American SECURITIZATION FORUM®

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: Regulation Z; Truth in Lending Act Proposed Rule
Ability to Repay / Qualified Mortgages
Docket No. R–1417; RIN No. 7100–AD75

Dear Ms. Johnson:

The American Securitization Forum ("ASF")[1] appreciates the opportunity to submit this letter in response to the request of the Board of Governors of the Federal Reserve System (the "Board") for comments regarding its notice of proposed rulemaking (the "Proposed Rule") under Regulation Z regarding the ability to repay requirement for residential mortgage loans enacted under section 1411 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Section 1411 requires that "in accordance with regulations prescribed by the Board," a creditor must make a reasonable and good faith determination, based on verified and documented information, that at the time a residential mortgage 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.

ASF supports reforms that will strengthen the confidence of the capital markets in the underwriting of residential mortgage loans. The private markets will return only with clear knowledge of the nature and quality of those assets. ASF appreciates the consideration the Board has given to its task of implementing the ability to repay requirement that now will apply to all closed-end residential mortgage loans (and not just to higher priced mortgage loans). As a threshold issue, we believe it is essential that the final rule minimize the legal risk to investors in residential mortgage loans. Liquidity in the residential mortgage market relies on investors that reasonably believe that loans are enforceable in accordance with their terms, without unnecessary impairment due to assignee liability or an inability to realize on the collateral. We respectfully request that the final rule (or a subsequent proposed rule, as discussed below)

[1] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory, and market practice issues. ASF members include over 330 firms, including securities issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. The ASF also provides information, education, and training on a range of securitization market issues through industry conferences, seminars, and similar initiatives. For more information about ASF, its members, and activities, please visit www.americansecuritization.com.

balance the important need to protect consumers with the legitimate goal of investors to invest only in assets that are what they purport to be—namely, a loan secured by an enforceable interest in a borrower's residence.

As ASF has described to the Board in previous comments on other rulemakings, over the past decade we have become the preeminent forum for securitization market participants, including investors, issuers, and broker-dealers, among others, to express their views and ideas on important public policy issues. ASF's purpose is to provide industry input on market and regulatory issues, and we have established an extensive track record of reaching consensus on and providing meaningful comment to various regulators on issues affecting the capital markets. This letter represents ASF members' thoughtful deliberation and discussion regarding the potential impact of the Proposed Rule on the capital markets if finalized in its current form. As we understand this rule will be finalized by the new Bureau of Consumer Financial Protection (the "Bureau"), we hope this letter will assist the Bureau in crafting regulations that meet the Dodd-Frank Act's goals of ensuring that creditors try to determine consumers' ability to repay mortgage loans, while promoting the return of a confident and vibrant secondary market for those loans.

I. SIGNIFICANT LEGAL RISK TO PURCHASERS FOR NON-QMS

While the proposed ability to repay requirements apply to creditors, the legal consequences of noncompliance essentially rest with the secondary market. For that reason, ASF is concerned about the Proposed Rule's implementation of the Dodd-Frank Act's ability to repay requirement. In the secondary market for most assets, a purchaser is somewhat shielded (as a holder in due course) from legal risk regarding claims against the assets' originator. However, of course, purchasers of residential mortgage loans face increasing exposure to claims that the loan originator failed to comply with applicable requirements. That increasing risk, many facets of which are explained below, is extensive and difficult to measure, presenting a significant obstacle to rebuilding a secondary mortgage market.

We understand the view that the capital markets should not be insulated against the bad acts of a loan originator, and that as between an innocent consumer and a capital markets participant, the law should protect the consumer—that the sophisticated capital markets have the capacity and willingness to protect themselves. On the other hand, it is the exercise of that capacity and willingness that should give the Bureau pause. If the Proposed Rule is too onerous in its application to the secondary market, then, as with the regulation of "high cost" loans under the Home Ownership Equity Protection Act ("HOEPA"), the secondary market would reduce its participation in the market. Alternatively, the markets might price back to the consumers the increased legal risk.

The Dodd-Frank Act recognized that legal certainty of compliance is required in order to promote a secondary market for mortgage loans. It provides that with respect to any residential mortgage loan, a creditor, and any assignee of that loan, may presume that the loan has met the new ability to repay requirement if the loan is a "qualified mortgage" ("QM"). The Dodd-Frank Act and the Proposed Rule provide guidance on what constitutes a QM and what level of legal certainty a creditor and its assignee may expect in connection with QMs. ASF emphasizes that the numerous questions (addressed below) about the lack of objective criteria for determining whether a loan is a QM, and how little legal certainty the Board/Bureau's rulemaking would actually provide, become of critical importance when considering the significant and perhaps insurmountable increase in legal risk that purchasers face in connection with non-QMs.

A. Assignees Face Defense to Foreclosure for Life of Loan

The Truth in Lending Act ("TILA"), as amended by the Dodd-Frank Act, provides that in spite of otherwise applicable statutes of limitation, whenever a creditor, assignee, or other holder of a residential mortgage loan (or anyone acting on their behalf) initiates a judicial or nonjudicial foreclosure of the loan, or any other action to collect the debt in connection with the loan, a consumer may assert, as a matter of defense by recoupment or set-off, a violation by the creditor of certain new prohibitions that the Dodd-Frank Act created.[2] Among other specified violations, the new defense to foreclosure applies to the Act's new ability to repay requirement. The amount of recoupment or set-off would be limited to the amount to which the consumer could seek in damages against the creditor under TILA (as described below), plus the costs of the action and reasonable attorney's fees.

Thus, while QM loans (to the extent one can determine that a loan is a QM loan) carry some degree of protection against challenge, a non-QM carries the risk for an assignee, without time limits, that a delinquent borrower will challenge a foreclosure or other collection action by claiming that the creditor did not adequately underwrite the loan, and thereby force a modification or settlement, or obtain a significant monetary off-set. The members of ASF are concerned that virtually any foreclosure can be stopped by a mere assertion of wrongful lending.

B. Availability of Significant Monetary Damages Without Regard to Harm

As indicated above, an assignee of a non-QM loan may be subject to a defense to foreclosure in an amount equal to what the consumer could seek in damages under TILA. The Dodd-Frank Act increased those amounts in connection with a class action, and other recent enactments increased the amounts available in an individual action. Specifically, TILA provides that a creditor that fails to comply with any TILA requirement is liable for any actual damages (if any), plus statutory damages of up to $4,000 in an individual action (or up to the lesser of $1,000,000 or one percent of the creditor's net worth) without regard to whether the consumer suffered any harm. The creditor also may be liable for the costs of the action and reasonable attorney's fees.

In addition, for certain violations, including the new ability to repay requirement, a creditor may be liable for "enhanced" damages, equal to the sum of all finance charges and fees paid by the consumer, computed for up to 3 years from the date of the violation, unless the creditor demonstrates that the failure to comply is not material. The types of violations that previously subjected a creditor to enhanced damages were limited to violations of HOEPA,

[2] We note that even prior to the enactment of the Dodd-Frank Act, section 130 of the Truth in Lending Act ("TILA") provided, and continues to provide, that a person may assert a TILA violation in a collection action as a matter of defense by recoupment or set-off in the action, except as otherwise provided by state law. 15 U.S.C. § 1640.

applicable only to high cost mortgage loans. The availability of such significant enhanced damages for HOEPA violations, along with the fact that assignees may be held liable for those violations without holder-in-due-course protection, has lead to the death of any market (secondary and thus primary) for HOEPA loans. The availability of enhanced damages for violation of the ability to repay requirement could similarly impair the non-QM market.

Thus, purchasing a non-QM loan exposes the purchaser to liability for the life of the loan (up until the point at which a foreclosure is initiated), in an amount equal to up to 3 years of finance charges and fees the consumer paid, plus statutory damages awarded without regard to whether the consumer suffered any harm. Once again, assignee liability coupled with significant monetary penalties may undermine the market for non-QM loans, thereby restricting access to credit to deserving borrowers.

C. Aiding and Abetting Liability

The broad authority of the new Bureau also may expose purchasers of non-QM loans (and all other assets) to significant legal risk that is impossible to gauge in advance. Among other significant authority of the Bureau, the Dodd-Frank Act imbued it with the authority to enforce against any acts or practices by a "covered person" that the Bureau deems unfair, deceptive, or abusive, or against any person that knowingly or recklessly provides substantial assistance to a covered person or service provider in committing those acts or practices. Under those circumstances, the provider of substantial assistance is deemed to be in violation to the same extent as the person to which that assistance is provided.[3] The term "covered person" includes any person that engages in offering or providing a consumer financial product or service, including the extension and servicing of consumer loans, and any person acquiring or purchasing those loans. The capital markets must take notice that the Bureau has potential new enforcement powers that expose them to "aiding and abetting"-type liability for (among others) originator violations of the ability to repay requirement for non-QMs, in excess of the explicit assignee liability provided for in the amended TILA.

D. Lower (More Inclusive) HOEPA Thresholds

The pricing for mortgage loans is, to say the least, getting squeezed. It is reasonable to guess that the non-QM market may correlate somewhat with borrowers that represent higher credit risk. That correlation, along with the legal risks explained above, leads to the likelihood that the secondary market will price non-QM loans (if at all) at higher margins than QM loans. In addition, as explained below, recent changes to the thresholds for HOEPA loans and the inclusiveness of the points and fees calculation means that pricing the risk for non-QM loans is likely to cause more loans to be classified as toxic HOEPA loans.

First, the Dodd-Frank Act amended the definition of a HOEPA loan (now officially called a "high-cost mortgage") by significantly lowering the points and fees threshold (and by changing the annual percentage rate metrics). While the regulations previously set the points and fees threshold at 8% of the total loan amount (or an adjusting dollar amount, whichever is

[3] Section 1036 of the Dodd-Frank Act; 12 U.S.C. § 5536.

greater), the new threshold is a mere 5% for loans greater than $20,000.[4] Any dwelling-secured consumer credit transaction with points and fees that exceed that threshold will constitute a HOEPA or high-cost mortgage, subject to significant assignee liability and generally absent from the marketplace.

Second, the Dodd-Frank Act amended the points and fees calculation applicable to HOEPA loans, and to QM loans, to be significantly more inclusive. For example, the amount of compensation paid to a loan originator by a creditor must be included in that calculation. Previously, TILA required the inclusion of amounts paid by the consumer to a mortgage broker, and excluded from the calculation any yield spread premium that the broker may receive from the creditor on the back-end. With the Dodd-Frank Act amendments, not only is the amount of that yield spread premium included in the points and fees calculation, but also any incentive compensation paid by a creditor to its loan officer employees in connection with a particular loan. That amount may include commissions, as well as bonuses and other forms of compensation (besides salary), even if that compensation is paid only at the end of the month or year, and even if the amount is contingent upon other factors such as the loan officer's aggregate origination volume (so long as that compensation can be tied to the particular transaction). The amount of creditor-paid broker or loan officer compensation will significantly contribute to the points and fees calculation, pushing many loans over the HOEPA threshold (not to mention the QM threshold, as addressed in further detail below).

Thus, pricing for the additional risk of non-QM loans (both credit risk and the risk of HOEPA-like assignee liability), along with the enhanced inclusiveness of the threshold calculation, may in fact result in pushing many non-QM loans over the HOEPA points and fees threshold. That will certainly put the nail in the coffin for that segment of non-QMs, which we do not believe was the purpose of the Dodd-Frank Act or the Proposed Rule. (As indicated below, ASF strongly suggests the Bureau use its authority to exclude from the points and fees calculation loan origination compensation paid from a creditor to its loan officer employees, particularly any amounts paid after the time of loan closing.)

E. <u>Consequence</u>

As indicated above, purchasing non-QM loans may be very risky. Assignees of non-QM loans, as described above, would face significant legal risk, and thus the future of a secondary market for those loans is extremely tenuous. The pricing for those loans will be very high, or the private market may simply never develop. Lenders will thus be very conservative if they elect to make any non-QM loans. They will avoid loans that could present more than low risk of default and this will restrict availability of credit. Thus, the Bureau must achieve the proper balance in fashioning the scope of QMs and the protection from risk those loans are intended to carry.

[4] Section 1431 of the Dodd-Frank Act; 15 U.S.C. § 1602(aa).

II. REFUSING TO PURCHASE NON-QM LOANS, OR PRICING SUCH LOANS TO ACCOUNT FOR THE HEIGHTENED LEGAL RISK, HAS ITS OWN SET OF PROBLEMS

Declining to purchase non-QM loans (a reasonable conclusion in light of the significant legal risk of doing so) may also bring real consequences. As mentioned above, it is reasonable to predict that the strict underwriting standards needed to comply with the QM definition will correlate with higher denial rates for certain sets of borrowers – likely those low or moderate income borrowers who rely on flexible underwriting standards. Those higher denial rates for QM loans could occur more frequently among protected classes of borrowers or in declining geographic areas. Thus, a decision not to purchase non-QM loans may disparately affect a protected class of borrowers and lead to discrimination claims. This concern is not diminished by the less drastic alternative of increasing the pricing to account for the lesser liquidity and higher risk, because then the claim could turn from a denial of credit claim to an adverse pricing claim (among other pricing issues, as discussed above). Similarly, the decision to avoid the risk of non-QM loans and thus cause higher denial rates for certain borrowers in certain areas may (for applicable depository institutions) result in lower ratings under the Community Reinvestment Act ("CRA"). Particularly in light of recent increased regulatory and enforcement scrutiny, a decision not to undertake the significant risk of purchasing non-QM loans could result in the risk of fair lending/disparate impact inquiries and/or the threat of lower CRA ratings.

III. PROPOSED RULE'S SUBJECTIVE STANDARDS FOR QUALIFIED MORTGAGES ALSO CREATE LEGAL UNCERTAINTY

As illustrated above, the stakes are very high for the capital markets and consumers, and for the Bureau, in the establishment of the appropriate scope of protection that certain "qualified mortgages" will receive. The Dodd-Frank Act clearly sought to provide legal certainty for creditors and assignees in complying with the ability to repay requirement, by creating a presumption in favor of QMs. A creditor may originate a QM and thereby benefit from a presumption that the loan meets the ability to repay requirement, and that presumption would follow the loan into the secondary market. However, the Proposed Rule provides subjective criteria and scant legal certainty surrounding this most important issue in terms of what is a QM and what is the legal consequence of classifying a loan as a QM.

A. QM Safe Harbor Is Not Safe

The Board states that it could not determine whether Congress intended for the Dodd-Frank Act's legal certainty for QMs to be in the form of a safe harbor, or simply a presumption that is rebuttable by the consumer (or possibly a regulator). However, even if the Bureau determines that Congress intended QMs to enjoy the relative certainty of a safe harbor, the QM definition includes some subjective and vague factors. Thus, there are some aspects of the QM definition that will make it difficult or even impossible to determine, at the time a loan is made, whether or not the loan qualifies.

For instance, the Dodd-Frank Act specifies that a QM is a residential mortgage loan "for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented." A creditor may indeed exert a reasonable, good faith effort to verify and document a consumer's income and financial resources in underwriting a loan, but without any clear-cut standards for accomplishing that task, the creditor and its assignees may be subject to second-guessing. The Proposed Rule declined to take advantage of the authority the Act granted to establish objective guidelines for verifying or documenting a consumer's income or other resources, or for determining whether a borrower can afford any particular level of additional debt or obligations. Thus, even if the Bureau determines that Congress intended the QM to provide a strong safe harbor, in order to facilitate compliance and to reinvigorate private mortgage markets, that protection is weakened by certain subjective criteria, making it difficult for a creditor or its assignee to determine whether a loan is "in" or "out."

The Proposed Rule presents the safe harbor as the option providing creditors with a reduction in regulatory burden and exposure to liability, and thereby providing an incentive to make QMs, since the creditor would be shielded from challenges for failing to underwrite a loan based on the additional factors included under the rebuttable presumption option, described below. However, without quantitative or objective tests, the creditor and its assignees may still be challenged after the fact to prove that the loan actually is a QM. If a court or regulator disagrees with the creditor's subjective determination, then the creditor is left with no legal certainty, and must prove that it made a reasonable and good faith determination at the time that the consumer could repay the loan. With such exposure to second-guessing (including as a defense to foreclosure), the safe harbor is not very safe.

ASF strongly recommends that the Bureau provide an actual safe harbor, that includes objective criteria and provides the legal certainty for creditors and their assignees that the Dodd-Frank Act intended. The Bureau must provide clear standards for the type of income verification and documentation that will satisfy the QM definition. While the Proposed Rule provides that creditors may "look to widely accepted governmental or nongovernmental underwriting standards, such as the Federal Housing Administration's handbook on Mortgage Credit Analysis for Mortgage Insurance on One- to Four-Unit Mortgage Loans," it still does not specify that following those guidelines constitutes a safe harbor. We believe it is essential that a lender be able to defend a contested foreclosure based on the ability to repay requirement with clear, irrefutable proof that the loan is a QM. Any subjectivity, ambiguity, or factual disputes as to whether a loan rises to the level of a QM renders the exception somewhat meaningless

B. QM Rebuttable Presumption More Onerous, Less Safe

ASF joins the multitude of commenters emphasizing that the QM option providing only for a rebuttable presumption, while requiring creditors to undertake more onerous and significantly subjective analyses and determinations, is a false choice. In addition to the criteria for meeting the QM definition for a safe harbor (some of which are subjective and thus uncertain), the QM definition that correlates with this rebuttable presumption alternative contains even more underwriting criteria, all of which are subjective and thus uncertain. Specifically, the creditor must (in addition to verifying and documenting the consumer's income and financial resources and other requirements) make individualized determinations regarding: (1) the consumer's employment status, (2) the monthly payment for any simultaneous loan, (3) the consumer's current debt obligations, (4) the total debt-to-income ratio or residual income, and

(5) the consumer's credit history. However, the Proposed Rule does not provide any quantitative or clear standards for making those determinations. The Proposed Rule even recognizes that this rebuttable presumption QM option provides no legal certainty to a creditor or its assignees, as it preserves the consumer's ability to challenge the creditor's subjective determinations in hindsight, including as a defense to foreclosure. In addition to challenging the creditor's determinations, as the Proposed Rule recognizes, a consumer could assert the primary claim that the creditor did not make a reasonable and good faith determination of the consumer's ability to repay the loan. It is unclear how a creditor (or its assignee) can prove the reasonableness or good faith of its underwriting determinations. Regardless, the fact that the loan is open to such second-guessing and legal risk means that the creditor will have essentially no incentive to make a QM.

C. Mortgage Capital Markets Depend Upon Objective Standards and Legal Certainty

As indicated above, private demand for mortgage loans in the capital markets can only return if the risk can be measured and priced. Thus, those markets generally must be able to determine at the outset and with certainty what type of assets they are purchasing – i.e., whether they are purchasing QMs or non-QMs. Congress recognized this need for certainty by providing the QM presumption of compliance. Congress, as well as the Board and several other federal agencies, recognized this need for certainty in crafting a proposal to define "qualified residential mortgages" ("QRMs"), the proposal for which includes objective ratios and criteria so that the capital markets can clearly determine the nature of a loan in order to craft securitization transactions and price for risk retention.[5] The Dodd-Frank Act instructed those agencies to define QRM to be "no broader" than the definition of QM, recognizing that the criteria for the two concepts must be coordinated and clear.

To the contrary, if the QM safe harbor or presumption is built upon subjective underwriting criteria, such as a requirement to verify a consumer's current or reasonably expected income or assets, there is no way for the creditor or its investors to determine whether or not a loan meets that criteria. The risk that delinquent borrowers (or regulators) may bring factual disputes about the creditor's good faith underwriting in connection with any foreclosure will continue to prevent the capital markets, which we believe otherwise have a demand for solid residential mortgage loans, from purchasing those assets. In finalizing the rule, the Bureau should provide a solid safe harbor, with objective criteria, so that the creditor and its assignees can determine at the time of closing whether or not a loan is a QM.

IV. DEMONSTRATED ABILITY TO REPAY ALSO SHOULD PROVIDE SAFE HARBOR

While objective QM criteria are critical for providing a safe harbor, so that a loan's status as a QM is established and clear to all at the outset, the Bureau also should provide that a

[5] The Office of the Comptroller of the Currency, the Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Federal Housing Finance Agency, and the Department of Housing and Urban Development published a proposed QRM definition as part of their proposed credit risk retention rule in April 2011. 76 Fed. Reg. 24,090.

consumer's demonstrated ability to repay results in safe harbor protection. Specifically, the regulations should, when finalized, provide that if a borrower has successfully performed under a residential mortgage loan by making timely payments for a certain number of months (e.g., 18 or 24 months), the loan is deemed a QM. The rationale is simple. The best evidence of a borrower's ability to repay a loan is the borrower's repayment of the loan for a reasonable period.

ASF understands that this seasoned loan safe harbor may not be available for loans with certain payment shock features, such as negative amortization or interest-only payments, as the borrower's payment difficulties may not have presented themselves. Similarly, for a hybrid adjustable-rate mortgage loan ("ARM"), the "demonstrated ability" safe harbor would measure payments during those months after the payment amounts have begun to adjust. However, aside from those exclusions, if a borrower actually has demonstrated that he or she is able to make timely payments under the terms of the loan, that loan should be deemed a QM, and creditors and assignees should enjoy the legal certainty of a safe harbor. Alternatively, if such a seasoned loan is not deemed a QM subject to a safe harbor, the rule, when finalized, should provide that such a loan is subject to a rebuttable presumption that it meets the ability to repay requirement.

V. PRICING OF QUALIFIED MORTGAGES UNBEARABLY HAMPERED

While ASF members understandably are concerned about the potential legal risk of purchasing non-QM loans, and the uncertainty in determining whether they are, in fact, purchasing such loans, they also are very concerned about the Proposed Rule's parameters for QMs. In particular, as mentioned above, the incredibly tight 3% limitation on points and fees for QMs (under both the safe harbor and the rebuttable presumption) is likely to push many residential mortgage loans into non-QM territory, and even into HOEPA territory, without adding to the goal of assuring that the consumer has the ability to repay the loan. ASF members strongly believe the Bureau should use its authority to exclude this criterion from the QM definition. Indeed, while we recognize that the 3% test is in the statute, it has absolutely nothing to do with the underwriting of the loan, and the Bureau has the proper delegation of authority to exclude such a test.

As indicated above, the Dodd-Frank Act provides that a QM must be one for which the total points and fees payable in connection with the loan do not exceed 3% of the total loan amount. For this purpose the Act defines "points and fees" to mean "points and fees" as defined by HOEPA (as revised by the Act), but excluding a limited number of "bona fide discount points" payable by the consumer so long as the interest rate (before discounting) does not exceed a certain threshold, and excluding bona fide third-party charges not retained by the creditor, loan originator, or an affiliate of either. This 3% limitation on points and fees is unduly tight – only two percentage points below a HOEPA loan – the calculation is overly inclusive (as explained above), and the exclusions are unclear and difficult to establish, making the origination of a QM nearly impossible.

A. Points and Fees Calculation for QMs is Overly Inclusive

As we describe below, the points and fees calculation has been expanded – not just for HOEPA loans, but also for QMs. Thus, just as it will be much more difficult to avoid HOEPA assignee liability due to the tight points and fees threshold, it will be much more difficult to comply with the QM limit on points and fees.

As mentioned above, the Dodd-Frank Act now includes within "points and fees" the amount of creditor-paid loan originator compensation. We believe the original inclusion of these amounts in the definition was intended to address yield spread premiums paid by lenders to mortgage brokers, which HOEPA previously did not include but many state "high cost loan" laws do. As a threshold issue, the concern over yield spread premiums is separately addressed in the Dodd-Frank Act's anti-steering provisions. We believe the Bureau could address the Congressional concern by limiting the inclusion of compensation paid to originators to that which is otherwise regulated under those anti-steering provisions.

While the Board (and Congress) is concerned about yield spread premiums paid to mortgage brokers, requiring those amounts to be included in the points and fees calculation will in no way help ensure that a creditor has determined the consumer's ability to repay. Further, that concern about yield spread premiums certainly does not pertain to compensation paid by a creditor to its employee. The inclusion in a loan's points and fees calculation of compensation that a creditor pays its loan officer employees is unrelated to amounts paid by a consumer and thus wholly unrelated to the consumer's ability to repay the loan. It is likely to make many otherwise solidly underwritten mortgage loans fall out of QM (i.e., reasonably marketable) territory. The Proposed Rule also recognizes that inclusion of those amounts will be considerably complex, by surprisingly including amounts the creditor pays at any time, whether at or before closing or anytime after closing (as long as that compensation amount can be determined at the time of closing). Thus, if a loan officer receives a certain level of basis points for originating 10 loans per month, but a certain higher level for originating 11 or more loans per month, that higher level of compensation must be included in the points and fees calculation for the 11th and subsequent loans that month, even though the 11th borrower does not pay any more for that transaction than did the 10th. If the Bureau decides to include a points and fees threshold in the QM definition, it should use its authority to exclude from that calculation any compensation paid by a creditor to its employees, particularly any amounts paid after closing.

Also, as indicated above, the Dodd-Frank Act amended the definition of "points and fees" to include (i) the maximum prepayment fees and penalties that may be charged or collected under the terms of the credit transaction, and (ii) all prepayment fees or penalties that are incurred by the consumer if the loan refinances a previous loan made or currently held by the same creditor or an affiliate of the creditor. The Proposed Rule would define "prepayment penalty" very broadly, to include amounts that are not customarily considered to be prepayment penalties, such as interest charges resulting from a practice of treating payments as received on their scheduled due date, although the borrower may have prepaid the loan in full before that date. It also would include closing cost amounts a borrower agrees to reimburse to the lender if the borrower prepays the loan before a certain agreed-upon time. Thus, although the permissibility of prepayment penalties are significantly limited under the Dodd-Frank Act (and the Proposed Rule), the inclusion of these fees, particularly as so broadly defined, in the points and fees calculation will contribute to pushing many loans over the QM threshold.

B. Points and Fees Exclusions for Bona Fide Charges Should be Revised

In addition, the exclusions from the points and fees calculation for bona fide discount points and third party charges are welcome, but limited in amount and applicability, and arguably difficult to prove. The term "bona fide discount points" applies only to amounts the consumer knowingly pays for the purpose of reducing, and which in fact result in a bona fide reduction of, the interest rate or time-price differential applicable to the mortgage loan. The "bona fide" nature of those amounts, and the consumer's knowledge regarding those amounts, are subjective and difficult to prove. Further, as the Proposed Rule recognizes, the points charged to the borrower generally include risk-based price adjustments, such as those issued by Fannie Mae and Freddie Mac (the "GSEs") in publicly-disclosed tables based upon the features of the loan or the consumer (e.g., the loan to value ratio or the credit score). The Proposed Rule states that the Board is aware that creditors must pass along those risk-based loan-level pricing adjustments in setting the rates and points for consumers. Without the ability to pass those fixed amounts along to the borrower as up-front costs for the loan, the creditor would be required to raise its interest rates. However, the Proposed Rule does not expressly clarify that those amounts constitute either bona fide discount points or bona fide third-party charges. Thus, while those amounts are paid to third parties, available to the public, based on fully objective criteria, and result in the creditor's ability to charge lower interest rates, it is unclear whether the Bureau would allow those amounts to be excluded. If the Bureau decides to include a points and fees threshold in the QM definition, ASF members strongly encourage the Bureau to exclude from that calculation the amount of any GSE or other investor loan-level pricing adjustments that are publicly-available, objectively-defined, and not retained by the creditor.

VI. PREPAYMENT PENALTIES DEFINITION SHOULD EXCLUDE INTEREST

The Dodd-Frank Act amended TILA to provide significant restrictions on prepayment penalties. Prepayment penalty restrictions on both the federal and state level have proliferated, dating back to the initial push to curb anti-predatory lending a decade ago, particularly in connection with higher priced mortgage loans. Now, in establishing the concept of a QM, the Dodd-Frank Act provides that loans that fall outside the scope of QM generally should not include prepayment penalties.

The Proposed Rule thus provides parameters for the types of loans that may and must not contain a prepayment fee. Under the Proposed Rule, a residential mortgage loan must not include a prepayment penalty unless the transaction is: (i) a QM (according to whatever definition is finally promulgated); (ii) a fixed rate or step-rate mortgage loan (i.e., the annual percentage rate cannot increase after consummation); and (iii) not a higher-priced mortgage loan. Even then, the prepayment penalty must not exceed 3% of the outstanding loan balance during the first year after consummation, 2% during the second year, and 1% during the third year. Thus, under the Proposed Rule only fixed-rate QMs that are not higher-priced may have a prepayment fee, and no closed-end residential mortgage loan (QM or non-QM) may have a prepayment penalty after the end of the third year after consummation. Additionally, a creditor offering a consumer a loan with a prepayment penalty (permitted only under the limited circumstances above) must also offer that consumer a loan without a prepayment penalty.

For these purposes (and for purposes of the points and fees calculation), the Proposed Rule proposes to codify a definition of "prepayment fee" that will create significant obstacles, particularly in connection with loans insured by the Federal Housing Administration ("FHA"). Specifically, the Proposed Rule would define "prepayment penalty" to include, in addition to a charge for paying all or part of a transaction's principal before the date on which it is due, a charge determined by treating the loan balance as outstanding for a period of time after prepayment in full and applying the interest rate to that balance, even if the charge results from the interest accrual amortization method used for other payments in the transaction. The Proposed Rule would provide a clarification in the Commentary of Regulation Z, stating that "interest accrual amortization" refers to the method used to determine the amount of interest due for each period (for example, a month) in a transaction's term.

This prepayment penalty interpretation directly implicates FHA loans in Ginnie Mae pools, under which federal guidelines require loan payments to be treated as being made on the scheduled due date (i.e., the end of the month) so long as the payment is made prior to the expiration of the grace period. This interest calculation method allows borrowers to make payments after the due date (but during the grace period) without incurring late fees or other penalties, as payments received during that time are considered to be received on the due date. However, if the borrower prepays his or her FHA-insured loan in full on a date other than the due date, interest nonetheless accrues on the remaining balance until that date, and that interest is collected from the borrower and must be paid through to the investors.

The Board has relied upon that definition of prepayment penalty previously, in connection with restrictions applicable to higher-priced mortgage loans. The Department of Housing and Urban Development ("HUD") explained Ginnie Mae's requirements and assured the Board that HUD does not consider the final interest payment as a prepayment penalty, but simply the result of the interest calculations for all payments under such loans. In the Board's response to HUD in September 2009, Saundra Braunstein of the Board's Division of Consumer and Community Affairs assured HUD that lenders following Ginnie Mae's requirements would not have to treat the interest charged from the date of prepayment until the next scheduled due date as a prepayment fee (see Attachment 1 hereto). The Board stated that creditors may rely on that response letter as an official interpretation of Regulation Z, and to our knowledge the Board has not withdrawn that interpretation.

As the Board recognized in that letter, the interest charge is not a prepayment penalty, but rather it constitutes an amount due in accordance with the treatment of all payments under applicable loans. The lender/servicer does not retain that amount, as federal guidelines require it to be passed through to investors. While certain FHA loans in Ginnie Mae pools may constitute fixed-rate QMs that are not higher-priced and for which prepayment penalties are permitted for the first three years, the Proposed Rule would still significantly limit the amount of "prepayment penalties" during that time (not to mention require the lender to offer the consumer a loan without a "prepayment fee").

The Board's changed interpretation with regard to these amounts thus will create a significant hardship for persons servicing Ginnie Mae loan pools, as they are required to transmit over those interest amounts, and thus will have to pay them out of their own pockets. The Board appears to recognize that its broad interpretation will have a significant effect on the availability of FHA loans. Since the amounts are not abusive prepayment penalties, and the Dodd-Frank Act could not be construed as intending such obstacles to the FHA program, the Bureau should continue to define a prepayment penalty to exclude amounts of interest the consumer must pay if the charge results from the interest accrual amortization method used for other payments in the transaction.

VII. COORDINATION OF REGULATORY EFFORTS

The ability to repay requirement of the Dodd-Frank Act was Congress's attempt to shore up the underwriting processes of residential mortgage lenders – to ensure that they make solid loans under which the borrower can likely perform (i.e., QMs). The Dodd-Frank Act also, of course, addressed the strength of residential mortgage lending decisions from another angle – by attempting to instill discipline in those decisions through credit risk retention requirements, with the exception of solid mortgage loans that present a lower risk of default (i.e., QRMs).

Although Congress intended the agencies to coordinate those definitions, by insisting that QRMs be no broader than QMs, the agencies have proceeded on divergent tracks. Unlike in the Board's Proposed Rule, the joint agencies' proposal for QRMs is more objective, providing express underwriting ratios, and it defines "points and fees" somewhat differently. Different agencies will be considering the comments and finalizing the two different rulemakings, perhaps on a different timeline, and different agencies will be called upon to enforce the two rules. However, consistent objectivity across the QM standards and the QRM standards is imperative – nearly as important, for the capital markets' purposes, as the minute details of the standards themselves. ASF strongly urges the Bureau to work with the other agencies to produce residential mortgage loan standards that are appropriately coordinated with equally objective criteria.

VIII. ANOTHER ROUND OF RULEMAKING/COMMENTS

With the occurrence of the "designated transfer date" for the Bureau, the Proposed Rule is a unique rulemaking that one agency proposed and another agency will consider and finalize. The Dodd-Frank Act contemplated that with the unprecedented mandates of the new agency, the Bureau would need sufficient time to finalize all the required rulemakings. Thus, the deadline for the issuance of a final rule in this rulemaking is not until February 2013. While the Board had a significant amount of work to do in preparation for the designated transfer date, the Bureau can now move with consideration and deliberation to ensure that the ability to repay requirements and their safe harbor are appropriately structured to protect the consumer and to facilitate the capital markets. Given all the serious comments provided in this comment letter, and the others the Bureau will surely receive, ASF respectfully requests the Bureau to consider those comments thoroughly, and issue a subsequent proposal for comment.

IX. CONCLUSION

ASF understands that Congress intended to hold the capital markets responsible at some level for the underwriting violations of creditors. At the same time, Congress sought to carve out a category of loans that did not present the same risk of default and as to which assignee liability through a defense to foreclosure would not be present. We believe it is essential that the Proposed Rule be revised to clarify with certainty the definition of a QM and the legal consequence of a loan rising to the level of QM status. Given that fixed income capital generally flows to predictable and stable uses, there likely will be a market reaction to non-QM loans in the form of appreciably lower liquidity and higher prices. As such, reasonable access to moderately priced credit will depend on a bright line test of a QM. Moreover, it is essential for the functioning of the secondary markets to synchronize the definitions of QM and QRM with equally objective criteria so that the legal risk and the applicability of credit risk retention requirements are easily discernible up front.

Thank you for your consideration.

*   *   *   *

ASF very much appreciates the opportunity to provide the foregoing comments in response to the Board's Ability to Repay / Qualified Mortgage Proposed Rule. If you have any questions or would like any clarification concerning the matters addressed in this letter, please feel free to contact me at 212.412.7107 or tdeutsch@americansecuritization.com, Evan Siegert, ASF Managing Director at 212.412.7109 or esiegert@americansecuritization.com, or ASF's outside counsel on this matter, Larry Platt of K&L Gates, LLP at 202.708.9034 or larry.platt@klgates.com.

Sincerely,

Tom Deutsch

Tom Deutsch
Executive Director
American Securitization Forum

Attachment 1

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SANDRA F. BRAUNSTEIN
DIRECTOR
DIVISION OF CONSUMER
AND COMMUNITY AFFAIRS

September 29, 2009

Shaun Donovan
Secretary, U.S. Department of Housing
And Urban Development
451 Seventh Street, SW
Washington, DC 20410

Dear Secretary Donovan:

In July 2008, the Federal Reserve Board ("Board") issued final rules amending Regulation Z, which implements the Truth in Lending Act (TILA). The July 2008 final rules adopted new protections for consumer mortgage loans, including several provisions that address recent problems in the subprime mortgage market. (73 FR 44522, July 30, 2008). Among other things, the July 2008 final rules define a class of higher-priced mortgage loans that are subject to certain protections. One protection involves prepayment penalties. Higher-priced mortgage loans may not have a prepayment penalty for longer than two years and, for some higher-priced loans, prepayment penalties of any duration are prohibited. The provisions concerning prepayment penalties are applicable to higher-priced loans for which a creditor receives an application on or after October 1, 2009.

You have asked whether the provisions limiting prepayment penalties would apply to certain FHA loans beginning on the October 1, 2009 effective date. In particular, you have asked whether FHA loans are covered by the Board's staff commentary to Regulation Z that provides that prepayment penalties include any "interest charges for any period after prepayment in full is made." See 12 CFR part 226, comment 226.18(k)(1)-1. You note that under FHA programs, for purposes of allocating a consumer's payment to accrued interest and principal, all loan payments are treated as being made on the scheduled due date so long as the payment is made prior to the expiration of the payment grace period ("monthly interest accrual amortization"). For example, if the consumer's installment payment of principal and accrued interest is due on the first day of each month, the portion of the payment that will be allocated to accrued interest is the same, whether the creditor receives the payment on the due date, an earlier date (such as the 20th of the previous month), or shortly after the due date. Under this arrangement, we understand that consumers would not be penalized for making payments during the grace period because all timely payments are considered to be received on the payment due date for purposes of calculating the accrual and payment of interest. At the same time, we understand that consumers that make early payments are treated as having paid on the payment due date and do not receive any reduction in interest due.

We understand that the same monthly interest accrual amortization method is also used when the consumer prepays the loan in full. Thus, if the consumer's prepayment occurs 10 days before the payment due date, the consumer owes the same amount of interest as if the prepayment occurs on the payment due date. You have advised the Board that, for federally-insured loans, due to the monthly interest accrual amortization method, HUD has not considered the payment of interest after the prepayment date as a prepayment penalty and has advised lenders that they need not disclose this practice as a prepayment penalty for these loans.

The Board's staff commentary noted above provides guidance about prepayment penalties but does not address the specific situation involving loans that generally use the monthly interest accrual amortization method. In light of the guidance given by HUD regarding the payment of interest after the prepayment date, and the fact that the Board staff commentary on this issue does not expressly address this issue in the context of monthly interest accrual amortization, Board staff believes that lenders that use such an interest accrual method discussed above may continue to follow that practice. Lenders that engage in this practice would not be required to treat the interest charged from the date of prepayment until the next installment due date as a prepayment penalty for any purpose under Regulation Z. Staff also believes that lenders who have followed this practice in the past have acted reasonably and have complied in good faith with the prepayment penalty provisions of Regulation Z in this circumstance, whether or not the additional interest was treated or disclosed as a prepayment penalty under Regulation Z.

We understand that HUD is considering revising this portion of its rules and FHA loan agreements. In addition, over the coming months, staff expects to review the staff commentary and consider whether the commentary should be changed to address specifically this aspect of FHA and other lending programs, including whether the commentary should be changed to treat this feature as a prepayment penalty.

Creditors may rely on this letter as an official interpretation of Regulation Z and, under TILA, liability will not apply to actions taken in good faith reliance on the guidance set forth in this letter, to the same extent as if this guidance were set forth in the commentary to Regulation Z.

Sincerely,

Sandra F. Braunstein

cc: David Stevens, Assistant Secretary & Commissioner
Federal Housing Administration

Thomas R. Weakland, Acting Vice President
Government National Mortgage Association