quite costly. Moreover, the actual benefit to consumers is clearly quite small in comparison to the costs for lenders. If you have any questions or concerns, please feel free to contact me.

Sincerely,

Dillon Shea

Dillon Shea
Associate Director, Regulatory Affairs