Comments to the
Consumer Financial Protection Bureau
and the
Federal Reserve Board

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Proposed Rule
on
Ability to Pay and Qualified Mortgage

by

Center for Responsible Lending
National Consumer Law Center, on behalf of its low-income clients
Consumer Federation of America
National Association of Consumer Advocates

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The Center for Responsible Lending (CRL) is a nonprofit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

The National Consumer Law Center (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit.

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.

The National Association of Consumer Advocates (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

I. Introduction

One of the key lessons from the last decade is that innovations in credit markets are double edged swords. They can be valuable and useful, but innovation can also fail, with significant broader consequences. Most recently, risky product design and lax underwriting led to disastrous results for millions of families. When these mortgage lending changes ultimately pervaded the market, they also spurred a series of events that caused the current recession. Dodd-Frank's ability-to-pay provision is necessary because the industry abandoned common sense rules.

We appreciate the difficult task facing the Board in drafting the proposal, and the Bureau in finalizing it.[1] We believe that overall the proposal is a balanced approach to difficult issues. However, the proposal also includes one provision – proposed in the alternative – which could seriously undermine the fundamental reform. We therefore discuss the proposal regarding the "safe harbor Qualified Mortgage" in depth in these comments.

All of the regulatory agencies involved in implementing Dodd-Frank's mortgage reforms face the difficult task of thinking about rules in terms of today's market as well as tomorrow's. There is no question that our financial markets are still overly cautious and skittish about lending, with the result that credit is not flowing as freely as it was. But of course, the ultimate lesson of the crisis is that it should never have flowed as freely as it did and in the way that it did. The purpose of these reforms is to find a balance somewhere between yesterday's reckless credit bubble and today's hyper-cautious market.

There are many forces at play in making today's market what it is, and the Bureau, as the decision-maker on the final rule, must not make the fatal error of assuming that it must offer up a safe harbor or the markets will refuse to "return to normalcy." There is no question that the markets are anxious about what the rules will be. But that is not just uncertainty as to the rules for complying with Dodd-Frank's ability-to-pay requirement. It also includes the risk retention rules, with their "qualified residential mortgage exception. There is uncertainty over what the capital requirements will be for depositories, and what restrictions may or may not be on the derivatives to hedge one or another business decision, and many others. More certainty will come from the simple act of finalizing new rules. Of course there is uncertainty about the unknown, but as we saw when states implemented mortgage protections in the last decades, lenders will adjust if responsible standards are in place.

But it is absolutely crucial to understand that the stuck-market is not simply attributable to uncertainty about implementing rules under Dodd-Frank, or Basel accords on capitalization. The financial collapse undermined the confidence of both consumers and investors in the financial sector. Even within the financial sector, confidence crumbled in fellow participants up and down the mortgage market. And the collapse from self-inflicted wounds triggered broader macro-economic consequences that in turn added even deeper and longer-lasting uncertainty and nervousness. It triggered a recession with stubbornly persistent high unemployment from which

[1] Throughout these comments, we use the "Board" when referring to the author of the proposal, and the "Bureau" to refer to the decision-maker, as the Board's duties are transferred to the Bureau as of July 21, 2011.

we still have not recovered, and may not for some time.[2] Even the current political debate over governmental debt is unnerving the markets. And, the foreclosure crisis and the continuing failure to get a meaningful grip on loan modifications and foreclosure avoidance is a direct and immediate impediment to normalizing the housing market.

We have not seen a world-wide financial upheaval of this scope in 70 years. Bearing this in mind, the Bureau should be highly skeptical that immunizing the market from one single litigation risk – and, as we shall discuss in these comments, a comparatively cheap litigation risk at that – is what is needed to get credit flowing again. The details in this proposed rule will only matter to the integrity and safety of the market if the fair and balanced system for accountability built into the statute itself stands.

II. Summary of Key Recommendations

In these comments, we focus primarily on the core choices facing the Bureau that will determine whether one of the most fundamental provisions of the mortgage origination reforms – the ability to repay provision – will serve its purpose. In the last decade, lenders forgot the most fundamental principle of their business: loans should be designed for success, not destined for failure.

Though we comment on a number of issues addressed in the proposals, our key recommendations are these:

- ***A Qualified Mortgage designation for a loan cannot and should not create a safe harbor for the creditor or holder of the mortgage.***

It is not only essential to the success of the ability-to-pay law that Qualified Mortgages not be given a safe harbor, but further, the statute does not confer any authority on the Bureau to create a safe harbor. The sole prompt for the safe harbor proposal was a phrase in a vestigial caption left over from proposed legislation in 2007. That legislation ultimately evolved into § 1412 of Dodd-Frank, and during that process, the concept was buried in 2009. The Bureau does not have the legal authority to resurrect it. Even if the Bureau did have such authority, it would be unwise and contrary to the purpose of the law to adopt it. Dodd-Frank created a finely tuned balance of market incentives and market discipline, and a safe harbor would upset that balance. It would once again make it difficult to hold irresponsible parties in the market accountable – thus repeating the mistakes of the past decade. The Bureau will certainly be urged to adopt it with threats that access to credit will dry up and the market will continue to stall. We urge the Bureau to view such claims with skepticism. It was the absence of regulation and the absence of accountability that let once marginal bad practices become industry wide. Reduced accountability will work no better in the next decades than it did in the last.

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[2] History tells us that economic crisis that starts in the financial sector tend to have very deep and long-lasting consequences, including "deep and prolonged" asset market collapses, "profound declines in output and employment," with the employment drop lasting on average more than four years, and exploding government debt, as tax revenues drop. *See* Carmen M. Reinhart & Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, at 224 (2009).

- ***A Qualified Mortgage must fulfill all of the requirements of Dodd-Frank's ability-to-pay provision. It will fail of its essential purpose if it provides a short-cut on sound underwriting.***

The purpose of the Qualified Mortgage designation was to encourage sustainable lending products and practices. Sound product design and sensible underwriting are the twin pillars of sustainable lending. For the Qualified Mortgage designation to earn the trust – and deserve the trust – of both consumers and investors, it must carry with it the assurance that it is a soundly designed *and* soundly underwritten loan.

- ***Non-qualified mortgage ARMs should be underwritten beyond the fully-indexed rate to account for index increases in certain cases.***

The non-qualified mortgage market will operate more freely of substantive consumer protections than any other. As long as those loans stay under HOEPA triggers, some the same flawed product designs of the past can continue. This will be the market segment where the new generation of predatory lenders will find their niche. The primary restrain from Dodd-Frank that will apply in this market segment is the ability-to-pay rule. Yet ironically, the proposed rule for calculating the rate to be used in determining the ability to repay these risky loans is weaker than the rate assumptions for the safer loan products. Underwriting to the fully-indexed rate in a low interest rate environment allows for significant payment shock. Payment shock matters to consumers, lenders and investors, and we recommend an adjustment to mitigate the potential for payment shock. We further urge the Bureau to monitor the business products and practices of non-qualified mortgage ARMs, and the movement of interest rate indices used so that it can promptly respond with further adjustments as warranted.

- ***HOEPA loans should be categorically excluded from the definition of a Qualified Mortgage.***

Because there are no rate-restrictions related to the Qualified Mortgage definition, a very expensive loan that is subject to HOEPA because it meets the rate threshold could be eligible to be a Qualified Mortgage, providing it is otherwise a standard loan. Such loans should be categorically excluded from the Qualified Mortgage definition.

III. A Qualified Mortgage Must Earn the Trust of Both Consumers and Investors by Assuring the Products are Soundly Designed and There Are No Shortcuts on Common Sense Underwriting: Trust, Not Immunity, Is Necessary to Restore Confidence and Reopen the Mortgage Market on a Sustainable Basis

The cornerstone issue that the Bureau will decide in this proposal is whether there is a "safe harbor" or a rebuttable presumption for Qualified Mortgages ("QM"). The Board ties that decision to the definition of a Qualified Mortgage. As proposed, the question of what requirements are necessary for the "QM seal of approval" is inextricably linked to the degree of

private litigation risk. Linking the definition of a Qualified Mortgage to the safe harbor question is not appropriate under the law, nor is it necessary. But more fundamentally, we do not believe that Dodd-Frank even confers authority on the Board or Bureau to grant a safe harbor, much less that Congress intended it or that policy favors it.

It is incontrovertible that immunity from the relatively modest litigation risk that deprives consumers of a way to vindicate statutory rights will by no means immunize investors and lenders from a much greater market risk – the increased risk of default resulting from reduced underwriting standards. The legal remedies available to consumers victimized in the run-up to the crisis were in fact extremely weak. Yet the absence of serious litigation risk certainly did not protect the market from the real risk – that of its own failure of business judgment.

The final rule on the definition of the Qualified Mortgage and the presumption it brings to courts must embody two principles.

- A Qualified Mortgage must confer a rebuttable presumption, not the conclusive presumption that a safe harbor would confer. That is what the statute requires, and that is what is necessary to reflect Congressional intent. Only a rebuttable presumption will achieve Dodd-Frank's goals of a fair balance between market incentives and market discipline, and a balance between consumers' legal rights and excessive exposure to litigation risk for lenders. The Board's proposed safe harbor alternative achieves neither of these goals.

- The definition must encompass the requirements of § 1411's ability-to-pay standard – not the short-cut that the Board's safe harbor alternative would sanction. The Qualified Mortgage is about reducing – though not eliminating – litigation risks as an incentive to avoid making risky loans in the first place; it is not about reducing responsible underwriting standards.

A. Summary of the Proposed Alternative Definitions of a Qualified Mortgage.

Sensible, sustainable loan origination encompasses both loan product terms and underwriting. The Board's two alternatives are similar as to product terms, but differ in requirements for underwriting.

As proposed, the Board's "safe harbor" Qualified Mortgage that would largely immunize the market has *weaker* underwriting rules than the alternative definition. Ironically, this "safe harbor" Qualified Mortgage is *less* likely to restore confidence to consumers, investors, and the financial sector itself. The Qualified Mortgage should grant a litigation advantage to its holder, not immunity from compliance with Dodd-Frank's fundamental ability-to-pay requirement.

The difference, as the comparison table below makes clear, is that the safe harbor definition is designed to streamline the market's ability to evaluate a product for compliance by looking at standardized loan design. There is only one, easily standardized underwriting protocol included in the safe harbor Qualified Mortgage.[3] That rule would, in effect, tell the courts that any

[3] See 76 Fed. Reg. at 27454 for a discussion of "bright-line standards."

creditor that uses those loan terms and does not use an artificially low interest rate to calculate the payment used for underwriting, is deemed by law to have made a loan that the consumer can repay – no matter what other facts to the contrary would be. The consumer would not even be able to bring such facts to the court's attention.[4]

By contrast, the rebuttable presumption definition of a Qualified Mortgage protects consumers, investors, and the market from loans that are predictably unsustainable and unsuitable for any given consumer, even if the product itself is a standard one. It is worth remembering that the subprime market was once dominated by fixed rate loans – with no teasers and no rate-resets, and no built-in payment shock. They were simply high cost loans, made to equity-rich, vulnerable consumers who could not afford them.[5]

	"Safe Harbor" QM Reg Z, § 226.43(e)(2), Alt. 1	**"Rebuttable Presumption" QM** Reg. Z, § 226.43(e)(2), Alt. 2
Loan Term	30 year maximum	Same
Price Standards	* Points and fees within specified limits (generally 3%; greater for small loan amounts) * No interest rate restrictions[6]	same
Restrictions on Product Features	* No negative amortization * No interest only * No balloon payments, except under prescribed conditions * Regular, substantially equal payments (except for effect of rate change in ARMs or step-rate mortgages) * No stated documentation loans	Same
Underwriting assumptions	* Take into account "mortgage related obligations", *i.e.*, principal, interest, tax & insurance obligations, homeowners' association, condo and coop fees, ground rent or leasehold payments & special assessments[7] * *ARMS:* use maximum interest rates that can apply during first 5 years, and principal and interest payments that will fully amortize the amount.	same

[4] 76 Fed. Reg. at 27453-54.

[5] This was the business model for the top subprime originators in the late 1990s and early 2000s, including those that attracted regulatory attention like Associates and Household. *See, e.g.*, *Butler v. Beneficial Homeowner Service Corp.*, 01-CV-6450 (W.D.N.Y. Filed Sept. 2011) (class action involving high, fixed-rate HOEPA loans with APRs ranging from 12.019% to 24.97% and mortgage payment to income ratios as high as 88%).

[6] As a practical matter, it is likely that the APR trigger for high-cost loans will generally function as a market restriction, but under the proposal, even a high-cost mortgage could be a Qualified Mortgage under both alternative definitions. Under Dodd-Frank amendments to HOEPA, the APR trigger for high-cost loans is the average prime offer rate (APOR) on comparable transactions plus 6.5% for first liens and APOR + 8.5% for subordinate liens. 15 U.S.C. § 1602(bb)(1)(A)(i). For example, in the April, 2011, the threshold for a first lien, 30 year FRM would have been 11.2% (4.8% + 6.5% = 11.2%). If the interest rates return to April, 2000 levels, it would be 14.5% (8% + 6.5%). http://www.freddiemac.com/pmms/pmms30.htm.

[7] "Mortgage related obligations" under the proposed definition does not include housing debt arising from other mortgage loans. *Proposed* § 226.43(b)(8).

Other underwriting requirements	Creditor "*consider* and verify" current or reasonably expected income or assets to determine ability to pay, considering: * current or expected income or assets other than value of collateral * third-party verification of income and assets	same, *plus*, consider and verify: * employment status, (if relying on income from employment) * monthly payment on simultaneous second lien that creditor knows or has reason to know will be made * current debt obligations * monthly debt-to-income (DTI) ratio or residual income[8] * credit history * in considering definitions of "current debt obligations," underwriting standards for DTI, and in defining and verifying credit history, the creditor may look to "widely accepted governmental and non-governmental underwriting standards."[9]

It is significant that the "ability to pay" requirement is in the Truth in Lending (TIL) Act. Unlike Title IX, with the risk retention rules, TIL governs key aspects of the interaction between individual consumers and their lenders with respect to individual transactions. It confers rights on individual consumers, including the right to hold certain market parties accountable in a court of law.

Simply by placing the ability-to-pay requirement in the Truth in Lending Act, instead of the new Consumer Financial Protection Act, for example, Congress demonstrated its commitment to allowing individuals whose statutory rights were violated to have access to the courts to vindicate those rights.[10] But the remedies available to successful consumers also were carefully designed to limit the exposure of even those creditors who violate the law.[11] The Qualified Mortgage concept in TIL gives a litigation advantage to creditors, by creating a statutory presumption, which is a procedural advantage in civil litigation. That litigation advantage is the incentive Congress gave to make sensible, sustainable mortgages. That is a vastly different thing from a free pass on common sense underwriting.

[8] The monthly debt to be included in DTI would include the sum of the mortgage obligation on the loan, simultaneous seconds, and other current debt obligations. Proposed §§ 226.43(c)(2)(vii), (c)(7).
[9] Proposed §§ 226.43(c)(2)(vi), 226.43(c)(2)(viii)-1, 226.43(c)(7)-1.
[10] Recognizing that there will never be enough public resources to police the market, TIL allows consumers the right to seek redress in courts themselves. By contrast, there is no private right of action in the new Consumer Financial Protection Act, which will rely entirely on public enforcement.
[11] See Sec. III-B- 4, 6, below for discussions of exposure to liability.

B. The Qualified Mortgage Creates a Rebuttable Presumption of Compliance. The Proposed "Safe Harbor" is Inconsistent With the Text of the Statute and the Intent of Congress and Would Destroy the Carefully Crafted Balance Between Market Incentives and Market Discipline in Dodd-Frank.

The Board proposes alternative definitions of a Qualified Mortgage. Alternative One would afford lenders a full-blown "safe harbor" – a conclusive or irrebuttable presumption[12] that the borrowers are able to pay the loans (safe harbor Qualified Mortgage). Alternative Two would presume lenders of Qualified Mortgages were originating affordable loans, but would allow homeowners to rebut that presumption of affordability (rebuttable presumption Qualified Mortgage).[13]

A safe harbor would immunize even those lenders who knowingly and intentionally made an unaffordable Qualified Mortgage and would prevent consumers who are given mortgages that are manifestly and predictably unaffordable from pursuing a claim of inability to repay.[14] Given the harsh impact of this proposal on consumers, it might be expected that a higher underwriting standard would apply to the safe harbor Qualified Mortgage. Paradoxically, the Board proposes a lower underwriting standard for the proposed "safe harbor" Qualified Mortgage, while at the same time conferring conclusive legal immunity on the maker and holder of the note as to compliance with Dodd-Frank's critical ability-to-pay requirements. A higher underwriting bar, and thus a higher probability of originating affordable mortgages, is proposed for a Qualified Mortgage with the rebuttable presumption.

Affording lenders of Qualified Mortgages a rebuttable presumption of compliance is well supported by the statutory text. The safe harbor alternative is not; indeed it finds no support in the statutory text, violates longstanding Supreme Court jurisprudence and would seriously undermine, if not render completely ineffectual, the ability-to-repay provision – one of the key provisions in Dodd-Frank designed to prevent an eventual return to runaway recklessness in the mortgage market.

An examination of the evolution of Dodd-Frank § 1412 demonstrates that the slender reed on which the Board's proposed safe harbor rests finds no support in the enacted statutory text, overrides the intent of Congress, is contrary to statutory construction principles, and fundamentally, runs counter to the underlying policy goals of restoring accountability and preventing a recurrence of the self-inflicted crisis to the marketplace.

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[12] Unlike rebuttable presumptions, which are matters of evidence, irrebuttable or "conclusive" presumptions are substantive rules of law. *See, e.g.*, *Michael H. v. Gerald D.*,491 U.S. 110, 119-20 (1989).

[13] As we discuss below, the law disfavors conclusive presumptions without compelling evidence of Congressional intent. A presumption will be conclusive only "upon grounds of expediency or policy so compelling in character as to override the generally fundamental requirement of our system of law that questions of fact must be resolved according to the proof." *United States v. Provident Trust Co.*, 291 U.S. 272, 281-82 (1934). *See also Vlandis v. Kline,* 412 US 441, 446 (1973); *Miller v. Carter*, 547 F.2d 1314, 1318 (7th Cir. 1977); *In re Wimmer,* 121 B. R. 539, 543 (Bankr. C.D. Ill. 1990), *aff'd* 129 B. R. 563 (C.D. Ill. 1991).

[14] 76 Fed. Reg. at 27453-54.

1. The text of the statute does not include a safe harbor, and there is no statutorily conferred authority to the Bureau to create a substantive immunity.

The statutory text amending TIL, 15 USC § 1639C (b)(1), makes no mention of a safe harbor. It reads simply:

> 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-pay provision], if the loan is a Qualified Mortgage.

(emphasis added). The text contains no language that suggests or even implies that the presumption may be conclusive.

The source of the suggestion for a safe harbor is contained solely in the *caption* to Dodd-Frank § 1412, the vehicle for amending TIL to add the above language. The caption to § 1412 is "Safe Harbor and Rebuttable Presumption." As we discuss below, it is a drafting error that the caption was not changed to reflect changes in the text as the legislation evolved. But there is a more fundamental fact about the text of the law. That caption does not confer the substantive authority to the Bureau to create a safe harbor.

As well-established and longstanding Supreme Court jurisprudence makes clear, "[t]he caption of a statute . . . 'cannot undo or limit that which the [statute's] text makes plain.'" *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241, 256 (2004) (quoting *Trainmen v. Baltimore & Ohio R. Co.*, 331 U.S. 519, 529 (1947)). The Supreme Court has repeatedly rejected attempts to limit or expand the text of a statute through the vehicle of the caption or title. *See, e.g.*, *Intel*, 542 U.S. at 256 (holding that the term "litigants" in the caption did not limit the broader meaning of the term "interested parties" in the statutory text); *I.N.S. v. St. Cyr*, 533 U.S. 289, 308-09 (2001) (affirming courts' habeas corpus jurisdiction based on statutory text despite caption "ELIMINATION OF CUSTODY REVIEW BY HABEAS CORPUS"). Yet that is precisely what the Board proposes here as an alternative for consideration.

The effect of a safe harbor would be to deprive consumers of their statutory rights to present evidence that the lender did not make a good faith and reasonable determination that there was a reasonable probability that they could repay the loan according to its terms.[15] A caption does not confer any authority to the Bureau to upset a carefully crafted, balanced system for accountability that Congress actually did enact, which we describe below.

2. The section 1412 caption referred to an earlier version of the Mortgage Reform and Anti-Predatory Lending Act which created a dual track for liability: a rebuttable presumption for creditors and a safe harbor for certain secondary market parties.

The wisdom of the Court's jurisprudence on this point is revealed through a review of the Dodd-Frank's legislative history. That history clearly demonstrates that the presence of the words "safe harbor and rebuttable presumption" in the caption to § 1412 was a drafting glitch carried

[15] Dodd-Frank § 1411, adding TIL § 129C(a)(1), proposed Reg. Z, § 226.43(c)(1).

over from a previous, modified, version of the statute and affirms that the Board's safe harbor proposal is without a glimmer of foundation.

Subtitle B of Dodd-Frank's Title XIV, containing both the ability-to-pay provision (Section 1411) and the Qualified Mortgage provision (Section 1412), evolved from earlier versions of the so-called "Miller-Watt-Frank" anti-predatory lending proposals, the earliest of which was introduced in 2005.[16] On October 22, 2007, H.R. 3915, a predecessor version of the Mortgage Reform and Anti-Predatory Lending Act was introduced in the House and passed the House on November 15, 2007.[17] This version created a dual track for liability in litigation: a rebuttable presumption for creditors and a safe harbor for secondary market parties.[18] The caption "safe harbor and rebuttable presumption" came from that bill and accurately reflected the text of the legislation at that time.

The timing is significant, because in the fall of 2007, there was still a belief that the secondary market was not fundamental to the prevalence of predatory lending. Though the subprime mortgage crisis had finally become manifest, it was not yet evident either how badly the subprime virus had infected the larger mortgage market, nor, critically for this purpose, how significant the secondary market's role was in contributing to the crisis.[19]

Consequently, H.R. 3915 set up an extremely complicated system for private enforcement of that bill's newly granted rights for consumers. It divided the supply-side of the mortgage market into primary and secondary market parties (and even further subdivided secondary market parties), assigning different levels of exposure to liability in private actions for violations.[20] It also set up two types of Qualified Mortgages – the "Qualified Mortgage" and "the qualified safe harbor mortgage." A "Qualified Mortgage" was essentially within the prime-rate price range, or government-insured VA or FHA loans.[21] A "qualified safe harbor mortgage" was one that met underwriting standards and loan term restrictions – the predecessor to Dodd-Frank's Qualified Mortgage.[22]

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[16] The Prohibit Predatory Lending Act of 2005, H.R. 1182, *available at* http://www.gpo.gov/fdsys/pkg/BILLS-109hr1182ih/pdf/BILLS-109hr1182ih.pdf.
[17] The Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, *available at* http://www.gpo.gov/fdsys/pkg/BILLS-110hr3915eh/pdf/BILLS-110hr3915eh.pdf.
[18] Id., § 203, *adding* TIL 15 U.S.C. § 1639b(c)(2).
[19] For example, in 2007 Chairman Bernanke testified before Congress that "the problems in the subprime market seem[ed] likely to be contained." Testimony of Ben S. Bernanke, Before the Joint Economic Committee (Mar. 28, 2007), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20070328a.htm.
[20] H.R. 3915 § 101, new TIL § 103(cc)(8) (definition of "securitizer"), § 204, adding 1639b(d)(2),(3), (8) (further limiting liability for securitizers and assignees and protecting them from class actions entirely as to claims that involved the ATP provision and one other claim), and 1639(d)(10) (excluding pools, investors and "instruments representing" pools from the definition of securitizer or assignee.) The latter would have had the effect of immunizing the actual holder of a securitized note from liability in the first place, irrespective of any presumption – conclusive or otherwise.
[21] For first lien residential mortgages, the APR either fell under 3% above comparable T-bills (5% for subordinate liens) or under 175 basis points above conventional mortgage rates, 375 BP for subordinate liens; VA loans or FHA loans. H.R. 3915, § 203, adding TIL § 129B(c)(3)(B).
[22] H.R. 3915, § 203, adding TIL § 129B(c)(3)(C).

To summarize, the basic picture for accountability for ability-to-pay violations was this:

- Creditors, assignees and "securitizers"[23] might "presume" compliance with the ability-to-pay provision (and one other requirement not enacted in Dodd-Frank) if the loan was a "Qualified Mortgage" or a "qualified safe harbor mortgage."[24]

- The presumption was rebuttable "only against the creditor of such loan" and then only if the loan at issue was a "qualified safe harbor mortgage."[25] (emphasis added).

- Since the presumption was rebuttable only against creditors, the effect was that assignees and "securitizers" were given the benefit of the safe harbor (functionally an irrebuttable presumption) referenced in the caption to that earlier incarnation of the proposed legislation.

- This heightened protection for assignees and securitizers was consistent with other provisions in H.R. 1315 that severely limited remedies available to consumers against secondary market participants.[26]

By May, 2009, when yet another version of the Mortgage Reform and Anti-Predatory Lending Act passed the House, H.R. 1728, the financial crisis was in full flame. The fact that there were unintended consequences flowing from the absence of "skin in the game" all the way through the origination and distribution chain had become more apparent. The need for more discipline in the secondary market, as well as the origination market, had become manifest.[27] Events challenged the previous conventional wisdom about the need to largely exempt the secondary

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[23] "Securitizers" were defined as assignees who "acquire[] . . . residential mortgage loans for the purpose of including such loans in a pool of assets for the purpose of issuing or selling instruments representing interests in such pools", but the trusts which actually held most mortgages were excluded from the definition of either assignee or securitizer. H.R. 3915, § 204, new TIL § 129B(d)(10). As drafted, the effort to protect the secondary market probably meant that there was in fact no accountability, other than tracking down the originator and filing an independent lawsuit. But subprime originators had already started to fail by that time in droves, so that the accountability provisions were probably meaningless in practice. That fact is also relevant for the changes to this system that occurred during the 2009-2010 process of updating Miller-Watt-Frank for inclusion into Dodd-Frank.

[24] H.R. 3915, § 203, new TIL 129B(c)(1). The presumption applied to both the bill's ability-to-pay provision (§ 201, predecessor of Dodd-Frank § 1411), and a provision requiring a "net tangible benefit" for mortgage refinancings (§ 202), a provision that does not appear in Dodd-Frank.

[25] The relevant text was: (2) REBUTTABLE PRESUMPTION. – Any presumption established under paragraph (1) with respect to any residential mortgage loan shall be rebuttable only (A) against the creditor of such loan; and (B) if such loan is a qualified safe harbor loan." TIL § 139B(c)(2). Under TIL, a "creditor" can only be the party to whom the obligation is initially payable on the face of the note. 15 U.S.C. § 1602(g).

[26] H.R. 3915 also included provisions that severely limited the exposure of secondary market parties to liability, e.g., § 204, adding TIL § 129B(d)(2), (3), and (8) limiting assignee and securitizer liability to rescission, not monetary damages; the rescission remedy was subject to extremely generous right-to-cure provisions. They were also protected entirely from class actions. Finally, the actual holder of a securitized note – the party that would be seeking to enforce it – was excluded from the definition of assignees and securitizer.

[27] *See, e.g.*, *Financial Crisis Inquiry Commission Report* at 89 (discussing "originate to distribute model" and consequent lack of accountability); Testimony of Eric Stein, Center for Responsible Lending, Before the Senate Committee on Banking, Housing, and Urban Affairs (Oct. 6, 2008), *available at* http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/senate-testimony-10-16-08-hearing-stein-final.pdf.

market. The need for reforms in the secondary market, such as those ultimately reflected in Title IX's "Qualified Residential Mortgage," became part of the debate.

Consequently, both the dual track and the secondary market's safe harbor disappeared from the corresponding provision in H.R. 1728.[28] The change carried through in the House-passed version of the larger financial reform legislation, H.R. 4173, § 9103,[29] which ultimately, as further revised, became Dodd-Frank § 1412. The caption from 2007 remained in each of the versions, from May 2009 to the present, but it no longer reflects the actual text of the legislation.

The Board's proposal to offer a safe harbor would impermissibly rewrite Dodd-Frank to not only revive legislative language from 2007 but also to expand the 2007 safe harbor well beyond the rejected legislative proposal immunizing secondary market players to immunize creditors as well. There is simply no statutory authority for this. If the Bureau chooses to promulgate the safe harbor, the rule would be at substantial risk of being overturned by legal challenge, thus creating unnecessary uncertainty in the mortgage market.

As a practical matter as well, after the very costly three-year learning curve about reckless lending and its far-reaching consequences, it is a highly unlikely notion that Congress would have created a broad safe harbor from a key protection – ensuring loans are only made to borrowers who the lender in good faith determines can repay them.

In the end, Dodd-Frank settled on both carrots and sticks – both positive and negative incentives – to go back to basic, common sense lending. It included some market-incentives, both in Title IX's "qualified residential mortgage" ("QRM") exception to the risk-retention requirements, and in the rebuttable presumption for Qualified Mortgages ("QM"), which reduces, but does not eliminate, litigation risk. The stick is evident in the disappearance from the final version of many of the special protections from liability for the secondary market players, including the real safe harbor for assignees and securitizers.[30] The foreclosure crisis had made apparent the need for consumers to be able to vindicate their statutory rights against the holders of their mortgages, whether they be creditors, assignees or trusts. Furthermore, the financial crisis had made apparent that the secondary market was not an innocent victim of originator malfeasance.[31]

The dual track that created a safe harbor for certain parties disappeared even from legislative proposals over two years ago, and certainly is not in the law as enacted. Congress abandoned it, as the evolution of the text makes clear. A caption is insufficient authority for an agency to resurrect and expand upon it.

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[28] H.R. 3915, § 203, http://www.gpo.gov/fdsys/pkg/BILLS-111hr1728rfs/pdf/BILLS-111hr1728rfs.pdf.
[29] *Available at* http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173rfs/pdf/BILLS-111hr4173rfs.pdf.
[30] Dodd-Frank ultimately entirely dropped the entire concept of "securitizers" with their complex and differential treatment for liability for violating the ability-to-pay law, and many of the most sweeping limitations on secondary market parties' liability failed to make it into the law. None of the special protections from H.R. 3915 or H.R. 1728 detailed in note 30 above are part of the enacted law.
[31] *See, e.g.*, *Financial Crisis Inquiry Commission Report* at 89 (discussing "originate to distribute" model and consequent lack of accountability).

3. Statutory construction principles provide that the presumption is a rebuttable one.

A safe harbor would effectively be an "irrebuttable" or "conclusive" presumption. In the absence of specific statutory designation to the contrary, a presumption is rebuttable.[32] Under rules of statutory construction, Congress knows how to provide for specific authorizations and Congress' failure to use specific terms is a forceful indication of its intent. *See, e.g.*, *Kimbrough v. United States*, 552 U.S. 85, 87 (2007) ("[d]rawing meaning from silence is . . . inappropriate . . . because Congress knows how to [use] express terms.); *Omni Capital Int'l v. Rudolf Wolff & Co.*, 484 U.S. 97, 106 (1987) ("Congress knows how to [provide for express authorization] when it wants to provide for it" and the fact that it did not do so "argues forcefully that such authorization was not its intention").

In the context of TIL's general remedies provisions, Congress has augmented normal rules of civil procedure and evidence by specifying presumptions and burdens of proof in various sections.

- Creditors and assignees must prove that they qualify for the statutory "unintentional and bona fide error" defense by a preponderance of the evidence.[33]

- With respect to high-cost loans, assignees are liable for any claims and defenses (subject to a cap), unless they demonstrate by a preponderance of the evidence that a reasonable person, exercising due diligence, could not know that the loan was a high-cost loan.[34]

- A written acknowledgement that the consumer received the disclosures and a notice of right to cancel creates a rebuttable presumption in a rescission action.[35]

- Outside the rescission context, a written acknowledgement of receipt of disclosures is a conclusive presumption as to assignees, but not as to original creditors. 15 U.S.C. § 1641(b) (". . . written acknowledgement of receipt by a person to whom a statement is required to be given . . . *shall be conclusive proof* of the delivery thereof . . . .") (emphasis added).

Clearly, Congress knows how to authorize statutory conclusive presumptions. Its failure to do so in this case is a forceful indication that Congress did not intend to provide for a conclusive presumption.

Further, conclusive presumptions that serve as the bases for a classification must be "necessarily or universally true in fact."[36] However, that would not be the case here where a lender could

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[32] *See, e.g.*, *Vlandis v. Kline*, 412 U.S. 441, 446 (1973); *Miller v. Carter*, 547 F.2d 1314, 1318 (7th Cir. 1977); *State v. Myers*, 271 N.E.2d 245, 252 (Ohio 1971).
[33] 15 U.S.C. § 1640(c).
[34] 15 U.S.C. § 1641(d).
[35] 15 U.S.C. § 1635(c) (". . . written acknowledgment of receipt of any disclosures required under this title . . . by a person to whom information, forms, and a statement is required to be given pursuant to this section *does no more than create a rebuttable presumption* of delivery thereof") (emphasis added).
[36] *Vlandis v. Kline*, 412 U.S. 441, 452 (1973).

exercise bad faith in originating a loan but nevertheless avoid liability for "ability to repay." As earlier incarnations of predatory lenders like Associates have shown, a fixed rate, fully-amortizing mortgage can still be unsustainable and unsuitable for any given consumer. In other words, there is not necessarily a link between a borrower's ability to repay a loan and the nature of the loan as a Qualified Mortgage; it is not universally true in fact. This statutory construction principle simply does not allow for an interpretation of the statute to provide a safe harbor.

Moreover, the term conclusive presumption (or irrebuttable presumption) is actually a misnomer – it is not a presumption at all, but in fact a binding rule of substantive law.[37] Thus, a decision to declare a statutory conclusive presumption – a rule of law – cannot be taken lightly and must be supported by sound policy or reason. Statutory presumptions are a matter of public policy and the imposition of irrebuttable presumptions "rest[] upon grounds of expediency or policy so compelling in character as to override the . . . fundamental requirement . . . that questions of fact must be resolved according to the proof."[38] Reading a conclusive presumption in a statute indicates that the "objective promoted by [such] presumption is of greater importance than the opportunity to present facts challenging the presumed fact."[39] Given the extent to which irrebuttable presumptions are disfavored, in order to provide for one, Congress must have been extremely clear. As discussed, it was not; there is no textual support other than the historical remnant of a caption.

4. The rebuttable presumption is a meaningful incentive for Qualified Mortgages.

Unlike conclusive presumptions, rebuttable presumptions are rules of evidence, governed by Rule 301 of the Federal Rules of Evidence, and operate to give one party a litigation advantage. The litigation advantage that comes with a Qualified Mortgage in Dodd-Frank gives the lender or holder a handicap advantage, not the championship title. It does not absolve lenders of the substantive obligation to make responsible underwriting decisions as both common business sense and the ability-to-pay provisions require. Even if the legislative history and legislative text had given leeway for the Bureau to establish a safe harbor – which they did not – the case for immunity could not be that a rebuttable presumption is too small a litigation advantage to constitute a market incentive. Indeed, complex cases like civil rights cases often turn on the evidentiary burdens allocated in the law.

The allocation of burdens in an ability-to-pay case would work like this: The consumer would file a lawsuit claiming s/he was unable to pay the mortgage from its inception. Normally, the creditor would have to present enough evidence that it had made a reasonable and good faith determination that the borrower had the ability to repay the mortgage to undermine the consumer's case. But with the presumption, the creditor or holder can simply defend by showing it made a Qualified Mortgage and verified income. It need not do more. The burden then shifts back to the consumer who must produce evidence that the lender did not make "a reasonable and good faith determination of the reasonable ability to repay." As a practical matter, this rebuttable presumption will enable the lender in many cases to dispose of the consumer's case through pre-

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[37] *See Michael H. v. Gerald D.*, 491 U.S. 110, 119-20 (1989); 1 Jack B. Weinstein & Margaret A. Berger, Weinstein's Evidence, P 300[01] (1993); 1 Charles E. Torcia, Wharton's Criminal Evidence § 29 (14th ed. 1985).
[38] *United States v. Provident Trust Co.*, 291 U.S. 272, 281-82 (1934).
[39] *Davis v. Provo City Corp.*, 193 P.3d 86, 90 (Utah 2008).

trial motions and avoid trial altogether. That is a significant litigation advantage to the lender. But, it is not a slam dunk. It at least allows the consumer who has a very strong case to come back and present that evidence before a fact-finder. In contrast, a safe harbor would completely deprive the consumer of that right – no matter how clear and compelling the evidence of inability to repay or the lender's bad faith.

As enacted, Dodd-Frank requires that Qualified Mortgage status confer a rebuttable presumption, not a safe harbor. Even in the early days of the subprime crisis, Congress did not consider giving a conclusive presumption to creditors, and it removed language that would have given a conclusive presumption to secondary market holders after the crisis became full-blown. The evolution explains the presence of the phrase "safe harbor" as a vestige of a proposal never enacted into law. By contrast, the text of the statute, well-established principles of law, and principles of statutory construction all support the rebuttable presumption.

5. The goals of safe and sound banking and sustainable lending are best served by a rebuttable presumption.

Given the above history and applicable law, we do not believe that Dodd-Frank allows the Bureau the flexibility to bestow a conclusive presumption on lenders. But even it if did, it would be contrary to the twin statutory goals of encouraging safe, sound, sustainable mortgage lending, and achieving a fair and balanced system of accountability for the Bureau to do so.

As explained above, under either definition of a Qualified Mortgage, the bottom line is simply that creditors "consider" all of the enumerated factors. There are elaborate proposed rules for the creditors to calculate the numbers they "consider," but in the end, there are no benchmarks for what they do after they "consider" and verify that information. [40] That leaves a huge gap between the goal that Qualified Mortgages will be both safe in design and soundly underwritten and the actual requirements.

Reasonable debt-to-income ratios are essential to sustainable lending but lenders have not always adopted them independently. Even before the tsunami of no-doc and low-doc loans, and NINJA[41] loans flooded the market, the so-called underwriting standards used in a significant part of the subprime market used an improbable and irrational 50-55% DTI as their "affordability" benchmark. Some of the organizations submitting these comments have represented elderly individuals who were placed into risky, equity-skimming refinance loans that would have predictably led to absurd DTIs – such 85% – after reset. While the new requirements prohibit using low teaser rates to qualify borrowers, the safe harbor proposal for QMs (and even the proposal for rebuttable presumption QMs) appear to still leave room for such unrealisic standards to apply in "considering" the consumer's ability to manage the payment.

Several recent examples are illustrative.

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[40] Under the Alternative 2 definition of safe harbor (the rebuttable presumption QM), the proposed OSC says that creditors may look to widely accepted underwriting standards for certain underwriting requirements. Because the specified requirements would not apply to the safe harbor QM, that benchmark apparently would not apply. *See* §§ III-C and IV-E for further discussion

[41] Refers to "no income, no job, no asset" loans made in the last several years.

- Tilton Jack[42]
  - Mr. Jack, an 82-year-old widower and retired car-inspector for the Metropolitan Transit Authority, owned his Brooklyn home since 1985. Mr. Jack received a pension and Social Security totaling about $4,725 per month.
  - In 2006, Mr. Jack received a solicitation for a low-interest mortgage. When he contacted the lender, he was promised a 1% loan and lower monthly payments.
  - Unbeknownst to Mr. Jack, the promised 1% rate only lasted for one day and the negative amortization loan would ultimately result in payments of approximately $3,300 including taxes and insurance, almost 70% of his income.

- Willie Lee Howard[43]
  - Mr. Howard, a 65-year old day laborer, purchased his first home in Northeast Washington, D.C. with HUD assistance in 2000. Mr. Howard grew up as one of 14 children of sharecroppers and was pulled out of school after seventh grade to farm full-time. He cannot read or write.
  - Mr. Howard was repeatedly solicited with telephone calls and mailings and received four refinances between June 2005 and November 2006. The payment on the last loan, an interest-only adjustable rate mortgage, was initially $1,706.37, almost $1,000 more than he was promised, and would ultimately reach $2,154.46.
  - Mr. Howard earned $15.89 an hour, for a monthly income of $2,542.40; the mortgage payments would reach almost 85% of his income. The fees he was charged for the refinancings caused him to lose just over $50,000 in home equity.

- Glenn Pevarski[44]
  - After Glenn Pevarski of Ohio was in a work-related car accident, Ameriquest promised his family an affordable loan that would refinance all of their existing debt.
  - In fact, the loan did not pay off all of their prior loans, and that it was an adjustable rate loan where the rate would never decrease, and instead would definitely increase.

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[42] Mr. Jack was represented by the Center for Responsible Lending and South Brooklyn Legal Services. *Jack v. Golden First Mortgage Corp.*, 07-CV-3088 (E.D.N.Y Filed Apr. 2008).
[43] Mr. Howard was represented by the Center for Responsible Lending and AARP Foundation Litigation. *Howard v. Countrywide Home Loans, Inc.*, 0001169-08 (D.C. Super. Ct. Filed Feb. 15, 2008).
[44] Mr. Pevarski was represented by Jason Causey, of Bordas and Bordas of Wheeling, West Virginia. Margot Saunders of the National Consumer Law Center provided an expert witness report in this case. *Deutsche Bank Nat'l Trust Co. v. Pevarski*, 08CA52 (Ohio Cir. Ct. Filed Feb. 26, 2007).

- The loan payments for the first two years required them to pay 50% of their pre-tax income. When the payments increased in June 2006, the new payment required 60% of their income. The last adjustment required 76% of the Pevarskis' gross monthly income.

- When the payments climbed above 50% of their income the Pevarskis contacted Ameriquest for the promised "affordable refinancing." None was available and the Pevarskis defaulted.

The proposed safe harbor Qualified Mortgage does exclude some of the most egregious examples of past risky loan terms, and does prohibit the practice of underwriting to low teaser rates on ARMs. However, it still leaves ample room for a lender to make predictably unaffordable lending in violation of the basic ability-to-pay requirement in § 1411.

While interest only and negative amortization would be banned for a loan to be considered a Qualified Mortgage, balloons limited, and points and fees limited to 3%-5%,[45] there is no limitation on rates, or the amount of the rate increase. Indeed, even a high APR HOEPA loan could be a Qualified Mortgage. (We include in our recommendations that HOEPA loans be categorically excluded from the definition of "Qualified Mortgages."[46]) While the underwriting in this proposal must be to the maximum rate allowable in the first five years, what does that mean in terms of outcomes? If the lender says it took the maximum rate into account and "consider[ed] and verifie[d] the reasonably expected income, it would not matter that the lender exercised bad faith in making a loan to our elderly homeowner facing an 85% DTI. With a safe harbor, the lender would be free to act in bad faith without consequences. The lender could make a conscious decision to accommodate an overall loss rate that would lead it to take a chance on an equity-rich, but unaffordable loan to an elderly homeowner.[47] The result would be no different than for the consumers in the only reported case involving HOEPA's original ability-to-pay requirement *Newton v. United Co. Fin'l Corp.*, 24 F. Supp. 2d 444, 457 (E.D. Pa. 1998). Though UC Lending's residual income guidelines were "demonstrably flawed" and a parade of consumers demonstrated to the court that loans were made without regard to the ability to pay,

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[45] The amount of the points and fees cap, as proposed, varies by loan amount. See Section III-D, below, for our discussion of these alternative proposals.

[46] *See* Section III-D: It should be remembered that the top subprime lenders' business model for subprime loans when HOEPA was enacted and for following 5-7 years were in fact fixed rate, 30-year loans. They just happened to have high points (addressed by the points and fees cap in the Qualified Mortgage definition) and very high interest rates – as much as 15-18% or higher (not addressed by the Qualified Mortgage definition.) *See, e.g.*, *Butler et al. v. Beneficial Homeowner Service Corp.*, 01- CV -6450 (W.D.N.Y. Filed September 2011) (class action involving high, fixed-rate HOEPA loans with APRs ranging from 12.019 to 24.97% and mortgage payment to income ratios as high as 88%). Under Dodd-Frank's new HOEPA provisions, the APR threshold would be at around 11.2% (PROA as of 4/11), and around 14.5% if the PROA returns to around 2000 levels (8%).

[47] The general requirement that the creditor consider assets other than the collateral does not adequately address this problem. Even prior to the decline in the housing price index, predatory lenders gave equity-skimming loans to many elderly home owners with low-value homes. The lenders knew at the time the loan was made that they were undersecured, and so were not basing the lending decision on the liquidation value of the home. They were setting a loan flipping scheme in motion. There is a subtle, but meaningful difference between equity-stripping schemes and collateral-based lending. *See* IV-C below for a discussion of the distinction in the context of the ability-to-pay proposal.

the court held that the plaintiffs failed to surmount the "admittedly heavy burden" of the law's pattern and practice requirement. If a safe harbor is enacted, such consumers would face more than a burden, they would face a bar at the door.

While the Board's proposal offers detailed guidance for how to calculate the maximum rate and even how to calculate "5 years"[48] and how to verify income, those fine details are meaningless where a safe harbor precludes any scrutiny whatsoever of whether the results of their "consideration" of the resulting calculations are reasonable and in good faith. As proposed, key factors are omitted from the Board's safe harbor Qualified Mortgage that common sense underwriting should – and in a more responsible past always did – require. That includes such fundamental factors as debt-to-income ratios, other recurring debt obligations – even credit history. (See Table 1, above.) Since it is a conclusive presumption, indeed, there is no opportunity for our elderly homeowner to even put his loan terms in the context of "widely accepted governmental and non-governmental underwriting standards," as would be the case for either non-Qualified Mortgages or the rebuttable presumption Qualified Mortgages.[49] The safe harbor Qualified Mortgage, as proposed, turns Dodd-Frank's ability-to-pay requirement and all of the detailed guidance about what interest rates to use in "considering" a consumer's ability to pay into a hollow exercise.

Given the last decade of absent underwriting, this free pass from accountability simply by saying "sure – we considered that" would be a remarkably bad policy. While the industry is currently overreacting to its recent abandonment of underwriting by perhaps being overly conservative, history also tells us that lessons learned are soon forgotten. The short span of time between the savings and loan debacle of the late 80s and early 90s and the mortgage market meltdown just a few years later is ample evidence of that. These rules will set the standard not just for the hyper-cautious market of this week, but for the future, which predictably will see the resurgence of the same market forces that brought us both the savings and loan crisis and the mortgage crisis.

Consumers must have the ability to put evidence before the court that the creditors' "consideration" of the ability-to-pay requirement was unreasonable or in bad faith. Dodd-Frank's language and Dodd-Frank's purpose require that.

6. The argument that a safe harbor is needed to assure the free flow of mortgage credit is overblown and based on misunderstanding of the extent of exposure to liability. The Congressional goals of "skin in the game," accountability, common sense underwriting, and fairly balanced lender and customer rights preclude the "free pass" of a safe harbor.

We noted earlier that some provisions of Dodd-Frank and other financial reform are geared toward the big-picture aggregate mortgage market activities, including the risk retention requirements of Title IX, capital requirements, and derivatives rules, for example. But the ability-to-pay requirement is in a federal law – the Truth in Lending Act – that governs

[48] Proposed §§ 226.43(d)(2)(iv).
[49] *See proposed* § 226.43(c)(7) (general ability-to-pay standards), and rebuttable presumption Alternative 2 proposed § 226.43(e)(2)(v)-1. That would not apply to Qualified Mortgages under proposed safe harbor Alternative 1 § 226.43(e)(2)(v)-1.

transactions one-by-one. It governs the point at which an originator interacts with a specific consumer to make a specific loan. That law has, since its inception, allowed individual consumers to vindicate their rights with regard to their individual transaction. Congress well understood the implications of putting the ability-to-pay requirement in a statute with a private right of action, and an already well-established and familiar framework for liability.

The remedial scheme in TIL has evolved over the past four decades, as Congress has repeatedly carefully balanced the interests of lenders and their customers, even going so far as to provide retroactive relief in 1995 after the industry had engaged in wide-spread non-compliance, and increasing the tolerances for error.[50] As the Bureau considers the degree of protection from accountability to consumers for non-compliance, it is important to keep in mind TIL's pre-existing general rules on liability. These already carefully calibrate the interests of the industry and its customers, and will be applicable even if there is a rebuttable presumption for ability-to-pay claims.

- The general provision on statutory damages would cap those damages at $4,000 for closed-end mortgages.[51]

- Though actual damages are available, in fact they are very rare due to the extremely high evidentiary hurdles courts have imposed.[52]

- Class action exposure for statutory damages is limited in amount.[53] (And, of course, any purported class action would also have to meet the standards of commonality and other requirements for a certifiable class action under Rule 23 of the Federal Rules of Civil Procedure.) [54]

- There is no liability for any violation if the lender establishes that the violation was not intentional and resulted from a "bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such errors."[55]

- The lender or assignee can avoid liability if it discovers the error on its own and promptly corrects it.[56]

- Assignees have an additional layer of protection in that, in many cases, they are liable for monetary damages for violations only where the violation is apparent on the face of the documents.[57]

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[50] 15 U.S.C. § 1649, Pub. L. No. 104-29 (1995)
[51] 15 U.S.C. § 1640(a)(2)(A)(i). Open-end mortgages are not subject to the ability-to-pay rule.
[52] 15 U.S.C. § 1640(a)(1). *See generally* National Consumer Law Center, Truth in Lending § 11.5.3-4 (7th ed. 2010) (on proof requirements for actual damages.)
[53] 15 U.S.C. § 1640(a)(2)(B) (lesser of $1 million or 1% of creditor's net worth, as amended by Dodd-Frank).
[54] Since ability to pay evaluations inherently deal with individual circumstances of borrowers, class actions are extremely unlikely in this context. They would be maintained only if the lender policies in place encourage non-compliance or there is a widespread pattern and practice of non-compliance. For class actions not subject to the general statutory damages cap, courts look to other factors to limit exposure when warranted. 15 U.S.C. § 1640.
[55] 15 U.S.C. § 1640(c).
[56] 15 U.S.C. § 1640(b).

In adding the ability-to-pay requirements, Congress consciously and carefully weighed what additional liability rules should govern violation of the ability-to-repay requirements. As explained above, prior versions would have given a safe harbor to assignees and securitizers for the ability-to-pay provision, and greatly restricted liability for the secondary market in other respects. But the final version, crafted after the collapse crystallized the problems in the market, reflected a different course. In the midst of the foreclosure crisis, the need to make the law's requirements enforceable by consumers in a meaningful way was abundantly clear. To that end, Congress crafted additional carefully balanced remedies applicable to the ability-to-pay requirement.

- Additional "enhanced" damages in an amount equal to the sum of all finance charges and fees *paid by the consumer within three years of consummation* are available.[58]

- There is no liability if the creditor demonstrates that the failure to comply was "not material."[59]

In the context of the ability-to-pay provisions, practical realities make the three-year cap on enhanced damages particularly key to limiting litigation risk for the market. As a general rule, the earlier in the process a default occurs, the more likely a court is to find that the ability-to-pay determination at consummation was not reasonable and in good faith. (Early defaults, indeed, were one indicator regulators used in identifying potential predatory lenders for enforcement purposes prior to the market collapse.) The amount of interest paid by a consumer – a component of enhanced damages – early on will be relatively small. The amount of interest paid would likely be largest where default occurs later in the life of the mortgage. By contrast, the longer it takes for the consumer to default, the more difficult the borrower's burden will be to show that the default was reasonably predictable at consummation and was caused by underwriting rather than a subsequent income or expense shock. And even if the consumer surmounts that burden, the amount of damages is still capped at three years worth of paid interest.

An instructive illustration is that of the Pevarskis in Ohio, whose case was described in III-B-5. They entered into a 2-28 loan in May 2004 with Ameriquest for $177,300. The initial interest rate was 6.3%. However, after twenty-four months the interest rate increased to 8.3%, and after month 30, the interest rate increased to 9.3%. The upfront fees and charges they paid Ameriquest at the origination of the loan totaled $9,041.11. The loan was unaffordable from the beginning.

If the Pevaraskis' case had been brought under this new ability-to-repay provision, their total damages would have been $23,221.43 after one year, and $50,294.13 after three years of payment. To put that in perspective, the homeowners would still owe the lender over $170,000.

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[57] 15 U.S.C. § 1641(a), (b), (e). The rescission remedy is available against assignees even if not apparent on the face of the documents, and there is expanded (though capped) liability against assignees on HOEPA loans.
[58] 15 U.S.C. § 1640(a)(4) (describing enhanced damages), (e)(three-year statute of limitations), (k)(allowing consumers to raise claim in defense to foreclosure after the three year statute of limitations, but capping the amount of the damages at three-years.)
[59] 15 U.S.C. § 1640(a)(4).

	After 1 year	After 3 years
Total interest paid	$10,180.32	$37,253.02
Total origination fees and charges	$9,041.11	$9,041.11
Regular Statutory damages	$4,000.00	$4,000.00
Total Damages under TILA	$23,221.43	$50,294.13
Amount *Still Owed by Consumer*	$175,241.88	$171,556.98

As a practical matter, the consumer's damages are simply credited against the outstanding principal obligation, which is typically still a significant amount, given the size of mortgage loans today. That adjusted balance is what the holder is entitled to if the consumer then refinances that debt, if the loan is modified, or if the holder forecloses.

Finally, there are extra-statutory, but unfortunately very real practical limitations on litigation exposure for non-compliance with the ability-to-pay provisions. The number of lawyers available to help individual home owners in consumer credit cases is only a fraction of what is needed. And while Truth in Lending's statutory attorneys fees bring consumer representation at least theoretically within reach of the average consumer, as a practical matter, many attorneys themselves cannot afford to wait months or even years for the attorneys fees awards to be paid, even assuming they establish the claim successfully. Legal services and public interest attorneys, who have historically formed the core of the consumer credit bar, have always been stretched for resources, and are even more so today, and will be in the foreseeable future. While the statute itself provides the market with protection from excessive litigation risk, economic realities limiting consumer access to representation provides even greater insulation. That is beyond the power of the Bureau to cure. But it is extremely relevant when the Bureau evaluates arguments sure to be made that out-of-control litigation over this one provision will keep the mortgage market from coming back to life unless there is a conclusive presumption.

C. The Qualified Mortgage Designation Must Include the Full Range of the Ability-to-Pay Requirements, Including Common Sense Underwriting to the Individual Borrower's Ability to Pay.

1. The imprimatur of a Qualified Mortgage must assure consumers and investors both that the product design is safe and that the loan was underwritten.

a. The mortgage meltdown was caused by the twin pillars of risky product features and the abandonment of common sense underwriting.

Undoubtedly many in the industry chafe at what they perceive to be over-intrusive regulations into their business judgments. But the industry earned the distrust of the world for abandoning common sense principles *en masse*. It earned that distrust one bad loan at a time.

By the mid-2000s, the origination of non-prime loans exceeded the origination of prime loans.[60] An insatiable demand for more volume and more profitable loan products created a credit bubble, which fed a housing bubble.[61]

> And so you had Wall Street's securitizers basically then talking to the mortgage brokers saying, 'We'll buy what you've got.'…*The big demand was not so much on the part of the borrowers as it was on the part of the suppliers who were giving loans which really most people couldn't afford.* We created something which was unsustainable. And it eventually broke. If it weren't for securitization, the subprime-loan market would have been very significantly less than it is in size.[62] (*emphasis added*).

The crisis stemmed from the fatal combination dose of risky loan products and bad – or even non-existent – underwriting. Lenders "lost sight of the basic tenets of underwriting and risk."[63] The meltdown has given empirical researchers a real-life corpus of loans to study for risk factors.[64] The bottom line is that when loans are not soundly underwritten, it is "risky loans, not risky borrowers" that expose homeowners, lenders and investors to unreasonably elevated risk of default.[65] Exploding ARMs, with predictable payment shock, piggy-back seconds, prepayment

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[60] By 2006, non-prime mortgage originations (jumbo loans, Alt-A, and subprime) of nearly $1.5 trillion surpassed prime mortgage originations, which had decreased to $990 billion. 2011 Mortgage Market Statistical Annual; Inside Mortgage Finance.

[61] The evidence is that the rapid expansion of the supply of money from securitization drove the bubble. *See* Atif Mian and Amir Sufi, *The Consequence of Mortgage Credit Expansion: Evidence form the 2007 Mortgage Default Crisis*, NBER Working Paper 13936 at 2 (Apr., 2008), *available at* http://www.nber.org/papers/w13936 (finding that "the expansion in credit supply was driven by a shift in the mortgage industry towards "disintermediation", which we define as the process in which originators sell mortgages in the secondary market shortly after origination"); "Structured Finance in Focus, The Subprime Decline – Putting it in Context" at 3, Moody's Investors Service (Mar. 2008) ("The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market.").

[62] "The Oracle Reveals All," Newsweek (Sept. 24, 2007). *See also* David Cho, *Pressure at Mortgage Firm Led to Mass Approval of Bad Loans*, Washington Post (May 7, 2007) (One bank explained that the pressure worked both ways – they lost business if they exercised too much due diligence. "The entire industry, over time, became more lax . . . . The more [loans] you accepted, the better relationship and the better price you would have. The name of the game was definitely volume."). *See also* Structured Finance in Focus, *The Subprime Decline – Putting it in Context*, at 3, Moody's Investors Service (March 25, 2008) ("The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market."); and sources cited in Center for Responsible Lending, *Comments on Proposed Interagency Statement on Subprime Mortgage Lending*, at 4-5, notes 11 & 12 (May 7, 2007), *available at* http://www.responsiblelending.org/pdfs/Subprime-Statement-CRL-Comment.pdf. *Cf.* Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru, Vikrant Vig, *Securitization and Screening: Evidence From Subprime Mortgage Backed Securities,* at 26-27 (Jan. 2008) (securitization weakens creditors' incentive to screen the loans they make) *available at* http://www2.law.columbia.edu/contracteconomics/conferences/laweconomicsS08/Vig%20paper.pdf.

[63] Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure and Next Steps*, at 38, *see also* 35-38 (2011) (internal quotations omitted).

[64] A partial bibliography of some of the recent studies exploring default risk factors is attached as Appendix A.

[65] *See, e.g.* Ding, Lei et al. 2011, Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models, *Journal of Real Estate Research* 33 (2): 245-78; "Structured Finance in Focus, The Subprime Decline – Putting it in Context" at 3, Moody's Investors Service (Mar. 2008) ("The subprime crisis is largely a product of increasingly aggressive mortgage loan underwriting standards adopted as competition to maintain origination volume intensified amid a cooling national housing market."); M. Diane Pendley, et al., Fitch Ratings, "The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance," *Structured Finance*

penalties, broker-origination, no-doc loans to hide the absence of underwriting – these all are product and market design risk factors, and are appropriately the focus of legislative and regulatory response. But those reforms alone will not suffice if common sense underwriting standards built into the ability-to-pay provisions are short-circuited.

b. Creating Qualified Mortgages that embed sound underwriting principles and confer a rebuttable presumption will allow more room for honest, efficient competition and affordable loans. It will not reduce access to responsible credit.

Dodd-Frank's reforms addressed both pieces of that equation – the underwriting and the loan features. The ability-to-pay provisions of § 1411 are a key cornerstone of the reform. It is intended to – and must – be the baseline in order for the Qualified Mortgage to serve the function intended. Both originator and investor demand for more lucrative in the short-term, but riskier, loan products, "crowded out" sound, sensible loans.[66] The Qualified Mortgage, and the related Qualified Residential Mortgage, were intended to reverse that "crowd-out" effect, and increase the incentives to originate sensible, sustainable loan products and terms, sensibly underwritten. The experience in states with stronger anti-predatory lending laws provides evidence that sensible rules can work to the advantage of honest, responsible lenders.[67]

The Bureau will no doubt receive a great many comments warning of dire consequences to the flow of credit resulting from finalizing these rules. They will warn that regulation will particularly adversely affect credit to low-moderate income families and to minority families and neighborhoods. Long experience and history tell us that these "Chicken Little" warnings from the industry form the key talking point for each and every consumer protection reform. But history also has made it abundantly clear that it is too little oversight and too little accountability that is more likely to lead the sky to fall. We urge the Bureau to look behind those talking points and made-to-order studies, and look instead to the significant record of research and evidence on the causes of recent mortgage failures and relevant experience in the market.

What harmed minority neighborhoods, and low-moderate income families was the disproportionate dose of toxic loans.[68] As a direct consequence, communities of color are now disproportionately suffering the devastating impact of foreclosures.[69] Meaningful, enforceable reforms are a vaccination against a recurrence of this plague on our vulnerable neighborhoods.

(Nov. 28, 2007) (noting the absence of adequate underwriting contributed significantly to the elevated default rates in 2007) [on file with CRL].

[66] Kathleen C. Engel and Patricia A. McCoy, *The Subprime Virus: Reckless Credit, Regulatory Failure and Next Steps*, at 38-40 (2011); Testimony of Kathleen E. Keest Before the U.S. House of Representatives Committee on Financial Services, *Regulatory Restructuring: Enhancing Consumer Financial Products Regulation*, at 3 (June 24, 2009) (noting the Gresham's Law effect of bad money driving out good money in a downward spiral that disadvantages honest, ethical and efficient businesses).

[67] *See, e.g.*, Wei Li and Keith Ernst, *The Best Value in the Subprime Market: State Predatory Lending Reforms*, Center for Responsible Lending (Feb. 23, 2006).

[68] *See, e.g.*, Robert Avery, et al., "New Information Reported under HMDA and Its Application in Fair Lending Enforcement," Federal Reserve Bulletin, Summer 2005.

[69] Debbie G. Bocian, Wei Li and Keith Ernst, Foreclosures by Race and Ethnicity: The Demographics of a Crisis, Center for Responsible Lending (June 18, 2010), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf.

The purpose of the ability to repay, the Qualified Mortgage and other Dodd-Frank reforms is to stem the flood of dangerous lending, cynically justified as providing "access" to credit and access to homeownership. But the flawed market of the past decade devastated millions of families and the economy. Strong, meaningful, enforceable ability-to-pay rules, bolstered by a well designed Qualified Mortgage definition, puts us back on the right track – the one we should have been on all along. Make sensible, affordable loans. Make loans that are designed for success, not destined for failure. That is the kind of access that the Bureau must facilitate.

c. The Qualified Mortgage designation must assure that the loan is responsibly underwritten, as well as sensibly designed.

As discussed above, the Board proposes two alternative definitions for a Qualified Mortgage. The definition that is tied to the safe habor ironically omits key underwriting requirements designed to reasonably assure that any given borrower will, under circumstances known at the time the loan is made, be reasonably likely to repay according to the loans terms.

The items that are not required for this safe harbor Qualified Mortgage designation are that the creditor consider and verify: employment status (if the ability to repay relies upon that income), monthly payments on simultaneous second liens of which the creditor is or should be aware, current debt obligations, DTI and residual income, and credit history. These are basic, core features of common sense underwriting that are clearly related to the risk of default.

By omitting those features, the Board's proposal would not even incorporate any general benchmark for "considering" ability to pay such as generally accepted underwriting standards. The proposed Official Staff Commentary specifically provides that the creditor may look to "widely accepted government and non-governmental underwriting standards" in defining "current debt obligations," underwriting standards for DTI, and in defining and verifying credit history.[70] Since none of those standards apply to the proposed safe harbor qualified mortgage definition, it appears that nothing in the Board's proposal would incorporate any benchmark standard for underwriting.

A Qualified Mortgage will only allow consumers and investors to trust that designation if it also assures that common sense underwriting is embedded in that designation. That means that a Qualfied Mortgage must include the full requirements of Dodd-Frank's ability-to-pay provisions, irrespective of the Bureau's decision as to the safe harbor or rebuttable presumption issue. The truncated underwriting provisions of the Board's proposed "safe harbor" Qualified Mortgage will fail in its essential purpose. Sound underwriting is an individualized decision. A Qualified Mortgage that does not carry with it an assurance that the borrower's capacity to repay was explored and considered in accordance with baseline standards will not create the positive market incentive for which it was designed.

We discuss in Section IV specific comments and recommendations regarding the ability-to-pay provisions.

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[70] Proposed § 226.43(c)(2)(vi), (viii)-1, and 226.43(c)(7)-i.

D. The Qualified Mortgage Definition Should Be Refined to Meet the Goals of the Statute.

1. Rate-threshold HOEPA loans should be categorically excluded from Qualified Mortgage status.

More than fifteen years ago, Congress identified high-cost mortgages as toxic. It enacted special restrictions on those loans. When a HOEPA loan is involved, consumers are given special disclosures, and the loan must even be "branded" to warn investors.[71]

There are independent price triggers applicable to the determination of whether an expensive loan is a "high-cost" loan as defined by HOEPA. The most commonly applicable trigger is the points and fees trigger, set at 8% now, to be 5% when Dodd-Frank is fully implemented. A points and fees HOEPA loan would be excluded from Qualified Mortgage status by the 3% cap in the QM definition.

But there are no rate restrictions in the QM definition, so there is no hurdle to keep a high APR-triggered HOEPA loan from being a Qualified Mortgage. It would be inconsistent for the rules to grant the same loan the Qualified Mortgage "seal of approval" and concurrently require cautionary signals to both consumers and investors about the pitfalls that come with that loan. Moreover, allowing a HOEPA loan to come within the QM definition would create tension between the fundamental ability-to-repay requirement in HOEPA and the QM presumption in Dodd-Frank.

We recommend a categorical exclusion from Qualified Mortgage status for HOEPA loans.

2. The points and fees adjustment for small loans should balance the costs to consumers, the costs of doing business and the ease of compliance.

A mortgage with more than 3% points and fees cannot be a Qualified Mortgage under the statute. However, Dodd-Frank directed the Board to adjust the points and fees limitation for a Qualified Mortgage to permit lenders making smaller loans to comply with the Qualified Mortgage criteria, expressing particular concern about the potential impact of the rules in areas where home values are lower.[72]

The Board proposes to apply the small loan adjustments to loans under $75,000. Points and fees of 5% would be allowed for loans under $20,000 to qualify if other requirements are met. We agree with the Board that the maximum allowable points and fees on a Qualified Mortgage should not exceed the 5% HOEPA points and fees trigger.[73] The proposal offers two alternatives for calculating allowable points and fees between 3% and 5% on loan amounts between $20,000

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[71] Reg. Z, § 226.32(c)(1) (consumer warning), 226.34(a)(2) (notice to assignee).
[72] 15 U.S.C.§ 1639c(b)(2)(D).
[73] 15 U.S.C. §§ 1639c(a)(5)(c); 76 Fed. Reg. at 27464. This is consistent with our recommendation that a HOEPA loan cannot be a Qualified Mortgage.

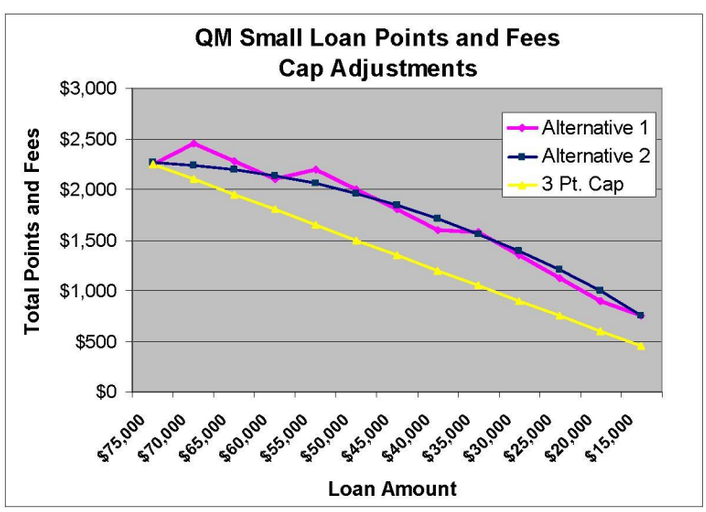
and $75,000. Alternative 1 uses a tiered approach, and Alternative 2 uses a sliding scale approach, calculated according to a complex formula.[74]

To assess that impact, we evaluated the cost to consumers of the Board's two alternatives, and believe that the increased points and fees percentage to small loan borrowers seems reasonable under either alternative. The table below compares the dollar cost to consumers of each alternative, and to a 3% cap.

QM Small Loan Points and Fees Cap Adjustments

Loan Amount	Alternative 1	Alternative 2	3 Pt. Cap
$75,000	$2,250	$2,265	$2,250
$70,000	$2,450	$2,240	$2,100
$65,000	$2,275	$2,197	$1,950
$60,000	$2,100	$2,136	$1,800
$55,000	$2,200	$2,057	$1,650
$50,000	$2,000	$1,960	$1,500
$45,000	$1,800	$1,845	$1,350
$40,000	$1,600	$1,712	$1,200
$35,000	$1,575	$1,561	$1,050
$30,000	$1,350	$1,392	$900
$25,000	$1,125	$1,205	$750
$20,000	$900	$1,000	$600
$15,000	$750	$750	$450

Though the tiered alternative moves less evenly in relation to the loan principal, as the chart below shows, the impact on the cost to consumers is modest.



[74] Proposed § 226.43(e)(3)(i), Alternatives 1 and 2.

As the table illustrates, there is no clear and meaningful cost advantage to consumers apparent as between the two alternatives. Looking at other factors, we believe that there are advantages and disadvantages to each alternative: the sliding scale approach evens out small pricing distortions, while the tiered approach is much simpler for lenders to administer. Given the relatively modest differential impact on consumers, we believe on balance the simplicity and familiarity of the tiered approach weighs in its favor, and we suggest that approach.

IV. The Ability-to-Pay Rules Should Ensure Access to Sustainable Credit

A. The Flexibility Provided in Dodd-Frank Should Be Used to Fulfill the Statute's Goal of Incentivizing Affordable Loans.

This section discusses the ability-to-pay rules that should apply both to Qualified Mortgages and those outside the presumption, except as noted. It addresses specific aspects of the underwriting and proposed exceptions and modifications to the general rule. The overall approach is simple: promote affordable loans with long-term sustainability both inside and outside the Qualified Mortgage presumption while discouraging unaffordable lending.

B. Non-Qualified ARMS Should Be Underwritten Beyond the Fully Indexed Rate to Account for Index Increases in Certain Cases.

There is a key question that applies solely to non-Qualified Mortgages – how to underwrite ARMs that are not Qualified Mortgages. Because of its importance to consumers in the segment of the market that will have the fewest protections otherwise, this is of critical importance, so we begin with it.

Flawed underwriting proved most devastating with the adjustable rate or adjustable payment mortgage products that flooded the market the last decade. These products were pushed on borrowers for whom they were wholly unsuitable, and who predictably could not manage built-in payment shocks: exploding ARMs, interest-only loans, payment-option ARMs. While the hope of the Qualified Mortgage and the Qualified Residential Mortgage is that sensible loan products will become the market's favorites, we must keep in mind that risky products will be in the non-Qualified Mortgage category. Whether the non-QM market share is large or small, only time will tell. But irrespective of the size of its share, we can predict with some certainty that the same vulnerable consumers who fell victim to predatory lending in the last two decades will be disproportionately represented in it.

The ability-to-pay provision is one of the few new provisions that would prevent a new Ameriquest from re-surfacing with only modest changes in its business plan.[75] Even the anti-steering provision in Dodd-Frank relies heavily on the ability-to-pay requirements. The anti-steering rules, yet to be written, must prohibit mortgage originators from steering consumers to a

[75] *See, e.g.* Michael W. Hudson, *The Monster* (2010).

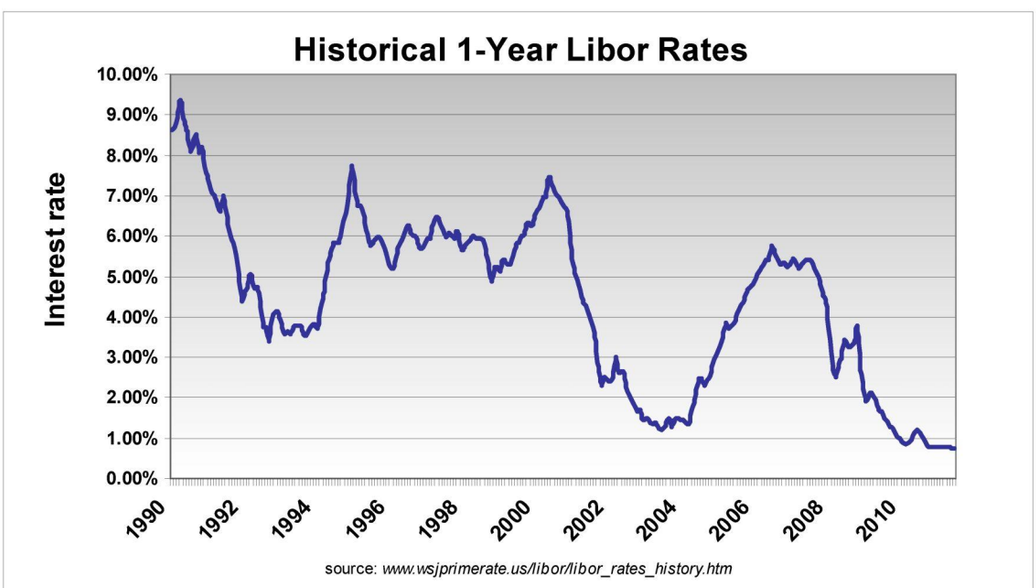
loan for which they lack the ability to pay "in accordance with" the regulations being considered here.[76]

For most of the last decade, the non-prime sector was dominated by ARM lenders who underwrote to low initial teaser rates, without consideration of the borrower's capacity to withstand the payment shock when the teaser expired. The statutory solution somewhat single-mindedly focused solely on the problem of teaser rates, by incorporating into the ability-to-pay provision a requirement that ARMs be underwritten to the fully-indexed rate, defined as the value of the index *at the time the loan is made* plus the margin that will apply after the expiration of any introductory interest rates.[77]

Though certainly a significant improvement, it fails to address a serious flaw in underwriting to the fully indexed rate – even the fully indexed rate can vastly understate the payment shock risk. This is especially the case in low interest rate environments. Responsible underwriting recognizes this. For example, Fannie Mae provides for underwriting at the *greater of* the fully indexed rate or the note rate plus 2% for ARMs with initial fixed rate periods up to five years.

1. Underwriting to the fully indexed rate can greatly underestimate the risk of payment shock.

When the index rate is low, it usually has nowhere to go but up, meaning that the fully indexed rate has a high probability of increasing in subsequent years. The following chart illustrates the historically volatile movement of the 1-Year Libor, a common index used in underwriting ARM loans.



[76] 15 U.S.C. § 1639b(c)(3)(A)(i). The existing anti-steering rules written under the Board's UDAP standards will likely be revised to reflect Dodd-Frank's anti-steering requirements.
[77] 15 U.S.C. § 1639c(a)(6)(D)(iii), (7).

A borrower who took out an ARM loan in January of 2003 would have seen their fully indexed rate increase by over 4% in just four years. Given the current historically low rate environment, significant increases in interest rates are again likely in the years to come.

Even when considering the protections offered by periodic rate caps, it is common for ARM borrowers to incur rate increases of 2% in their first adjustment period on one- to three-year ARMS. A Fannie Mae study in 2004 looking at the ARM rate adjustments found that from early 1994 through the end of 2000, "the ARM rate [on one-year ARMs] would have *almost always* increased by the maximum 200 basis points."[78]

These periodic caps are limited in their protection since borrowers are still exposed to high levels of payment shock. Using the most recently published rates from Freddie Mac's Weekly Primary Mortgage Market Survey, we illustrate below the level of payment shock under a variety of cap structures. With an increase to a 2% periodic cap, the payment on a one-year ARM would increase by 27.4%. If the 5-year ARM increased to a maximum of 5% at the first adjustment (typical initial cap for 5-year ARMS), the payment shock would be 72.2%.

Example ARM payments on current 1-Year and 5-1 ARM products

ARM product	*Start Rate	Loan Amount	Original P&I Payment
5-1 ARM	3.29	$125,000	$546.76
1 yr ARM	2.95	$125,000	$523.64

*source: *Freddie Mac's Weekly Primary Mortgage Market Survey*, weekly average posted 7/14

Payment shock associated with illustrative periodic cap adjustments

Note rate plus 2%			**Note rate plus 3%**			**Note rate plus 4%**			**Note rate plus 5%**		
rate	**adj payment**	**payment shock**	rate	adj payment	**payment shock**	rate	adj payment	**payment shock**	**rate**	**payment**	**payment shock**
5.29	$693.35	**26.81%**	6.29	$772.90	**41.36%**	7.29	$856.11	**56.58%**	**8.29**	**$942.60**	**72.40%**
4.95	$667.21	**27.42%**	5.95	$745.42	**42.35%**	6.95	$827.43	**58.02%**	**7.95**	**$912.85**	**74.33%**

Payment shocks matter to borrowers, lenders and investors. Moreover, the bigger the payment shock, the more it matters. One study found that initial payment shocks of over 30% increase the risk of default over what it had been before the shock *by 90% within the first year* following the interest rate adjustment. Even payment shocks of less than 20% raised the default hazard 40%.[79]

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[78] J. Noel Faheym,*The Pluses and Minuses of Adjustable-Rate Mortgages*, Fannie Mae Papers, Volume III, Issue 4, December 2004.

[79] Sewin Chan, *et al.*, The Role of Neighborhood Characteristics in Mortgage Default Risk: Evidence from New York City, at 16 (Working Paper 2010, Furman Center for Real Estate & Urban Policy).

Responsible underwriting recognizes and takes this into account. We believe that the Bureau can and should follow a model already available to do so for non-Qualified Mortgage loans.

2. The Bureau should require that non-qualified mortgages be underwritten to the greater of fully-indexed or note rate + 2%, as Fannie Mae guidelines go, and should monitor the adequacy of this metric.

Because the problem of underwriting to the fully indexed rate in a low-rate environment is so predictable, there is a simple model in place which the Bureau should adopt, or modify if data suggests that is appropriate. It is within the Bureau's exception authority to do so.

Fannie Mae guidelines call for underwriting ARMs of 5 years and under to the greater of the fully indexed rate or the initial note rate plus 2% for purchases of new loans.[80] This is a model already in place and understood by the industry, so it would be simple to implement.

We recognize, however, that even this, of course, would still underestimate the payment shock for a borrower when the index is at 1%. (For that reason, some believe strongly that non-qualified ARMs should be underwritten at least to the same rules as Qualified Mortgages, particularly in view of the fact that the Qualified Mortgages, by definition, will have fewer other risky terms to layer over the ARM feature.[81])

Consequently, the Bureau should, at a minimum, adopt the Fannie standard. But we urge that it recognize that the non-QM segment could evade sensible underwriting even with this standard in place. To minimize that prospect, we suggest that the Bureau's research and markets division closely monitor both the type of ARM products used in the non-Qualified Mortgage market and the movement of commonly used index rates to assess the magnitude of payment shock that would be allowed by this standard. Armed with that information, the Bureau should consider making adjustments to the margin allowed under the Fannie standard as necessary to reduce the risk of default due to payment shock to serve the interests of both consumers and investors. Through such monitoring, the Bureau could also assess the impact of this standard on access to responsible, affordable credit. We do not believe this common sense standard will reduce such access, but by keeping this part of the ability-to-pay rules on on-going watch, the Bureau will be able to make any changes based on an informed and empirically sound basis.

It is well within the Bureau's authority to make this adjustment to the statutory definition of "fully indexed."[82] Indeed, the Board already has recognized the need for some adjustment to that definition to avoid one problem with the definition – that of the introductory premium rate loan.[83] It proposed the premium rate adjustment pursuant to its § 1605(a) adjustment authority and its discretionary authority under § 1639b(e) to condition practices as necessary and proper to

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[80] Fannie Mae Selling Guide, Section B3-6-04, available at https://www.efanniemae.com/sf/guides/ssg/sg/pdf/sel012711.pdf.
[81] The National Consumer Law Center, one of the authors of these comments, supports this view.
[82] The Bureau has the authority to provide for adjustments as are necessary or proper to effectuate the purposes of the law. 15 U.S.C. § 1604(a).
[83] Proposed § 226.43(c)(5)(i)(A).

effectuate the purposes of both the anti-steering and ability-to-pay provisions of Dodd-Frank.[84] The low-rate index, like the introductory premium rate, are both problems that undermine the goal of responsible underwriting. The justification for the introductory premium rate adjustment proposed by the Board applies equally to the problem we identify here: it will "help ensure that the consumers are offered, and receive, loans on terms that reasonably reflect their ability to repay, and to prevent circumvention or evasion."[85]

C. The Ability to Repay Rules Should Be Carefully Constructed to Promote Credit Only Where Affordable.

1. We support the Board's suggestion to require reliable sources for third-party income and asset verification with examples of those that can be used efficiently, rather than prioritizing whatever can be verified "quickly and effectively."

The Board proposes to implement the statutory requirement that income verification in TILA Section 129C(a)(4)(B) be both "reasonably reliable" and able to be "quickly and effectively" verified 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.[86] 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 still 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.

In addition, we agree that 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.

2. The Board should not provide an affirmative defense for creditors on income verification.

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.[87] The point of the income verification

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[84] 76 Fed. Reg. at 27428-29.
[85] 76 Fed. Reg. at 27429.
[86] 76 Fed. Reg. 27426 (proposed § 226.43(c)(4)).
[87] The Board requests comments on this proposal. 76 Fed. Reg. 27426.

requirement is to ensure that loans are affordable. This requires routine verification of income (and assets, where relevant). The establishment of an affirmative defense is likely to result in too many cases where the rule is observed in the breach. Because enforcement resources (public and private) are inevitably limited, many cases where income was not verified and loans were unaffordable will never be brought to the fore and the creditor would not be held accountable.

If this part of the proposal is adopted, because the proportion of cases where a homeowner will be able to challenge the underwriting afterwards are limited and because government enforcement is necessarily limited, some creditors are likely to make the financial calculation that failure to verify will not result in any negative consequences except in the few cases where they are challenged. Thus, the few cases where a creditor is fined for noncompliance will be simply the cost of doing business without income verification. 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 ignore the rule.

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.

3. The Board should exercise caution in allowing acceptance of nontraditional credit references, especially public utility payments.

The Board notes that the statute requires creditors to consider and verify credit history as part of the ability-to-repay determination and states that a creditor may rely upon credit bureau reports or nontraditional credit references in third-party documents, such as rental payment history or public utility payments.[88] As with the broad approach to third-party documentation of income, a flexible approach to verifying credit history will enhance access to credit for some borrowers, especially those in traditionally underserved communities.

However, some nontraditional credit reporting sources underestimate a borrower's ability to make on-time mortgage payments. In particular, utility reporting may not be predictive because the ability of utility customers to remain current varies greatly by price, weather (homeowners in very warm or cold climates are most likely to face nonpayment), and availability of payment assistance. Thus utility payment histories are not uniformly predictive of a consumer's ability to repay a mortgage. Moreover, most electric and gas utilities currently report a customer only when an account has been written off as uncollectable. Full file reporting (reporting by utility companies to credit bureaus of all customer payment histories), including late payments from customers whose accounts have not been written off, would generate the reporting of millions of new adverse transactions disproportionately concentrated among low-income utility customers.

[88] 76 Fed. Reg. at 27426.

Finally, full file utility reporting would conflict with certain state consumer protections, including disconnection prohibitions or deferred payment agreements. The intent of such protections is to shield a homeowner from adverse consequences associated with utility nonpayment. Many homeowners face nonpayment due to shortage of income and the state's goal of protecting such consumers would be defeated by a full file reporting approach.[89] Utilities are a unique service and have been recognized as such by the states through their varied programmatic and consumer protection structures. We ask that the Bureau exercise caution and qualify any acceptance of nontraditional credit references regarding utilities to account for this concern.[90]

4. Credit insurance premiums and similar payments are mortgage-related obligations and should be included in the repayment analysis.

The Board proposes that mortgage-related insurance premiums not required by the creditor be excluded from the repayment analysis.[91] While Dodd-Frank bans the sale of single-premium credit insurance and similar products in mortgages, it leaves open the possibility of monthly premiums on credit insurance and similar products. Monthly payments for credit insurance or similar products are a) part of the loan payment and b) intended to cover payments associated with the loan. Thus, these payments are mortgage-related obligations. While the paperwork may say the product is voluntary, the transaction often results in the homeowner having the impression that it is required. The payments may be able to be terminated voluntarily, but the homeowner will find that difficult to realize and execute because the payments are combined.

It is well known that credit insurance provided at origination is generally expensive while providing minimal benefit to the homeowner. Often the credit insurance is wrapped in with the loan product sale. The increasing use of debt suspension and cancellation agreements, especially in the credit card area, is a sign that vendors of such products are able to circumvent any state regulation applicable to credit insurance to maximize benefit to the insurer and the seller at the expense of the homeowner.[92] A resurgence of these products in the mortgage area, even on a monthly basis, would be harmful to homeowners and communities. The record on this issue is clear and long-standing.[93] Inclusion of monthly credit insurance and similar payments in the affordability analysis also will serve as appropriate downward pressure on insurance sales abuses. If a borrower can afford such insurance, they can still purchase it.

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[89] For a fuller discussion of these issues, see John Howat, *Full Utility Credit Reporting: Risks to Low Income Consumers*, National Consumer Law Center (Dec. 2009), *available at* http://www.nclc.org/images/pdf/credit_reports/credit_reports_full_utility_dec2009.pdf.

[90] NCLC and CFA would support an approach where utility credit reports are bases for credit history only where the borrower voluntarily provides such information.

[91] 76 Fed. Reg. at 27423.

[92] U.S. Government Accountability Office, *Credit Cards: Consumer Costs for Debt Protection Products Can Be Substantial Relative to Benefits but Are Not a Focus of Regulatory Oversight* (Mar. 2011), *available at* http://www.gao.gov/new.items/d11311.pdf.

[93] For a discussion of credit insurance abuses and litigation related to the voluntariness issue, see National Consumer Law Center, *The Cost of Credit, ch. 8 (4th ed. 2009).*

5. The Board should preserve the statute's ban on consideration of equity.

The statute provides that in making the repayment ability determination, creditors must not consider the consumer's equity in the dwelling or real property that secures loan repayment.[94] This provision seeks to prevent the practice of loan flipping, a commonplace practice in the last several decades that resulted in the diminished equity of many long-time homeowners.[95] Loan flipping involves repeated refinancings, often close in time, where the financed closing costs are paid immediately to the creditor (or broker). Such loans are enabled by the existing equity in the home.

> *Lenders or brokers would convince homeowners to take out high-cost loans that the salespeople knew would eventually become unaffordable. The loans might contain balloon payments coming due in a few years or adjustable rates that would only go up. Just when borrowers were on the brink of defaulting, the brokers or loan officers reappeared on their doorsteps, ready to refinance the borrowers into new loans. Some went so far as to adopt systems for tracking the amount of equity borrowers had in their homes. Each "loan flip" resulted in more fees for the brokers and lenders, which they tacked onto the principal. With each flip, the borrowers' equity shrank and their monthly payments went up, until their equity disappeared and they could no longer qualify for loans.*[96]

By requiring an examination of income and assets, and not equity, the statute focuses on ensuring that the homeowner can afford the loan payments and that homeowners are not subject to loan flipping that serves the lender's needs by yielding immediate payouts with little benefit to the homeowner. Now that other forms of loan officer and broker compensation are greatly restricted, the statute's discouragement of loan flipping as a means of compensation is important to prevent a resurgence of this practice. These loans typically provided minimal cash-out, if any, and historically have been characterized by higher rates and fees than the loans they were refinancing.

The Board proposes to change this provision to ban lending based on the home's value. Without basis, the Board assumes that Congress' goal was to prevent lending based on the amount that could be recovered through a foreclosure. While it may be advisable to also proscribe lending based on the property's liquidation value, it is essential that the notion of a ban on lending based on equity remain in the rules. A creditor could make a loan on a home that has sufficient value for one more flip but would not be profitable at foreclosure.

Removal of the ban on equity-based lending would open up a loophole some creditors would not resist. Because the underwriting requirement only covers the first few years of the loan term, a creditor could structure the unaffordable piece for year six in order to flip the loan and extract

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[94] TILA § 129C(a)(3).

[95] For a discussion of loan flipping, see Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus* (Oxford University Press 2011) at 23; Hearing, U.S. Senate Special Committee on Aging, *Equity Predators: Stripping, Flipping and Packing Their Way to Profits* (March 31, 1998). The Willie Lee Howard story discussed earlier in these comments provides an excellent example of the damage wrought by loan flipping.

[96] *Id.*

equity. Moreover, if the Bureau pursued the Board's proposal to allow an affirmative defense for failure to verify income, the lack of a ban on equity-based lending would combine with the ill-conceived affirmative defense to potentially bring us back to the types of equity stripping that have been too common in recent decades. The Board notes that it would make its proposed changes with the use of its exception authority in section 105(a) and its authority under section 129B(e) relating to mortgage loans. This authority should be used sparingly and only to better implement the goal of protecting homeowners from unsustainable loans. The proposal to remove the ban on equity lending does not meet that standard.

6. Future changes of circumstances that are not included in a consumer's application or records used to determine repayment ability should be used with care; future changes that may decrease income should be considered.

We support the Board's proposal to allow consideration of future changes of circumstances that might significantly decrease income, such as an impending retirement.[97] In fact, it is essential that such a change be incorporated so such individuals cannot be approved for loans that will soon be beyond their means. However, impending increases in income are generally speculative. Even today's law school and medical school graduates cannot assume they will obtain employment at a specific time for a specific salary. While some flexibility based on governmental standards may be warranted, reliance on income increases that have not yet occurred would undermine affordability in most instances.

Further, while the Board is clear that those changes not listed should not be included, it would be worth clarifying that an applicant on maternity leave from her employment should be considered employed unless she, of her own initiative, indicates that is not her plan. As the lawsuit by the Justice Department against MGIC[98] demonstrates, no woman should be denied access to a loan because she is on maternity leave. We support such a clarification in addition to supporting the Board's proposed comment to clarify that the creditor is not required or permitted to make inquiries prohibited by the Equal Credit Opportunity Act and Regulation B. The Fair Housing Act also should be included in that clarification.

7. Negative amortization loan payments should be calculated based on the maximum increase followed by the remaining term's contract payments.

The statute requires in section 129C(a)(6) that payment calculations to determine affordability of negative amortization loans outside the Qualified Mortgage purview should be done by using the higher of the fully indexed or introductory rate and substantially equal, monthly principal and interest payments that will repay the maximum loan amount over the term of the loan remaining as of the date the loan is recast. The Board clarifies that for purposes of this rule, the creditor must first determine the maximum loan amount and the period of time that remains after recast.[99] This clarification makes clear that the payments after recast should be based on both the

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[97] 76 Fed. Reg. at 27420.
[98] *See* Press Release, U.S. Department of Justice, *Justice Department Sues Nation's Largest Mortgage Insurance Provider for Discrimination Against Women on Paid Maternity Leave* (July 5, 2011) (announcing suit against mortgage insurer for requiring applicants on maternity leave to return to work before insurance would be provided).
[99] 76 Fed. Reg. at 27428.

maximum principal increase under the terms of the note and also the higher payments that will be required for the term that is shorter than the full loan term. We strongly support this approach. Only by accounting for the effect of the low payments on the increased principal, and then the shorter timeline for paying off an amount greater than the initial balance, will the calculation yield realistic results.

D. Debts That Will Expire Soon and Loans in Forbearance or Deferral Generally Should Be Included in Debt Obligations Used to Determine Ability to Repay a Mortgage Loan.

The Board solicits comment on whether it should provide additional guidance on considering debt obligations that are almost paid off.[100] It notes that some underwriting standards limit consideration of debts that will expire in fewer than 10 months or 12 months. The Bureau should not specify an immutable rule and certainly should not allow all debts that expire in under 10 months to be ignored.

The goal of underwriting is to ensure that the homeowner can afford the loan, and the statute's focus is especially clear about the importance of affording the early years. If the debt in question is a car or student loan payment, or a subordinate lien, the payment could be quite high in those months before expiration. This will have a greater impact on homeowners with low cash reserves. Many households also replace an expiring debt with new debt to fill that capacity in their budget, and thus the assumption that debt will disappear may not be well founded. In general, if a soon-to-expire debt puts a loan out of the affordability zone, the homeowner should wait until the debt expires unless the creditor finds a basis for making an exception. Recent experience with early pre-reset defaults on payment option ARMs bolsters this conclusion.[101]

The Board also solicits comment on whether it should provide guidance on consideration of loans that are in forbearance or deferral for at least 12 months, especially student loans. For the reasons stated above, these amounts generally should be included in the loan analysis although referral to generally accepted governmental standards could allow for exceptions in cases where such deferral or forbearance does not bear on affordability (such as where a borrower is in graduate school). The goal of the statute is to provide long-term affordability for loans. While

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[100] 76 Fed. Reg. at 27424.

[101] Federal Reserve Board, 74 Fed. Reg. 44,522, 44,540-541 (July 30, 2008) ("Payment increases on 2-28 and 3-27 ARMs have not been a major cause of the increase in delinquencies and foreclosures because most delinquencies occurred before the payments were adjusted."); Susan E. Barnes, Patrice Jordan, Victoria Wagner & David Wyss, *Standard & Poor's Weighs in on the U.S. Subprime Mortgage Market,* Standard & Poor's, at 12 (Apr. 5, 2007), *available at* http://www2.standardandpoors.com/spf/pdf/media/TranscriptSubprime_040507.pdf (increase in early payment defaults within four months of origination); Joint Center for Housing Studies, *State of the Nation's Housing 2007* at 20, *available at* http://www.jchs.harvard.edu/publications/markets/son2008 (subprime ARM 60 day delinquency rates reach 10% to 28%, depending on the origination year, for loans made in 2002-2007, at least 6 months before reset); Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages*, at 15-17 (Federal Reserve Bank of St. Louis, Working Paper No. 2006-042A, 2006) (hybrid 2/28 ARMs have a higher probability of default at any age and the rate of default increases during the first two years, even before any payment shock); Morgan J. Rose, *Predatory Lending Practices and Subprime Foreclosures – Distinguishing Impacts by Loan Category*, at 25, 32 (Dec. 2006), *available at* http://www.chicagofed.org/cedric/2007_res_con_papers/car_62_morgan_j_rose_foreclosures_draft.pdf (average purchase money ARM that entered foreclosure took only 12.4 months to enter foreclosure from origination).

the Board should allow for individualized analysis, the baseline assumption should be that current debts are included.

The Board also asks if it should provide guidance on income verification for joint applicants. As with other aspects of income verification, the Board should emphasize the importance of verifying income upon which the creditor relies for analyzing repayment ability or where the creditor relies in any way on that income as assurance of repayment.

E. Guidelines on Debt-to-Income Ratios and Residual Income Should Provide Flexibility While Ensuring Affordability.

1. Consideration of both DTI and residual income are essential to making reasonable decisions about affordability. The Bureau should use its research capacity to set informed and realistic standards for integrating debt-to-income analysis with residual income review.

The Board's proposed implementation of the requirement to consider debt-to-income (DTI) ratio or residual income[102] rightly notes that some flexibility for case-by-case analysis is needed to ensure that the approach with the maximum ability to predict affordability is used. The Bureau should review the role of DTI ratios in affordability and should take on the essential task of examining means for integrating debt-to-income analysis with a residual income review.

The Bureau should conduct research on the role of front and back end ratios. The recent experience with the Administration's Home Affordable Modification Program makes clear that analyzing affordability based only on front-end ratios (31% in this case) has had some success (for those who have been able to obtain the final modification terms under the program). Nevertheless, many homeowners with such modifications still face large back end ratios and the longer term effects of that situation are still playing out.

The statute's inclusion of residual income also highlights a key aspect of affordability, especially for low-income homeowners. At the end of the day, how much money do you have for ordinary expenses? The Bureau should review the VA's integrated approach to residual income and DTI[103] and update the cost of living tiers (which were last updated in 1997).

Residual income is an essential component of an affordability analysis, especially among lower-income families.[104] After making housing related monthly payments, and all other regularly scheduled debt payments due as of the date the home loan is made, sufficient residual income

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[102] 76 Fed. Reg. at 27424.
[103] 38 C.F.R. § 36.4840.
[104] *See* Michael E. Stone, *What Is Housing Affordability? The Case for the Residual Income Approach,* Housing Policy Debate, Vol. 17, Issue 1 (Fannie Mae Foundation, 2006), *available at* http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_stone.pdf. *See also Newton v. United Companies Fin'l Corp.*, 24 F. Supp. 2d 444 (E.D. Pa. 1998) (company's residual income guidelines were "deeply flawed" and all the borrowers presented to the court had loans made without regard to ability to repay. Despite this, no liability for violation of HOEPA's ability to pay requirements due to the law's "pattern and practice" requirement.).

must be available to cover basic living necessities including, but not limited to, food, utilities, clothing, transportation and known health care expenses.

Research in this area and consideration of revised, meaningful standards that amplify the relationship between DTI and residual income would be worthwhile because more specific standards, even with ranges of acceptable ratios or residual income, could better support safe and sound underwriting criteria. Specificity will result in higher compliance rates and more performing loans. Notably, many subprime lenders purported to consider residual income and to set DTI limits yet the loans were clearly unaffordable.[105]

Higher income borrowers can generally afford to carry a higher DTI than can lower income borrowers without putting themselves and their families at imminent risk of foreclosure. As residual income increases, borrowers can generally safely tolerate a higher DTI. Conversely, as residual income decreases, permissible DTI should also decrease. Adopting a tiered or teeter-totter approach, such as the VA's rule, would allow the Bureau to ensure that all loans are made with an eye to long term affordability while permitting higher income individuals unfettered access to credit.

The VA guidelines combine specificity and flexibility. They allow loans to be approved without special supervisory approval if the veteran has a DTI of 41% or less *and* meets a residual income test. The DTI takes into account the monthly PITI of the loan being sought, homeowners' and other assessments such as condo fees, and any other long-term obligations. The residual income test is used to determine whether the veteran's monthly income, after subtracting monthly shelter expenses and other monthly obligations, will be sufficient to meet living expenses. The VA standards reflect family size, regional differences, and loan amount.

A critical feature of the VA guidelines is the flexibility they provide to make exceptions based on documented facts, and the manner in which DTI and residual income relate to each other. If the veteran meets the DTI standard but not the residual income standard, or if the DTI is greater than 41%, the underwriter must justify the loan in accord with detailed guidelines, and the underwriter's supervisor must approve the loan.[106] If, however, the veteran has residual income substantially in excess of the guidelines, the loan can be approved without special justification.[107] This rule recognizes that the importance of DTI recedes if the borrower has larger residual income.[108] The VA guidelines demonstrate that adopting specific DTI and residual income standards does not mean that creditors would be forced to focus woodenly on just one or two underwriting factors.

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[105] By contrast, most servicers impose inflated residual income standards when a consumer seeks a loan modification. So, a lender can structure a loan that is predictably unaffordable with an unrealistically low residual income threshold, and then, when the loan fails, deny a modification because the borrower lacks residual income.
[106] 38 C.F.R. § 36.4840(c)(4), (5).
[107] 38 C.F.R. § 36.4840(c)(3) (special justification unnecessary if residual income exceeds guidelines by at least 20%).
[108] As an illustration, a borrower with a million dollars in annual net income might be able to afford a $800,000 housing expense, an 80% DTI ratio, because that borrower would have $200,000 in residual income for other annual expenses. On the other hand, if a borrower paid 80% of an annual net $20,000 for housing expenses, that borrower would have only $4000 for all other annual expenses, and the loan would clearly be unaffordable.

The VA guidelines include the veteran's credit record and downpayment as factors to consider in approving a loan that does not meet the DTI or residual income standards. These factors work in the context of the VA guidelines, with specific guideposts for residual income and demanding requirements regarding debt. There should be no exception provided to the Dodd-Frank requirement to consider DTI or residual income. A good credit history and equity in the property have no bearing on whether the borrower actually has the money to pay the mortgage each month. Credit scores and downpayments tell us about past behavior and about incentive to make the payments, not ability to repay. If the money is coming from income, only a DTI and residual income analysis can answer the forward looking question of ability to repay. Indeed, reliance on a high down payment to waive residual income or DTI requirements could be seen as an abrogation of the statutory requirement to ban lending based on equity. Moreover, without specific requirements, bank examiners – and for that matter, assignees – have no guideposts against which to measure compliance or safety and soundness.

It should be stressed that the VA guidelines were adopted by an agency whose mission is to help veterans obtain stable housing. These guidelines therefore are concerned with ensuring that the borrower benefits from the loan, while at the same time avoiding rigid exclusion of veterans who may be able to sustain homeownership despite lower incomes. If these goals had informed mortgage lending during the past decade, it is unlikely that the current mortgage crisis would ever have developed.

2. The benchmark reference for underwriting standards should be widely accepted governmental standards. If non-govermental standards are to be included, they should be backed by proven, statistically valid evidence, utilizing realistic assumptions.

We also note that the proposed Official Staff Commentary to the DTI provision states that creditors may look to "widely accepted governmental and non-governmental underwriting standards" in considering DTI, and two other requirements of the ability-to-pay provision. We should need no reminder that there were "widely accepted non-governmental underwriting standards" in place during the credit bubble, such as the standard subprime DTI of 50-55% we mentioned earlier. We believe that in view of this track record, the benchmark should be widely accepted governmental standards. If other standards are to be acceptable measures, they should at least be ones that are backed by proven, statistically valid empirical evidence. Further, the standard for what constitutes proven, statistically valid evidence should be set by the Bureau with the flawed assumptions and models of the 2000s firmly in mind.

F. Exceptions or Modifications of the Ability-to-Repay Determination Should Promote Affordability.

1. HELOCS and simultaneous loans should be considered in the affordability analysis.

The Board proposes to incorporate HELOCs explicitly into the requirement to consider simultaneous loans in the affordability analysis.[109] HELOCs used both for purchase money loans and for refinancings should be included in this rule in order to satisfy the statutory goal of ensuring that loan origination produces sustainable results. If the rule required only the inclusion of purchase money HELOCs, it is likely that abuses would migrate to the area left untouched – refinancings. We have seen abuses migrate in the past when a certain type of transaction is not covered by legal protections. For example, one of the practices targeted by the multi-state investigation of Household involved its piggy-back HELOC second liens, all of which were refinancings.

In addition, where the HELOC does not affect affordability, there is no harm in including it. The results of omitting it could be harmful to homeowners with significant debt load increases due to these loans. The inclusion of HELOCs in this rule is especially important because of the broader exclusion of HELOCs from the affordability requirement. While they may not themselves be subject to the overall rule, they may strongly affect the affordability of covered loans.

2. The Board should include HELOCs in an anti-evasion rule.

The Dodd-Frank requirements should include HELOCs in the anti-evasion rule. While HELOCs are explicitly carved out of the baseline rule, the inclusion of an anti-evasion rule that includes HELOCs is the only way to ensure that abuses do not migrate to this area as a result of this lack of coverage.[110] The Board's previous inclusion of HELOCs in the anti-evasion provisions of its mortgage rules should be continued here. Inclusion of HELOCs is necessary to provide meaningful implementation of the core ability-to-repay requirement in Dodd-Frank. Banks held $624 billion in HELOCs in the first quarter of 2011.[111] This significant line of business is part of the mortgage business and part of the homeowner's affordability picture, and the rule should recognize it as such.

3. Higher-priced balloons should be subject to more rigorous underwriting.

The Board's proposed rule requires that higher priced balloons be reviewed for affordability based on the loan's payment schedule.[112] As a result, the affordability analysis for such loans will include a review of the homeowner's ability to repay the balloon. This is appropriate.

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[109] 76 Fed. Reg. at 27417-18, 27422-23.

[110] Household's practice of writing piggy-back seconds as HELOCs, which carried interest rates of 20% or more, was designed to evade HOEPA, which excluded HELOCS. (That exclusion is dropped under Dodd-Frank because of such evasions.) Because there are in fact abuses associated with HELOCs, we recommend that the Bureau implement a strong set of rules to protect HELOC borrowers.

[111] Gretchen Morgenson, *Second Loans, Second Wave of Losses,* N. Y. Times, July 17, 2011 (citing Federal Deposit Insurance Corporation data).

[112] 76 Fed. Reg. at 27428, 31.

Balloon loans have been used for several decades as a means to quickly refinance homeowners into newer loans – with the fees associated with origination going to the creditor, again. The lower monthly payments on a balloon loan provide the appearance of an affordable, sustainable loan but often simply paved the way for a new (perhaps also unsustainable) loan. These abuses were particularly prominent in the high-cost loan market and thus consideration of the effect of the balloon on borrowers in that market is a sensible approach to ensuring affordability. The Board's proposed rule also provides that balloon loans that are not higher priced covered transactions will be evaluated based on the fully indexed payments for the first five years.[113] While creditors may need some flexibility to address specific situations where a balloon loan is not inappropriate or unaffordable for a homeowner, this lower standard may result in an increase in 5 year balloons, a development that would not promote sustainable lending.

V. The FHA Streamlined Refinance Exemption From Income Verification Should Be Expanded To Include GSE Loans.

It is in the best interests of lenders, borrowers and investors to efficiently migrate borrowers from higher cost or higher risk loans into more stable sustainable loan products. Limited and careful exemption from income verification, provided that there are protections in place, can help borrowers and communities, while still barring the door to the reckless and abusive no-doc and low-doc tactics so prevalent in the heyday of the subprime crisis.

A. The Bureau Should Use Its Exception Authority Under the Streamlined Refinance Proposal to Expand the Existing Exemption for FHA and Other Government Streamlined Refinance Programs to Include Streamlined Refinances of GSE-Held Loans While Fannie Mae and Freddie Mac Are in Conservatorship.

Dodd-Frank established an income verification exception for government guaranteed refinanced loans, such as those refinanced under the FHA streamline guidelines.[114] These refinance transactions could afford to be exempted because the U.S. government issued guarantees on these loans and government entities established guidelines to protect consumers; to qualify for the program the FHA has identifiable standards, procedures and protections in place to ensure that homeowners are only refinanced into affordable and sustainable loans.[115] The specific conditions for these refinances provided by the statute[116] promote the use of these transactions for sustainable lending.

GSE-held loans should receive the same income verification exemption as the federally guaranteed programs. Chairman Dodd stated during the 2010 floor debate[117] over the Dodd-

[113] It is worth noting here that the Board's use of the term "maximum payment scheduled" is confusing because it appears to not mean the maximum payment but rather the highest payment assuming conditions on the date of origination of the loan—payment based on the fully indexed rate.
[114] TIL § 129C(a)(5).
[115] FHA streamline products and February 2011 Mortgagee letter *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=FAQsML201111.pdf , http://nhl.gov/offices/adm/hudclips/letters/mortgagee/files/11-11ml.pdf.
[116] 15 U.S.C. § 1639C(a)(5)(A)-(G).
[117] *See* 156 Cong. Rec. S4034-02, 2010 WL 2010614 (Cong.Rec.).

Frank Act that loans guaranteed and/or fully backed by the federal government should receive a streamline refinance exemption. Since the GSEs are currently held in conservatorship by the federal government, the GSE-held loans also have the full backing of the federal government. As the regulators determined for the risk retention rules, the GSEs should be treated the same as FHA for streamlined refinance programs, which are ultimately about reducing the risk to the taxpayer by avoiding default by borrowers who could receive lower-cost mortgages. Borrowers in these loans, like the FHA loans, would benefit from becoming eligible for the streamline exemption and its corresponding protections.

To ensure that the streamlined refinances represent a true benefit for the borrower, standards must be put in place. The protections in the statute's FHA exemption that prevent against churning include: the limitation in principal increases to capped costs associated with the refinancing; the mandate to lower interest rates and provide fully amortizing loans; and the ban on balloon loans. We recommend that GSE streamlined refinance transactions be subject to standards at least as stringent as those for the FHA streamlined program. For example, while the current FHA streamline program requires a minimum 5% reduction in mortgage payments,[118] the Bureau and FHFA should consider whether the FRB's proposal for hybrid refinances of 10% reduction should be a minimum applied to GSE mortgages.[119]

B. We Support the Proposal for Limited Income Verification Exemption for Streamlined Refinances from Certain Nonstandard Loans to Standards Loans, with Modifications.

We agree that a "material reduction" safe harbor should be defined as providing a sustained 10% reduction in monthly mortgage payments.[120]

We also recommend that the program be expanded to include applications filed after the initial reset of the ARM interest rate. The intent of the proposal is to avoid "likely default." For some borrowers, notification that their interest rate has adjusted and their payment has gone up may be their first notice that their loan may have just morphed them into a borrower who needs to avoid "likely default."

Since balloon payment loans place currently performing borrowers at risk of "likely default" and in need of a material reduction, the Bureau should use its exception authority to include balloons.

We strongly object to any inclusion of a balloon product into the "standard" mortgage. Balloon products, even those that have a self-executing renewal, have a built-in feature that should disqualify it from any relaxation of underwriting standards. Balloon loans will necessarily

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[118] *See* February 2011 Mortgagee letter *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=FAQsML201111.pdf

[119] One of the authors of this comment, National Consumer Law Center, prefers that the requirement be a 20% payment reduction. It notes research demonstrating that, in the context of loan modifications for borrowers in default, a 20% payment reduction had a significantly lower redefault rate than a 10% reduction. *See* Li & Garrison, "Fix or Evict? Loan Modifications Return More Value Than Foreclosures" *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/fix-or-evict.pdf.

[120] One of the authors of this comment, National Consumer Law Center, prefers that the requirement be a 20% payment reduction.

(absent available cash to pay off the balloon payment) lead to the need for another refinance, or a default.

The Board asks if "the proposed rule could be structured differently to better ensure that the creditor on a refinancing under § 226.43(d) retains an interest in the performance of the new loan and whether additional guidance is needed."[121] To ensure adequate alignment of interests between the creditor and borrower, we recommend that to be eligible for the income verification exemption, lenders should maintain full interest in the refinanced loan for a minimum of twelve months.

VI. Selected Issues Regarding Prepayment Penalties

A. Definition of Prepayment Penalty.

Dodd-Frank includes a number of reforms regarding prepayment penalties. The Board proposes to define "prepayment penalty" for purposes of § 226.43 to include unearned interest, including interest that results from the interest accrual method of accounting used for other payments in the transaction. It also would include fees, such as closing costs, that are waived unless the loan is prepaid.

We support this definition. Adding unearned interest to a pay-off amount can cost homeowners hundreds or even thousands of dollars. If they are refinancing, they lose that much more equity in their home. If they are paying a loan off, they lose that much more capacity to support other local business and pay other bills. It is not money the lender is entitled to. In these days of sophisticated computer technology, there is little burden on the servicer to make an accurate pay-off calculation. It is analogous to the anachronistic and now mostly banned Rule of 78s method that resulted in consumers paying more interest than accounting math requires. Just as state and federal bans on the Rule of 78s did not adversely affect access to credit, neither should limiting this analogous overcharge.[122]

B. Reverse Mortgages Should Not Be Excepted from the General Ban on Prepayment Penalties.

Dodd-Frank gave the authority to the Board to allow prepayment penalties in some categories of reverse mortgages, though prepayment penalties generally would not be permitted in reverse mortgages under the law.[123]

The Board does not propose to create an exception to permit prepayment penalties on these categories of reverse mortgages, noting that most reverse mortgages are FHA insured, which itself includes a ban on prepayment penalties. We support this position. Because reverse

[121] 76 Fed. Reg. 27441.
[122] Federal law bans the use of the Rule of 78 in loans over 61 months. 15 U.S.C. § 1615.
[123] Prepayment penalties are generally banned in closed-end mortgages except lower cost, fixed rate Qualified Mortgages. Most reverse mortgages could not be Qualified Mortgages due to the product design.

mortgages negatively amortize, homeowners who wish to get out of a reverse mortgage to preserve equity should not be penalized for doing so.

C. Permitted Prepayment Penalties in Certain Qualified Mortgages.

The Board makes a number of proposals regarding prepayment penalties where permitted in connection with lower-cost, fixed rate Qualified Mortgages. We will comment here on three of them.

Step Rate Mortgages: The statute prohibits prepayment penalties when the rate can vary. The Board proposes to interpret that to mean "annual percentage rate," which would result in permitting prepayment penalties on step rate mortgages (because the APR does not change), while banning them on ARMs.

We do not support this proposal. The purpose of the prepayment penalty ban on rate-changing mortgages was that they lock people in as the cost of their loan rises. While step rate mortgage rate changes are predictable, unlike ARMs, they still raise the rate and typically the payment. The policy dictates they be treated the same. Furthermore, we do not believe the text of the statute supports it. When Congress meant "APR", that is the term it used. Indeed, in the very provision allowing prepayment penalties in lower-cost, fixed rate Qualified Mortgages, Congress used "APR" in defining the cost threshold.[124]

Balloon Qualified Mortgages: Generally there can be no prepayment penalties in balloon loans because balloons cannot be Qualified Mortgages, except in the limited circumstances regarding rural and underserved areas. The Board seeks comment on whether it should use its adjustment authority to prohibit prepayment penalties on balloon payment Qualified Mortgages.

We support this proposal. Balloon payments are as much of a challenge for consumers in rural and underserved areas as they are anywhere else. Indeed, if there is so little competition in those areas, they may be even more of a challenge. Prepayment penalties should be banned from all balloons.

The "Transaction Coverage Rate" as the Price Threshold Benchmark: The statute pegs the price threshold for permissible prepayment penalties to the annual percentage rate. Despite the clear and conscious use of a long-defined term, the Board proposes to substitute a concept not in the statute at all – the "transaction coverage rate" – which would omit certain closing costs in making the calculation.

We strongly oppose this proposal. It resurrects this concept from earlier proposals, and we strongly opposed it then. First and foremost, it would irrationally discriminate among consumers who pay the very same cost for a loan. Creditor A who outsources closing services would have a lower "TCR" than Creditor B who does not. Yet the cost is the same to the borrower. The prepayment penalty ban is a consumer protection based on the cost the consumer pays, not what party pockets those costs. Further, the statute says the APR is the benchmark. It complies with the letter and the purpose of the law to use the APR.

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[124] TIL § 1139C(c)(1)(B).

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APPENDIX A: Selected Studies on Default Risk Factors

Author (Year)	Measure of Mortgage Risk	Data	Methodology	Impact of Loan Design/ Underwriting on Risk*	Impact of Macroeconomic Factors on Risk*
Haughwout, Peach, & Tracy (2008)	Early loan default (90+ days within 1 year of origination)	LoanPerformance: subprime and Alt-A, originated 2001-07; n=117,000	Linear probability regression model	LTV (+) DTI (+) FICO (-) Level of Documentation (-)	
Danis & Pennington-Cross (2007)[i]	Serious delinquency (60 and 90+days)	LoanPerformance; originated 1996-2003; n=97,852 with OFHEO Home Price Index; BLS; Freddie Mac's Primary Mortgage Market Survey	Nested logit regression model	LTV (53%) FICO (-64.8%) Prepayment penalty (2.5%) No documentation (336.8%) Low documentation (87.9%)	
Bajari, Chu, & Park (2008)	Default (foreclosure or REO)	LoanPerformance subprime and Alt-A originated 2000-07 with Case-Schiller, Census, and BLS data; excludes IO or balloon	Regression	DTI (+) Low documentation (+) FICO (-)	
Austin (2008)[ii]	Serious Delinquency (90+)	Concentrance Corp. data; FHA loans with downpayment assistance and original LTV >95%; n=5000	Regression	Downpayment assistance (29%) FICO (-) HTI (+)	

Meyer, Pence, & Sherlund (2009)	Rise in serious delinquency 2003-07[iii]	LoanPerformance; subprime and Alt-A originated 2003-07	Correlation	LTV (+) Presence of piggyback lien (+) Low/No documentation (+) FICO (-) Investor Owned (-)	
Alexander et al. (2002)	Default (120+, foreclosure, or borrower bankruptcy)	Proprietary data from subprime mortgage lending firm; originated 1996-98; n=23,200	Regression	Third party originator (27.76%) Loan Grade (-)[iv]	
Chan et al (2010)[v]	Default (90+)	LoanPerformance with NYC Dept. of Finance, HMDA, and NYC tax records; NYC loans originated 2004-07	Regression w/ time fixed effects	Payment shocks (40%-60% depending of timing of shock) FICO (90%) DTI (13%)	Neighborhood foreclosure rate (25%)
Elul et al (2010)[vi]	Delinquency (60+)	LPS data with Equifax consumer credit reports, FHFA and BLS; n=364,000 FRMs	Logit regression model	CLTV (+) Credit utilization (1.1pp) Presence of 2nd mortgage (.22pp)	Unemployment (+)
Bhutta et al (2010)[vii]	Default (90+ for two consecutive months)	LoanPerformance subprime and Alt-A loan with 100% CLTV originated in 2006 in FL, CA, AZ, NV	Maximum likelihood regression model	Equity in Home (-) FICO (-)	Unemployment (+)

Deng & Gabriel (2006)[viii]	Default (foreclosure or deed-in-lieu)	FHA-insured loans originated 1992-96; n=12,012 with Census data for geography	Regression	FICO (-) LTV (+) HTI/DTI (NS) Borrower liquidity constraints (-) Negative equity (+)	Local unemployment rate (+)
Kau, Keenan, and Li[ix] (2011)	Default	Proprietary data from servicing co. of 30 yr FRM originated 1976-2004 with 2000 Census demographic data	Frailty models	LTV (8.1%)	State house price index ratio (.04%) State unemployment rate (11.4%)
Pennington-Cross & Ho[x] (2010)	Default (REO or foreclosure)	LoanPerformance originated 1998-2005; ARM & FRM observed in first 60 months of loan	Regression	Payment Shock (23.9%) FICO (-31.5%) CLTV (29.2%) Low/No Doc (46.5%)	
Ding, et al.[xi] (2011)	Default (90+)	Self-Help CAP data n=9221 originated 2003-06 compared to LPS subprime data	Propensity score matching – CAP loans to subprime loans	Subprime ARM (1.2x) Subprime ARM w/ prepayment penalty (3.0x) Broker-originated subprime (2.8x) Broker-originated subprime ARMS with prepayment penalties (3.8x)	

*(+)=significant positive effect; (-)=significant negative effect

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[i] Interpretations of IV magnitudes: Magnitudes represent percent change, not percentage points, when all variables are held at their mean values and the variable of interest is adjusted by one standard deviation. The effect of prepayment penalty is relative to no prepayment penalty; and is the effect of low/no documentation relative to full documentation. Significant at 5%

[ii] The presence of down payment assistance had delinquency rates 29% higher than comparable loans with buyer funded down payments. Significant at 1%

[iii] Authors attempt to distill which loan features were responsible for the increase in default and delinquency of subprime and Alt-A loans between 2003-2007. For this article a (+) indicates a feature contributing to rise in defaults, while a (-) indicates a feature that did not contribute.

[iv] Authors use "loan grade" as an indicator of three ability to pay variables: FICO, LTV, and HTI. Higher grades indicate greater ability to pay and therefore lower risk of default.

[v] Payment shock of 20%-30% upon the initial interest rate results in 40%-60% higher risk of default depending on the timing of the payment shock: within 3-6 months the risk is 60%, within 7-12 months the risk is 40%, beyond 12 months the effect was small and insignificant. FICO refers to those with scores below 530 compared to those with above 720. DTI refers to those with DTI greater than 45% compared to those with below that. Neighborhood foreclosure rate of greater than 3% increases default risk by 25%

[vi] Magnitudes are for percentage point change per quarter. Credit utilization refers to the relationship between card limits and current balances. For high utilization (>80%) relative to low utilization; effect becomes stronger as CLTV rises, peaking at 1.5 percentage points when CLTV nears 100%. Unemployment is insignificant when CLTV is low (<50%), but the magnitude rises as CLTV rises, peaking at 1.1 percentage points when CLTV is 120%. The additional risk associated with having a second mortgage is .22 percentage points

[vii] Author's main goal of the paper is to model the strategic default decision. Finds that as negative equity increases, default risk also increases significantly.

[viii] Author's main purpose of the model is to determine whether the prepayment risk of extending credit to underserved borrowers outweighs the default risk of lending to these groups. FICO scores are modeled non-linearly with cutoffs at 620, 680, and 740.

[ix] Holding all other variables at their sample means, the change in default risk from a one unit increase in the independent variable. Magnitudes are reported as percentage changes, not percentage point impacts. House price index ratio is defined as the house price index at the time of mortgage termination divided by the index at origination. Results reported are from the frailty model, which the author's argue provides a better fit to the data than a model without frailty since it includes unobserved factors. "Default" was undefined in their paper.

[x] Magnitude of impact refers to a 1 standard deviation increase in the independent variable holding all other variables at mean values. Standard deviations are: payment shock (4.4%), FICO (49.7 points), CLTV (12.4%), Low/No Doc dummy indicator (.395).

[xi] Source of data is from the Community Advantage Program at Self-Help, a CDFI located in Durham, North Carolina that lends to low to moderate income borrowers with loan products similar to prime mortgages. Impacts are comparing the performance of CAP loans to subprime loans originated during the same time in similar geographic areas. The impact reported are ratios of default rates – for example, compared to CAP loans the default rates on subprime ARM loans were 1.2 times higher, subprime ARMS with prepayment penalties had default rates 3 times higher than CAP, subprime loans originated by a broker had default rates 2.8 times higher than CAP, and subprime ARMs originated by brokers with prepayment penalties had default rates 3.8 times higher than CAP loans.