



Consumer Federation of America

1620 I Street, N.W., Suite 200 * Washington, DC 20006

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, Docket No. R-1417, RIN 7100-AD75

Dear Ms. Johnson:

Thank you for the opportunity to share our comments on Proposed Rulemaking 12 CFR 226, Regulation Z, Docket No. R-1417, RIN 7100-AD75 addressing changes in the Truth in Lending Act. We respectfully submit these comments on behalf of Consumer Federation of America (CFA). Consumer Federation of America (CFA) is a nonprofit association of some 300 national, state, and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education. . We have also joined the Center for Responsible Lending (CRL) and the National Consumer Law Center (NCLC) in a separate comment letter that is being submitted under separate cover.

The proposed rule would establish important consumer safeguards for mortgage lending. The recent crisis illustrated all too clearly the importance of having clear rules of the road that creditors must follow in extending credit to consumers. Purchasing a home is the largest investment most consumers will ever make. Whether purchasing a first home, a trade up, or refinancing an existing home loan, the mortgage transaction is likely to be the most complicated financial transaction in which most consumers will participate. The size of the obligation and the significant portion of income that must be devoted to the mortgage loan and associated homeownership costs make the quality of the underwriting that determines the size and terms of the mortgage that a consumer is offered of the highest priority.

The Dodd-Frank legislation recognized that during the last decade there was a significant deterioration in underwriting standards for home mortgages. Regulators allowed lenders in both the regulated and unregulated marketplace to stray far from the traditional and dependable standard that a creditor should base credit decisions on whether or not the borrower has a reasonable ability to repay the debt. The legislation restores this focus on sound underwriting in Title XIV by requiring mortgage lenders to base their underwriting decisions on this simple principle of ability to pay. We strongly support this intention of Title XIV. Reestablishing creditors' obligations to act as a responsible counterparty by accurately and honestly assessing a borrower's ability to repay a debt is of paramount importance in reestablishing a functioning mortgage market.

The legislation also created a so-called "qualified mortgage" provision through which lenders could attain a presumption of meeting the statute's ability to pay requirements. We also strongly support this approach as a means of encouraging lenders to focus primarily on loans that have the safest and most reliable features, and to offer consumers products that are safe, sustainable and stable.

Safe Harbor vs. Rebuttable Presumption

The Board has proposed two alternative means through which to execute the "qualified mortgage" provisions of the legislation. Alternative 1 would establish a legal safe harbor for loans that meet four specific criteria drawn from the broader ability to pay standards. Alternative 2 would establish a rebuttable presumption of compliance that would require a creditor to meet the four tests of Alternative 1 along with an additional five criteria.

We do not believe the statute supports the adoption of Alternative 1. Moreover, we believe its adoption would be a major step away from the important expectations that Dodd-Frank meant to establish for creditors. We strongly support the adoption of Alternative 2, with suggested modifications and clarifications discussed in more detail below.

The legislation clearly states in TIL §1639c(b) that

"(b) PRESUMPTION OF ABILITY TO REPAY.—

"(1) IN GENERAL.—Any creditor with respect to any residential mortgage loan, and any assignee of such loan subject to liability under this title, may presume that the loan has met the requirements of subsection (a) [the ability to repay provision], if the loan is a qualified mortgage.

We believe that this section is clear and direct – Congress intended to establish a presumption of compliance with the ability to pay standard, not create a legal safe harbor.

The Board suggests in the proposed rule that a safe harbor will encourage lenders to emphasize loans that meet the QM definition. We believe that Alternative 2 will also accomplish this goal, and will do so while assuring consumers of significantly greater protection from abusive or ineffective underwriting than the standard proposed in Alternative 1. The Bureau is likely to receive comments arguing that private lenders will be unable to offer a wide range of products or adequately serve all populations -- particularly diverse populations – unless they are granted a legal safe harbor. It is true that lending volumes are down and credit has become much more difficult to obtain for even well-situated applicants. Uncertainty over the impacts of a host of new regulations, as well as new domestic and international capital standards, the state of the economy, unresolved questions about government support for mortgage finance, a separate pending rulemaking on the Qualified Residential Mortgage (QRM) exemption to the risk retention requirements of Title IX of Dodd-Frank, unemployment and consumer demand all weigh on the industry and play a role in its diminished scale.

But we do not agree that the adoption of Alternative 2 will further exacerbate this situation, and do not believe it should lead to a severe cutback in credit. Consumers were subjected over the last 10 years to a wide range of abusive lending practices. The evidence is clear that without strict guidelines and consumers' ability to pursue relief where lending standards have been ignored or applied inappropriately, weak and even fraudulent underwriting can victimize consumers. Moreover, we do not believe that the penalties to which lenders could be subject on a finding of failure to meet the ability to pay standard are so injurious or even so likely to be applied in all but the most egregious situations that they provide a meaningful risk to lenders. Nevertheless, they will provide an important potential avenue of relief for any borrower that is granted credit that s/he could not reasonably have been expected to repay. Lenders that follow the rules and ensure that their loan originators are using sound, well documented and verified underwriting will, we believe, be well protected by the proposed rebuttable presumption in Alternative 2.

Under the proposed rule, lenders would be eligible for the Alternative 1 legal safe harbor by meeting four criteria:

1. The loan does not contain negative amortization, interest-only payments, or balloon payments, or a loan term exceeding 30 years;
2. The total points and fees do not exceed 3 percent of the total loan amount;
3. The borrower's income or assets are verified and documented; and
4. The underwriting
 - a. Is based on the maximum interest rate in the first five years,
 - b. Uses a fully amortizing payment schedule, and

- c. Takes into account any mortgage-related obligations.

Unfortunately, these criteria exclude several important provisions that are required under the broader ability to repay standard that applies to non-QM loans, an exception that we find difficult to understand and impossible to support. Loans qualifying for the QM should represent the best underwritten and most fully documented loans, hence justifying some form of protection from future claims.

Therefore, we strongly support Alternative 2, which would require creditors to meet the criteria above *and* consider and verify

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 (DTI) ratio or residual income; and
5. The consumer's credit history.

We would add to these a further requirement, which is that when assessing the consumer's income and determining whether the consumer will be able to meet the monthly payments that other recurring but non-debt related expenses also be taken into account. Many consumers, and especially low- and moderate income consumers, face significant monthly recurring expenses. While these will not show up as debt or mortgage related expense, they nevertheless can make a large claim on disposable income and, together with a mortgage payment, consume an unreasonably large portion of a household's income. Such expenses as medical supplies or prescriptions and child care expenses needed to enable the borrower or co-borrower to work outside the home are only two important examples of such obligations. Even where the percentage of disposable income in such situations seems reasonable, the nominal amounts left to low and moderate income borrowers may be too small to enable such households to reasonably meet all their obligations. This could put their ability to repay the mortgage in jeopardy. We strongly believe that the QM standard should require lenders to consider such obligations in making the overall determination of whether a consumer has the ability to repay the proposed mortgage debt.

We strongly urge the Bureau not to create a "safe harbor." The statute itself struck a balance: consumers' have the right to turn to the courts for justice where no reasonable and good faith consideration of ability to pay was made, but the creditors are protected from excessive liability by a multitude of protections within the statute itself. The creditors' cry that they face "draconian" litigation risks without a safe harbor is overblown. It is the same hyperbole that has accompanied every reform for decades, and it has never proven accurate. We believe that the safe harbor would, once again, mean that there is very little accountability for violating the law, which will undermine its effectiveness. The absence of accountability was part of the reasons the crisis metastasized. We must not repeat that mistake. But if the Bureau decides to move

forward with Alternative 1 and make the QM a legal safe harbor, then we strongly urge the Bureau to expand the criteria and add all of those now included in Alternative 2.

These views are expanded on with greater detail in the comment jointly submitted by CFA, the Center for Responsible Lending and the National Consumer Law Center, referenced earlier.

Calculation of points and fees

The proposal seeks comment on whether to use specific cut-offs to implement the legislation's direction to allow a higher total of points and fees, or to use instead a more complex but potentially more sensitive sliding scale calculation. While we do not want to disadvantage borrowers of smaller loans, a high proportion of whom are likely to be low and moderate income families and families of color, we also support a simple and straightforward rule that minimizes both purposeful and inadvertent miscalculations that could harm consumers. We therefore support the fixed cut-off approach proposed in the regulation.

The proposal seeks comment on whether to use the "total loan amount" or the "principal loan amount" as the basis on which to determine the 3 percent limitation on points and fees. We support excluding prepaid finance charges from the denominator of this calculation. To do otherwise would encourage the financing of points and fees to the detriment of the consumer, adding not only initial cost but increasing the lifetime interest charges on the financed total. We believe it was the intent of the cap on points and fees to limit the opportunities to charge consumers beyond a reasonable amount.

We support the proposal to exclude from the calculation of points and fees insurance and guaranty fees under state and federal programs.

We support the inclusion in calculating points and fees of compensation paid directly to a loan originator, whenever that compensation occurs, whether at or before closing or at any time thereafter. The intent of this provision is to protect consumers from paying excessive amounts for lender services, regardless of when that compensation is awarded. The proposed rule would insure that the points and fees cap appropriately accounts for payments loan originators receive for selling a mortgage to a consumer.

We support the Board's proposal to include in points and fees qualified mortgage fees paid to lender affiliated settlement services providers.

We support the inclusion of all upfront premiums and charges for credit insurance and debt cancellation and suspension coverage in the definition of points and fees. These are services that are sold to consumers as part of the mortgage origination process and can potentially add

significant costs. There is no defensible reason to exclude them from the overall restriction on points and fees.

We strongly support including in the calculation of points and fees any prepayment penalty assessed by the lender, if the lender or its affiliate is the holder of the original loan. Many consumers were victimized by “loan flipping” during the housing bubble, and lenders profited from collecting fees to refinance these mortgages, which consumers might otherwise have been unable to pay. This results in a piling on of charges and stripping of equity from the consumer. This is very different than an arms-length transaction where the consumer chooses to refinance one loan with lender A with a new loan with lender B. Lender A may receive a prepayment penalty, but lender B is not incented to extend the refi loan in order to obtain that fee. Requiring such payments to be included in the points and fees calculation when the original lender is reaping the benefit is sensible and will provide much needed protection from potential abuses.

Simultaneous Loans

The board seeks comment on its proposal to include HELOCs as simultaneous loans in refi as well as purchase loans. We support doing so. While much of the most widely known recent abuse in simultaneous loans occurred in the purchase money context, there is no compelling reason to exclude a calculation of the cost of a simultaneous loan when it is extended as part of a refi.

Ability to Repay

We support consideration of any self-reported likely changes in the consumer’s employment or income that would reduce his or her ability to repay the loan. We are less supportive of allowing assertions of future earning potential, whether or not verified by third party documentation, in determining ability to repay. Sound underwriting should “hope for the best, plan for the worst” in order to protect both the debtor and creditor from unforeseen events that could jeopardize the debtor’s ability to repay the loan. Speculating on potential increased income is not a sound basis for underwriting a loan. In fact, there is some evidence from examinations of underwriting practices at the height of the mortgage boom that creditors *encouraged* borrowers to overstate their income on the premise that “you could be earning that in the near future.” Creditors should be expected to exercise sensible diligence and count on earnings that are documented. They should discount those earnings in light of any self-disclosed information from the applicant that suggest they are an unreliable basis on which to make a determination of ability to repay.

The Board proposes to implement the statutory requirement that income verification in TILA Section 129C(a)(4)(B) be both “reasonably reliable” and to be able to “quickly and effectively”

verify such income by requiring the use of third-party records that are reasonably reliable and providing examples of reasonably reliable records that creditors can use efficiently to verify income and assets. We support this proposal. The goal of including third-party verification rules is to provide maximum access to credit by applicants who may need to rely on less conventional third-party documentation while ensuring the accuracy of the information and the efficiency of the process. While the statutory language signals the importance of both aspects of this process—reliability and efficiency—the Board’s approach ensures that both concerns are met in the verification process. Efficiency without reliability would serve neither creditor nor borrower. While reliability is the paramount concern, maintaining efficient systems that produce reliable results will enhance access to credit. The particular list provided by the Board is helpful in identifying certain types of income verification that may be used by low and moderate income homeowners and that may not be typically included in the industry’s list of verification protocols, including check cashing receipts, government benefits letters, employer records with consumer-specific information, financial institution records, and funds transfer records.

The Board should not provide an affirmative defense for a creditor that can show that the amounts of the consumer’s income or assets relied upon in determining the consumer’s repayment ability were not materially greater than the amounts the creditor could have verified using third-party records at or before consummation. One of the key lessons of the current foreclosure crisis, and one of the key requirements in Dodd-Frank, is that income verification is a baseline requirement for responsible lending. The establishment of an affirmative defense would defeat the statute’s purpose and give creditors carte blanche to thumb their noses at common sense business practices and decency. Finally, the process for determining whether an income verification discrepancy is “material” is subjective and likely to ignore the real-life impact of small payment differences on low and moderate income homeowners. Such leeway would leave homeowners with adequate but limited income at the mercy of certain creditors who would be willing to take such chances in the hopes that the court, if one ever looked at the case, would find the discrepancy to be minimal.

The Board proposes to replace the legislative ban on basing ability to repay on a borrower’s equity with a ban on using the collateral’s *value* for this purpose. We strongly oppose this and urge the Bureau to restore the use of “equity” in this provision. By requiring an examination of income and assets, and not equity, the statute focuses on affordability and discourages the making of loans that increase the loan amount simply to provide fees to a loan originator (an incentive that may increase now that other forms of compensation are better-regulated). These loans typically provided minimal cash-out, if any, and were characterized by higher rates and fees than the loans they were refinancing. The Board without basis assumes that Congress mistakenly meant “value” when it specified “equity.” The Board assumes the concern here was the foreclosure value of a home. It is essential that the notion of a ban on lending based on equity remain in the rules because a ban on lending based on value will not necessarily protect a homeowner who receives a loan based on equity if the value of the home is low. While the

statute requires an affordability analysis, removal of the ban on equity-based lending would open up a loophole that could harm consumers.

The Board proposes to allow creditors to “look to widely accepted governmental and non-governmental underwriting standards in determining...” a number of the factors it would require lenders to take into account when establishing a consumer’s ability to repay. We strongly support the Board’s decision *not* to incorporate hard and fast “bright line” limits or standards in the rule and to give creditors the ability to look to such standards. As the Board notes elsewhere, consideration of any one factor, such as debt to income ratio or residual income, without considering other potentially compensating factors, like liquid assets, could inadvertently deny credit to some consumers who could repay the obligation. We believe the legislation’s principal purpose was to restore an obligation on the part of creditors to thoroughly underwrite debtors and to use widely accepted and standardized factors to do so. We note that Fannie Mae and Freddie Mac underwriting guidelines, along with FHA’s, long provided a reference standard for lending that served as an effective benchmark to insure adequate documentation and consideration of the most relevant underwriting factors. These guidelines permitted the balancing of an individual borrower’s strengths and weaknesses to arrive at a comprehensive assessment of their ability to repay. The factors that the legislation requires to be taken into account in making this determination include a wide enough variety that these strengths and weaknesses could be assessed.

The worst-performing loans that led the housing sector into a crisis were plainly and aggressively well outside the parameters of these standards. Yet one could argue that these inadequate and ultimately disastrous “standards” were “...widely accepted...” in the non-governmental subprime and Alt-A mortgage market. We therefore recommend that the Board further qualify this provision by requiring that the standards used should be those validated by experience, either through long-standing application from which loan performance can be adequately predicted, or sanctioned by a governmental body, such as FHA or FHFA, or state agencies actively involved in the assessment of credit risk.

These standards should include those incorporated into automated underwriting systems, such as Desktop Underwriter© and Loan Prospector©, subject to the same limitations, eg., that they can demonstrate sufficient, documented success in underwriting and/or they have been sanctioned by FHA, FHFA, or a state agency directly involved in the assessment of credit risk. Automated underwriting systems present particular challenges with respect to transparency and accountability. Many lenders have proprietary AUS; some of these were employed during some of the most aggressive and disastrous lending in the 2000’s. The Bureau should exercise caution in approving the use of these tools, limiting its approval to those that are well proven and/or overseen by third parties. The Bureau should further require creditors to document as part of the underwriting process what standards were used in making the determination.

The Board seeks comment on whether to include in the determination debt that is disclosed in a third party document, but not by the borrower, and vice versa. We strongly support consideration of *all* debt to which the borrower is obligated, regardless of how it is disclosed. Lenders should have an affirmative responsibility to act on information they reasonably can expect to be reliable and true.

The Board has asked for comment on whether debt that is nearly paid off should be included in considering on-going debt burdens. We note that this kind of debt can come in many “flavors,” and recommend that the final rule direct lenders to consider the likely impact of such debt on the consumer’s ability to repay the loan, taking into consideration other relevant underwriting factors, such as liquid reserves after closing. One hoped-for outcome of the legislation and the rule is that lenders will take borrowers’ circumstances into account and, where appropriate, counsel them to reduce outstanding debt, and/or refrain from taking on additional debt after the mortgage closing. Many borrowers believe that if a lender approves a mortgage that the consumer must therefore be able to repay it. Lenders can play a crucial role in a unique “teaching moment” to help consumers use credit responsibly while helping to increase the likelihood that a debt will be repaid.

The proposed rule would require lenders to use the fully indexed rate, using a fully amortizing schedule, following consummation in considering the consumer’s ability to repay a variable debt instrument. The board seeks comment on whether to apply this test to the loan amount at consummation or at the time the fully indexed rate would apply. Where the variable rate loan has a fixed loan period that is substantial -- at least 5 years – this seems a reasonable approach that would enable consumers to gain the advantage of a fixed rate loan and be underwritten to the actual obligation they would be responsible for discharging at the fully indexed rate when the variable rate kicks in. Since the consumer will have paid off some portion of the principal during the fixed rate period, it seems reasonable to require the ability to pay determination to be made based on the actual amount against which the fully indexed rate would be charged. But if the variable payments themselves are based on the loan amount at consummation and *not* on the current outstanding principal balance, then the proposed calculation would make no sense and could jeopardize the consumer at the expiration of the fixed rate term.

We support the Board’s proposal to require lenders to underwrite step-rate mortgage borrowers using the highest rate that can occur during the life of the loan. The maximum rate is known at consummation in such transactions. This is the only sensible approach to take to protect consumers against payment shock or underwriting them to an unrealistic estimated payment. We also do not support the Board’s proposal to allow prepayment penalties on step rate mortgages. The Board argues in its commentary that the interest rates in such mortgages are known to the consumer, and, while they vary over time, they do so in predictable and disclosed fashion. While this is true, we note that the purpose of banning prepayment penalties on mortgages where the rate varies was to protect consumers from being locked into a particular

mortgage from which he or she could escape only by paying a significant penalty. The fact that the size and duration of a step rate's interest rate changes are known at consummation does not change the fact that the consumer will be subject to higher costs over time, exposing him or her to additional risk. Because the interest rate on a step rate mortgage does change over time, we believe the final rule should prohibit prepayment penalties in conjunction with them.

The Board asks for comment on whether it should in the general ability to pay determination "require that creditors underwrite an adjustable-rate mortgage using the maximum interest rate in the first seven years or some other appropriate time horizon that reflects a significant introductory period? (FR Vol. 76, No. 91, p. 27430)" Both QM alternatives would require underwriting such instruments to the highest payment in the first five years. QM mortgages would also benefit from protection from unstable features such as interest-only, negative amortization, and balloon payments, while loans outside the QM space would not. It seems, therefore, logical and desirable for the ability to repay calculation on non-QM mortgages using variable rates – which may include these other, unstable features -- to be underwritten to the highest payment possible during a specific and reasonable time period, but not less than five years. An alternative course would be to adopt Fannie Mae's guidelines in this area, which require the loan to be underwritten to the *greater* of the indexed rate or 2 percent more than the initial note rate for ARMs with introductory periods of 5 years and under.

Qualified Mortgage

We have already commented on our strong recommendation that the Board adopt Alternative 2, with the change outlined in our comments above, to determine QM. The Board also has asked a series of questions about standards within the QM.

The Board proposes to limit QM loans to those with a maximum 30-year term. We support this limitation. Longer term mortgages may be desirable or useful in certain circumstances. But we believe that those loans should be outside the QM definition and be subject to the full ability to repay requirements of the rule without the QM's protection from liability.

The Board seeks comment on whether or not to include Graduated Payment Mortgages (GPMs) in the QM definition, noting that they permit the deferral of principal and therefore share that characteristic with negatively amortizing loans, which are specifically excluded from the QM definition. We support this prohibition, in general, but note that there are some programs administered by state and local governments that have used GPM structures in conjunction with soft debt, repayable only if affordable, that have performed very well and expanded homeownership opportunities. We urge the Board to consider an exception to this exclusion where state and local programs with a proven track record in making mortgage credit available to

moderate and lower income households are used, particularly where some or all of a portion of the debt is soft and repayable only if affordable.

Streamlined Refinancings

The Board has solicited comment on the legislation's provisions regarding waiver of certain ability to pay requirements for so-called "streamlined refinancing" from non-standard to standard products. We support the legislation's and the proposed rule's intent to encourage shifting borrowers from abusive and other nontraditional loans into standard loans. Doing so will help borrowers stay in their homes and improve the likely credit performance of most of these borrowers.

The Board solicited comment on whether to require creditors to retain an interest in the refinanced loan to qualify for the waiver of certain requirements. We believe that it is appropriate to require the creditor to retain an interest in the newly offered loan for at least 12 months following consummation. To do otherwise opens the potential for loan flipping of loans that are likely to fail in their present form without being required to carry out the necessary diligence that otherwise would be required for a new loan. Allowing such loans to be sold immediately to a third party would, we believe, invite abuse by lenders anxious to get potentially weak loans off their books without providing full value to the consumer.

We support the Board's recommendation that a streamlined refi only qualify for the exemption if the payment on the new loan is materially lower than the original loan, and agree that 10 percent should be the minimum size of the reduction in order to qualify.

We understand the Board's interest in assuring that streamlined refi's without certain verifications be offered only to those consumers with a high likelihood of succeeding in the new loan. The Board has proposed to require that consumers not have more than one delinquency in the past 24 months in order to qualify for this treatment. We support the intent of this requirement, but believe the proposed limitation is too severe. We recommend requiring no delinquencies (as defined elsewhere in the proposed rule) in the previous 12 months. We agree with the Board's proposal to identify "late pays" as those made 30 or more days beyond the contractual payment date of the loan.

We urge the Bureau to use its authority to expand eligibility for the streamlined refi income verification exemption to loans held by Fannie Mae and Freddie Mac while they are in conservatorship. Doing so will fulfill the same objective as the FHA exemption by giving the companies the ability to forestall potential losses and reduce taxpayer liability for them.

On behalf of CFA's members, thank you for the opportunity to comment on this important proposed rule making. We look forward to working with the Bureau as it continues to develop a final version of this rule.

Sincerely,

/s

Barry Zigas

Director of Housing Policy