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Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
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Re: Docket No. R-1417; RIN No. 7100-AD75
Proposed Rule Amending Regulation Z: Ability-To-Repay Requirements (76 FR 27390)

Dear Ms. Johnson:

The American Bankers Association[1] appreciates this opportunity to comment on the Federal Reserve Board's Proposed Rule regarding ability-to-repay requirements, mandated by recent provisions of Title XIV of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("DFA"). This complex proposal implements a significant new addition to the regulation of our housing finance system and as such will profoundly affect our member banks. Most importantly, the rule is a significant addition to the regulation of our housing finance system. Since the stakes are so high, and failure to strike the right balance will further damage an already weakened housing economy, it is of utmost importance that policymakers carefully consider and weigh the needs and requirements of all stakeholders.

Overview of Comments

While lenders cannot foresee the challenges a consumer may face in their future, lenders can and should underwrite and originate loans that the consumer can repay. A good regulatory structure would both protect consumers and guard against systemic risk of poorly underwritten loans. These regulations must, however, also ensure that the mortgage finance system continues to provide all the mortgage credit required by creditworthy families across America. ABA believes that any final rule pursuant to this proposal must be carefully calibrated to ensure that these two vital interrelated goals are met.

To achieve these stated objectives, ABA believes that the contents of the Board's proposed rule must be reconsidered. In our comments below, we offer full discussion of the two principal elements of concern for ABA members. Initially, ABA notes that in light of the legal scheme set forth by the Dodd-Frank statutory reforms, the Qualified Mortgage ("QM") loans will be the only viable loans for virtually all bank lenders. The QM segment will become the necessary center of practically all mortgage lending going forward, as financial institutions will access its

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. The majority of ABA's members are banks with less than $165 million in assets. Learn more at www.aba.com.

protections and seek to avoid unreasonable risks. Regulators must therefore craft a safe harbor structure that is not only protective, but also broad enough to sustain mortgage lending necessary to satisfy our housing and financing demands.

To assist regulators, ABA sets forth a proposed solution, one that is well balanced through a mix of amplified consumer protections and provisions that incentivize increases in safe and sound lending activities. ABA is committed to making sure these rules work as intended, and that housing reform works to everyone's advantage.

Background and Overview

On April 19, 2011, the Federal Reserve Board ("Board") issued a proposed rule to implement the ability-to-repay requirements for closed-end residential loans as mandated by Sections 1411, 1412 and portions of 1414 of the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act of 2010 ("DFA"). *See* Pub. L. No. 111-203 § 1411, 124 Stat. 1376, 2142. The rule would establish minimum mortgage underwriting standards for covered mortgages.

The changes proposed in this rule would amend Regulation Z to prohibit creditors from making mortgage loans without regard to the consumer's repayment ability, and would be inserted as new regulations pursuant to a new TILA section at 15 U.S.C. 1639c. The proposed changes are meant to implement the DFA amendments where creditors are prohibited from making a mortgage loan unless there is a reasonable and good faith determination, based on verified and documented information, that the consumer will have a reasonable ability to repay the loan, including any mortgage-related obligations (such as property taxes).

These proposals also implement Section 1412 of DFA, where Congress sets forth a "safe harbor and rebuttable presumption" that a QM will meet the ability-to-repay standards of Section 1411. The Act sets forth certain standards that would define the QM category, and these proposals clarify and expand such standards. If a mortgage loan meets the elements of a QM, the creditor and assignee of the loan would enjoy a safe harbor presumption that the loan meets the Section 1411 standards. Finally, provisions under Section 1414 of the Dodd-Frank Act limit prepayment penalties for residential mortgage loans that qualify as QMs, and outright prohibit prepayment penalties for mortgage loans that do not meet the QM standard. The proposal addresses these provisions as well.

The Act requires the Bureau of Consumer Financial Protection ("Bureau") to prescribe regulations to implement the ability-to-repay provisions, the QM safe harbor, and most importantly, grants the regulator very broad authority to amend and adjust the criteria set forth in the statute.

Observations on Legislative Structure

In this very important rulemaking, ABA believes that the regulators must begin by analyzing the statutory intent and purpose of the statute, and effectuating its purposes. The legislative purpose of the statutory framework being implemented under this proposal is to ensure that consumers are offered and receive loans on terms that they can reasonably repay. The statutory intent is more expansive, however, and the legislation states that Congress created new TILA Section 129C upon a finding that "economic stabilization would be enhanced by the protection, limitation, and regulation of the terms of residential mortgage credit and the practices related to such credit, while ensuring that responsible, affordable mortgage credit remains available to consumers.'' Dodd-Frank Act Section 1402; TILA Section 129B(a)(1). Further, in the section that establishes the Consumer Bureau, Section 1021, DFA is explicit in stating that the Bureau shall seek to implement financial law for the purpose of ensuring that "all consumers have access to markets for consumer financial products and services, and that markets for consumer financial products and services are fair, transparent, and competitive."

The Congressional articulation of intent is therefore clear on two very important objectives. First, the mortgage-shopping consumer must be better protected through enhanced rules and regulations. Second, although it may be necessary to limit the scope and array of mortgage financing, the availability of safe and responsible mortgage credit must be ensured. Through these statements of intent, Congress sets forth the command that there be careful and explicit balancing of goals, and expresses that the public will be best served by a careful consideration of all the interests at play in the implementation of the new regulatory order. The statute's dual purposes must be carefully balanced.

ABA recognizes that the "ability to repay" rules constitute a fundamental pillar of Congress' effort to address the market failures that contributed to the recent meltdown of the financial market. We stress from the outset that this goal should not come at the cost of unreasonably limiting financial options. Responsible and affordable mortgage credit must remain available for all qualified borrowers.

The QM takes on added importance because it defines the outer boundary of the Qualified Residential Mortgage (QRM) exemption to the proposed Credit Risk Retention Rules authorized under Section 941 of the Act.

It is in this spirit that ABA offers these comments. We understand that under DFA, Congress has given the regulators very broad authority and discretion to shape these new rules. Our members recognize the aforementioned dual responsibility facing policymakers as they implement these new statutory provisions. The views expressed in this letter are meant to ensure that we achieve a true equilibrium of interests and that we construct a new legal system of solid consumer protections that are compatible with the ability to effectively satisfy the public's demands for mortgage financing.

Impact of the New Ability-to-Repay Legislation

The ambitious goal of the ability-to-repay portion of the DFA is to set the minimum underwriting standards to which all mortgage loans must adhere—these proposed rules will apply broadly to both owner-occupied and non-owner-occupied property loans. As such, these new provisions will alter the legal and underwriting foundations of the mortgage lending system.

Clearly, these proposals have great impact on all aspects of mortgage lending—they modify the legal responsibilities of lenders and loan originators, they fundamentally impact the types of products offered to the public, they affect channels and systems used to deliver these loans to consumers, and influence the very cost and price of mortgage loans across all markets. Even if banks already follow the general underwriting standards set forth in the rule, placing ability-to-repay strictures into a law means that a bank's existing guidelines must be specifically channeled, verified and structured in compliant ways. It also means that there is absolutely no leeway outside of the written text of the law.

In light of the enormous impact of this legislative order, there are fundamental considerations that regulators must understand with respect to this rulemaking. Most importantly, policymakers must first understand the how the ability-to-repay laws will affect the creditors' willingness and ability to offer mortgage loans in the post-DFA market. These following elements describe the effects of the Dodd-Frank rules upon mortgage lending by banks.

1. Non-ATR Loans Are Prohibited

As a threshold matter, this rule sets forth real prohibitions on a wide range of products and market activities. Under the proposed rule, mortgage loans that do not meet the "ability to repay" standards, or the QM safe harbors, will be effectively proscribed. The legislation states that no creditor may make residential mortgage loans unless "ability to repay" is established pursuant to Section 129C requirements. In short, the rules being proposed here will serve to strictly delineate the universe of legal and acceptable loans—all mortgage lending will have to occur within the proposed rule's boundaries, and no mortgage lending may exist outside of them.

It is important to realize that the act of inscribing these broad new standards and prohibitions in the rulebooks means that regulators will develop new enforcement procedures and interpretations, and examination staff will develop new examination guidelines, to ensure that proscribed loans are not made. Likewise, secondary market players and investors will have to ensure that none of the loans they purchase fall outside the standards set forth by this rulemaking.

2. TILA Structure & Liability

The new minimum standards being implemented in this rulemaking are incorporated into the existing body of the Truth-In-Lending Act. As such, the provisions of these proposed regulations will be subject to the existing body of law contained in TILA and Regulation Z. The "ability to repay" rules will, therefore, be subject to the penalties and liabilities that are contained in TILA, and these have been significantly expanded by DFA. When added together, these new liabilities are tremendously burdensome. Specifically, lenders that violate repayment ability requirements will be subject to:

- Expanded damages applicable to Home Ownership and Equity Protection Act (HOEPA) loans, which would include an amount equal to the sum of all finance charges and fees paid by the consumer.
- A lengthened statute of limitations of three years.
- Recoupment or set-off provisions, where the consumer will be allowed raise a violation of these provisions—including against the creditor or an assignee—in

connection with judicial or non-judicial foreclosures or other action to collect the debt as a matter of defense. Violations of the ability-to-repay rule will subject creditors to all TILA remedies, including the enhanced civil remedies that apply to violations of TILA's high-cost loan rules (as described above). These provisions apply regardless of the statute of limitation.
- New enforcement authorities by state attorneys general.

3. Assignee Liability

Finally, the DFA amplifies liabilities for loan assignees. The new legal structure would attribute liability under this section to the holders of mortgage loans for the acts, errors and omissions of originators and other settlement service providers. As noted above, such liability would include magnified monetary liability as well as rescission and/or recoupment actions under the underlying mortgage loans. New Section 130(k) of DFA allows the consumer to sue creditors, assignees or holders of the mortgage loan, notwithstanding any other provision of law, for recoupment or set off. This explicit attribution of risk to any and all holders will greatly exacerbate risks that assignees are likely to face with respect to any mortgage-backed assets.

Effects of the Law

The hard restrictions and astounding levels of liability imposed by the DFA dramatically affect lenders' calculations on the risks associated with mortgage lending. After much consultation with member banks, we understand that the DFA provisions, including this ability-to-repay standard, will lead most institutions to rethink and reconfigure their mortgage lending operations. In short, the legal and economic implications of real estate lending will be entirely changed. The impact of the three elements above, and the general considerations now occurring within institutions that engage in mortgage finance, are summarized as follows—

- *Penalties*: The heightened penalty provisions described above are nothing short of draconian, and lenders will make it a priority to ensure that they do not come close to violating their strictures. The rational response to the type of severe penalties contained in this law is to seek as much assurance against its risk as possible. ABA has consulted widely with bank members active in mortgage lending, and they all affirm that it is very unlikely that they will chance exposure outside of whatever legal protection is granted by the QM. In their view, the QM safe harbor's legal protections would be the only viable method to ensure against the devastating liability risks imposed under this title of the legislation.

- *Assignee Liability:* Regardless of whether the QM standard becomes a safe harbor or just a rebuttable presumption, secondary markets will demand a "safe harbor" from the seller for purposes of quality assurance, risk avoidance, and efficiency in guaranteeing compliance. This point is axiomatic—the DFA explicitly states that consumers will be allowed raise a violation of these provisions against the creditor or an assignee in connection with any foreclosure. This provision means that asset purchasers are "on the hook" for the details of this regulation, until the very end of the loan repayment process.

As a result, in order to sell a loan on the secondary market, originating lenders will be forced to agree to strict representations and warranties that provide absolute protection to the purchaser that the loan was made in accordance with the ability to repay standard. The penalties for breaching the representations will be severe, to include indemnification, repurchase, and even termination of the relationship.

- *Litigation:* The litigation realities are such that virtually any consumer who defaults for non-payment will be tempted to sue for recoupment in connection with any resulting foreclosure on the ground that the creditor violated the ability to repay requirement. The potential for this liability—and the reality that such liabilities will be decided by disparate judges across many jurisdictions—may lead to overly-cautious lending, even with otherwise qualified borrowers, and create particularly strong incentives to move towards origination of safe "qualified mortgages." In particular, our members believe that adoption of a rebuttable presumption standard will result in litigation risk management practices which establish a de facto underwriting threshold well below the rebuttable presumption standard defined by regulation. This "risk management cushion" will limit availability of credit to many creditworthy borrowers.

- *Stratification:* By stratifying the market, this law produces a structure of "superior" vs. "inferior" mortgage loans. Although some would argue that this legislative stratification of the mortgage market is inadvertent, the very terms of the DFA legislation offer explicit reinforcement of some intention to classify non-QM loans as qualitatively "inferior." In separate but related provisions of DFA, Congress explicitly prohibits that creditors "steer" a consumer from a QM loan to a non-QM loan. *See* Section 1403(c). Such a prohibition reflects a Congressional view that non-QM loans could be sufficiently detrimental so as to specifically merit special protections in the loan shopping stage of the mortgage process.

  Whatever the true intent on Congress, this market stratification is real, and necessarily forces adjustments in risk assessments that will price these loans accordingly, or as we expect, cause them to not be made at all. Insurance entities, investors, regulators—all players with a stake in mortgage lending—will assess the market in accordance to the "QM-vs.-Non QM" dichotomy. ABA believes that such assessment will result in a very limited market for non-QM loans, if such a market exists at all.

- *Reputation Risk:* The stratification of the mortgage market creates a palpable reputational risk for mortgage market players. Banks are very reliant on community trust, and no institution will want to become known for making any level of "inferior" loans. Just as the media, activist groups, and others have equated "subprime loans" with "predatory" lending practices, it would not be a stretch to imagine an environment in where non-QM loans are branded substandard or "bad deals" for consumers. A related factor is the negative publicity that would result from the litigation risks associated with non-QM loans. Without doubt, banks and savings associations will examine whether making non-QM loans would be viewed by the general public as being net negatives for consumers, along with any potential for negative publicity that could result from such lending.

- *Regulatory Scrutiny*: In the same way that high cost loans generate more intense scrutiny from regulators in terms of fair lending and other analysis, the presence of non-QM mortgages will create greater risks of scrutiny and investigation from regulators. This already happens in today's examination procedures, where higher-priced and high-cost loans are isolated for additional scrutiny, and scrutiny is applied as to why such loans are even made. It also follows that regulators will assess—and regulate upon—the increased legal risks that emanate from non-QM loans, and determine that they pose greater "safety and soundness" hazards to banks' portfolios.

- *Higher Servicing Costs*: Given the experience of the past few years, the servicing of loans has become riskier and more expensive. Servicing non-QM loans will be deemed riskier, thus more expensive in terms of servicing costs.

Importance of the "Qualified Mortgage" Protections

ABA cautions that the various elements identified above will mean that the special protections afforded by the QM provisions will be more than just optional—indeed, they will be necessary and compulsory to establish the legal assurances that lenders and investors will require to safely operate in the mortgage market going forward. ABA firmly believes that the majority of lenders, particularly regulated depository institutions, will seek to operate exclusively within the QM segment, and will entirely avoid making loans outside this safe harbor. Member banks report, almost unanimously, that they will not venture outside the bounds of the safe harbors. Those few institutions that express a remote possibility of offering non-QM loans have stated that such lending would likely be insignificant in terms of overall volume.

We urge, therefore, that the QM standards must be crafted with full realization that these will encompass almost all mortgage lending. The QM category must be designed, not as a refuge for certain selected loans, but rather, as the stage on which most mortgage lending will take place. Any product development aimed at specialized needs or populations, or any product tweaks to allow banks to navigate through change or adapt to market evolution, will have to be explicitly permitted within the QM segment or such lending will simply not be occur.

HOEPA as Historical Precedent: The experience with HOEPA loans provides an excellent illustration of this potential, as the legal dynamics involved with the HOEPA legislation are almost identical to the QM rule-making.

Congress enacted the Home Ownership and Equity Protection Act (HOEPA) in 1994 in response to evidence of abusive practices in the home-equity lending market. Public Law 103–325, 108 Stat. 2160. HOEPA amended TILA by defining a class of "high-cost mortgages," which are generally closed-end home-equity loans (excluding home-purchase loans) with annual percentage rates (APRs) or total points and fees exceeding prescribed thresholds. HOEPA created special substantive protections for high-cost mortgages, including prohibiting a creditor from engaging in a pattern or practice of extending a high-cost mortgage based on the consumer's collateral without regard to the consumer's repayment ability. Under HOEPA, Congress enacted the very same penalties and remedies that are now being applied to the ability-to-repay requirements subject to this proposed rule (though the current DFA provisions will *enlarge* that liability appreciably.) Like the current ability-to-repay requirements, the HOEPA penalty provisions explicitly subject secondary market purchasers to all liabilities that would apply to the originator.

It is beyond doubt that HOEPA loans today are extremely rare, almost non-existent, and lenders avoid such loans because of the extraordinary legal risks they carry, and the reputational blemishes inherent in the "HOEPA" label. Notably, since its inception, a viable secondary market for HOEPA loans never materialized—today, it is practically non-existent. Secondary market players—including the GSEs—have developed strict policies to completely avoid purchasing HOEPA loans.

The experience with HOEPA loans is instructive and directly applicable to the current rulemaking. We note that HOEPA loans can be underwritten in a safe and compliant manner—the existing "Section 32" regulations are quite clear about definitions, the threshold calculations and what is required once lenders cross into that segment of lending. In terms of compliance and product feasibility, a market could have developed to adequately assess repayment risk and to offer loans to individuals that qualify into this market segment.

Notwithstanding the capability to develop and offer HOEPA loans, the credit markets entirely spurned any product marked "HOEPA." The actual risk and viability of any particular HOEPA loan did not matter—what mattered was that such loans carried new legal risk and a negative governmental label, and eventually, funding for those loans completely dried up. Lenders avoided the elevated legal risks of these products without regard for market need or ability to originate compliant loans. A hard ceiling developed in the mortgage lending industry, and although these loans are technically legal, practically no loans exceeding the threshold are made.

It is hard to ignore, therefore, that the penalties for violating the ability-to-repay rules are even higher than those applicable to HOEPA. The same transfer of liabilities to secondary market sources will apply under the ability-to-repay standards proposed here. It must be noted that, even if the ability-to-repay rules are crafted with utmost care, and even if lenders are confident about their abilities to originate "compliant" loans, the HOEPA precedent confirms they will not do so for the same reasons that the market avoided the HOEPA segments—the reputational risks and the associated liabilities are too great to risk operating in that sphere. ABA cautions that we should not expect a different market reaction when the current rules go into effect.

In summary, the HOEPA experience demonstrates that lenders and investors will take immediate flight into segments where they will not be viewed as making "dangerous," "unsafe," or "inferior" loans. Lenders (and investors) will not operate within a market segment where they cannot reasonably assure that draconian penalties will not arise, inadvertently or otherwise. We warn that these proposed regulations are setting up a scenario that is identical to that experienced with high cost loans. Lenders will simply not lend where they are exposed to massive penalties that have the potential to put them out of business. Even if banks are confident that they can make a compliant loan—i.e., a loan with all indicia of repayment ability—the liabilities outside of a safe harbor are so high that they will avoid that market segment altogether.

Safe Harbor: Alternative 1 is Key Component to Compliant Lending

The proposed rule sets forth two alternatives for affording legal protections to lenders pursuant to the QM provisions of Section 1412. Under the first approach, a creditor that makes a mortgage loan that satisfies certain specific conditions that meet the QM provisions would be entitled to "safe harbor" protections with regard to the repayment ability determination requirements. Under the second proposed approach, a creditor making a QM loan and satisfying the conditions specified in the first alternative plus additional underwriting elements would be entitled to "rebuttable presumption" of compliance with the repayment ability determination requirements.

The Board is soliciting comments on these two alternatives because it found that DFA is not clear as to whether a qualified mortgage is eligible for a safe harbor or a rebuttable presumption. In the proposed rule's preamble, the Board posits that "it is unclear whether that protection is intended to be a safe harbor or a rebuttable presumption of compliance with the repayment ability requirement."

ABA appreciates that the statute lacks full clarity on whether the protections offered under DFA are intended to be a safe harbor or a mere presumption of compliance with the repayment ability requirement. ABA believes that there are important considerations that compel the adoption of the *safe harbor* protections that are set forth under *Alternative 1*. The structural arrangement of the "qualified mortgage" provisions within the DFA legislation, as well as pragmatic realities of the market, lead to the conclusion that the legal protections under Section 1412 must necessarily constitute more complete "safe harbors." The reasons to interpret the QM to be a full safe harbor are various—

- *Differing Standards:* As per the Board's analysis in the rule's preamble, the statutory structure suggests that the QM is an alternative to the general ability-to-repay standard and must therefore operate as a safe harbor. Since the various QM standards, as set forth by the statute, contain items that differ from the general ability-to-repay standards, it follows that one is meant to apply *in lieu of* the other, and is therefore to be considered a complete legal safe haven if all of its elements are met. It would make little sense for Congress to provide a scheme where it mandates a set of standards, and then provides that such a standard will be *presumed* to be met through a substantively different set of separate standards. If the two sets of standards that give rise to compliance are substantively different, then they must be viewed as alternatives to each other—in other words, achieving compliance with one set of standards means that one must be safe from the application of the differing standards.

- *Mere Presumptions are Insufficient and Inconsistent in the Statutory Scheme:* A second textual indication that Congress intended that there be full safe harbor protection stems from the fact that a mere rebuttable presumption would be completely illusory within the current legal and statutory context.

In common judicial usage, a so-called "rebuttable presumption" is an assumption that is made in the law that will stand as a fact unless someone comes forward to challenge the factual basis of the assumption. This so-called "presumption" is only good until it is contested and shown to be wrong to a judge or jury. The inherent deficiency in reading Section 1412 as setting forth a mere "rebuttable presumption" is that it provides no real protection to lenders in this context. Since the proposed repayment provisions confer the consumer the right challenge a loan's minimum standard provisions, it is by definition the consumer that will be the party that initiates the dispute to challenge a loan's repayment ability. This procedural posture requires that the consumer be the party to show that the ability-to-repay standards were not met. In such a system, conferring a "presumption" to the defendant/respondent offers absolutely no legal protection that the defendant does not already have—the consumer, as plaintiff, must meet the *prima facie* elements of the case, which includes the necessary assertion that the lender did not meet the standards. This *prima facie* case is virtually identical to that which must be proven under a "rebuttable presumption."

Since Congress intended that there be "special protections" afforded under the qualified mortgage, <u>something more</u> than a mere rebuttable presumption must be read into Section 1412 in order to ensure real legal safeguards for lenders and investors.

- *Ambiguities:* From a more pragmatic perspective, we urge that regulators take notice of the inconsistencies that would be created by imposing an ambiguous term such as "rebuttable presumption." The basic question of what level of proof courts will require under such a standard is far from settled. Every judge will decide this question differently. Courts may look to the testimony of other witnesses, like loan officers, loan processors, the closing agent or others involved in the settlement. Some have held that a borrower can rebut any presumption simply by testifying to the contrary. Courts may look to the paper trail of the transaction in isolation. Courts may look to whether the lender has a record of having given certain disclosures or followed the requisite standards in past transactions, or whether the lender conducts audits of the loan file and whether the lender has a system in place which, in the normal course of doing business, would generate the appropriate underwriting decision. Courts may look at whether the borrower has adequately accounted for, and kept, other documents from the closing. Judges may allow consideration of the borrower's recollection of other aspects of the closing. The judicial disarray in the application of this standard leaves lenders entirely unprotected, and destroys any certainty that the rule purports to infuse under the Qualified Mortgage standard.

- *Potential for Costly and Abusive Litigation:* A further practical consideration that weighs in favor of granting full safe harbor status to the QM comes from the potential for abuse against lenders. Given the fact that the provisions analyzed under the QM constitute a determination of a consumer's ability to repay, ABA is particularly concerned that the proposed rule would lead to situations in which borrowers whose loans are delinquent or are about to go into foreclosure would automatically file suit against the lender, arguing that the borrowers were put into loans that were unaffordable and that the lender should not be permitted to foreclose on the properties. This part of the rule potentially sets up creditors for frivolous challenges every single time a borrower defaults: the argument would be that the mere fact that a default occurred means that the creditor evidently did not adequately consider the borrower's ability to repay. Since the standard for rebutting the QM presumption is nebulous at best, the potential for protracted, expensive litigation is enormous.

- *Need for Lender and Investor Confidence:* As set forth above, both lenders and investors must have conclusive certainty that their loans, or loans that underlie their assets, cannot be capriciously challenged. A mere "presumption of compliance" assures nothing but the ability of a plaintiff to challenge such presumption at his or her option. The only way to ensure predictable originations under these complex rules is to provide a safe harbor protection.

  If lenders cannot have assurance at origination that they have fully complied, and every loan that goes into default can potentially be subject to a fact-intensive "ability to pay" litigation that cannot be swiftly dismissed with a minimum of cost, the cost of a defaulted loan to the lender—even a defaulted loan that the lender can show did comply—will include not only the actual credit losses, but also legal fees likely to rise into the tens of thousands of dollars. And if the lender loses the "ability to pay" suit, which can be years after loan origination, it will be subject to HOEPA damages as well. These damages are too steep to risk—banks will need the guarantees afforded by a safe harbor.

ABA agrees with the Board's statement in the rule's preamble that the "drawback of treating a 'qualified mortgage' as providing a presumption of compliance is that it provides little legal certainty for the creditor, and thus little incentive to make a 'qualified mortgage,' which limits loan fees and features." This is a correct and accurate statement—a mere rebuttable presumption provides no added certainties to lenders, and would not therefore achieve the statutory objective of providing lenders the confidence and legal and economic assurances they require. It is therefore crucial that the Bureau grant lenders the meaningful protections that a legal "safe harbor" would confer.

ABA urges that the Bureau adopt *Alternative 1* and allow for a true safe harbor under the QM protections. ABA also believes, however, that any such safe harbor should make certain that consumers are assured full legal guarantees that their loan is affordable and safe. ABA is advancing an alternative set of more robust protections than those offered by the proposed rule to ensure that borrowers are well protected. These additional recommendations are set forth below in the section entitled "ABA Recommendations."

Points and Fees Test

The DFA legislation requires that the special legal protections contained in the qualified mortgage classification be afforded only in transactions where total "points and fees" do not exceed 3 percent of the total loan amount. This condition is significant, as it strictly demarcates which transactions may qualify for QM treatment. As described above, since we believe the market will be concentrated within the QM category, the ability to qualify for QM treatment will largely determine which lenders participate in the market and what products are offered to consumers. In short, the formula for "points and fees"—its threshold level and how it is defined—will determine market entry and lender participation, and will therefore profoundly shape pricing and loan availability.

ABA believes that the proposed points and fees test is overly inclusive, thereby rendering it rigid and limiting. The proposed test will, if finalized in its current form, greatly constrain the ability of banks to enter or remain in the residential mortgage market. Under the proposal, the definitions that apply to "points and fees" and "total loan amount" would be the same definitions that apply to HOEPA loans. The proposed formula is extremely complex and contains definitional contortions that make it difficult to ascertain its precise application.

Below, ABA describes the more problematic elements of the proposed "points and fees" test. The three elements below need to be reworked in any final rule. ABA makes explicit recommendations for fixing or excluding these items, and these are set forth below in the section entitled "ABA Recommendations."

1. *Loan Size and Formulas:* For loans of $75,000 or greater, the proposed points and fees cap would be three percent of the total loan amount. The Fed proposes two approaches to the points and fees cap for loans that are less than $75,000. The first approach includes four proposed points and fees levels, based on the loan amount:

    - 3.5 percent of the total loan amount for loans of $60,000 to less than $75,000.
    - 4 percent of the total loan amount for loans of $40,000 to less than $60,000.
    - 4.5 percent of the total loan amount for loans of $20,000 to less than $40,000.
    - 5 percent of the total loan amount for loans less than $20,000.

    The second approach would provide for a cap of five percent of the total loan amount for loans less than $20,000 and the following formula to determine the cap for loans of $20,000 to less than $75,000:

    - Total loan amount – $20,000 = $Z
    - $Z x .0036 = Y
    - 500 – Y = X
    - X x .01 = Allowable points and fees as a percentage of the total loan amount

    The stated intent of the latter multi-formula approach is to avoid certain anomalous results that small loan amounts would have under the first approach. The Board recognizes that the second formula approach adds a great deal of complexity and would present a high degree of difficulty to smaller creditors in their compliance efforts.

2. *Definitions--Originator Compensation*: The term "points and fees" is defined by reference to the definition of that term in the DFA's revised high-cost mortgage threshold rules. In the high-cost provisions, the term "points and fees" includes, among other elements, all compensation payable directly or indirectly to loan originators. The broad reference to "loan originators" would sweep in compensation that is paid to third-party mortgage brokers, table-funding creditors, as well as in-house loan officers. A "loan originator" is defined by reference to the definition set forth in the Federal Reserve Board's recently finalized loan originator compensation rule. (See Section 226.36(a) of Regulation Z.) This compensation of payments to loan originating employees is therefore broadly defined to include commissions, bonuses, trips, prizes, and hourly pay for the actual number of hours worked on any particular mortgage loan.

   It is difficult to overstate the impact of this definitional provision—in short, the inclusion of any compensation paid directly or indirectly by a consumer or creditor to an employee loan originator will severely limit the ability to qualify for the QM protections.

3. *Definitions--Affiliates:* In the proposal, the Board is asking for input on whether to include in the definition of points and fees those amounts paid to entities that are affiliated with the creditor. The Board notes that Congress appears to have rejected excluding from points and fees real estate-related fees where a creditor would receive indirect compensation as a result of obtaining distributions of profits from an affiliated entity based on the creditor's ownership interest in compliance with RESPA. The Board requests comment on the proposal not to exclude from the points and fees calculation for qualified mortgages fees paid to creditor-affiliated settlement services providers.

ABA Recommendations

In light of all the comments above, we urge that the Bureau revisit a number of details contained in this proposal. It is clear that the new ability-to-repay requirement will generally apply to all mortgage transactions going forward, and such near universal scope creates the imperative that the rules and standards proposed in this regulation be very precisely calibrated. As per the DFA, these ability-to-repay rules will categorically prohibit transactions that fall outside of its strictures, and any violation will bring extensive liability to lenders and assignees. Since virtually no lender will opt to operate outside the boundaries of the QM, it is essential that policymakers fully understand the importance of the safe harbor protections under this new regulatory regime.

The stakes are extremely high—these rules will determine the scope of all future mortgage lending.

To assist the regulators in finalizing these rules, ABA has devised an alternative approach to the QM elements of this proposed rule. These recommendations are similar to proposals offered by other industry representatives with a stake in mortgage transactions, and ABA has engaged with such representatives to ensure uniformity in the proposals.

In its proposal, ABA supports a set of QM standards that are generally consistent with those proposed by the Board, and with changes to the points and fees calculation. A most important element of this alternative approach is that the proposal requires that the rules be finalized with full safe harbor protections (as per Alternative 1), and would pledge ABA support for stricter standards than even those proposed by the Board under either Alternative 1 or 2.

To that end, we note that DFA grants the Bureau great discretion to shape these new rules. Congress afforded the Bureau broad authority to modify the qualified mortgage requirements, and granted broad authority to revise, add to, or subtract from the criteria for determining what constitutes a qualified mortgage. The Act allows regulators discretion to make changes "upon a finding that such regulations are necessary and proper to ensure that responsible, affordable, mortgage credit remains available to consumers." ABA urges that the Bureau use this authority to tailor the proposal along the lines suggested below.

Points and Fees

ABA believes the three percent limit on points and fees requires significant adjustment.

First, based on calculations and data that developed by lenders, the definition of smaller loans demanding an adjustment should be increased to $150,000.[2]

Second, whether the customer chooses to use an affiliated provider of the lender or not, the bona fide charges for such non-lender service should be excluded from the calculation. The largest of these fees for title services are "filed fees" over which the lender has no discretion.

Third, the compensation paid to mortgage originators should be excluded from the calculation of the points and fees triggers since such compensation does not constitute a point and fee element. Compensation paid to originators has come under very tight regulatory control in recent Federal Reserve rulemaking, and such compensation is, in any event, already incorporated in other pricing elements of a mortgage loan. This compensation need not be re-added to a point and fee trigger definition—double counting in this manner is simply unfair. The final rule should reflect this through a regulatory correction of the definition. Fourth, ABA supports the other exclusions in DFA, including but not limited to certain up-front mortgage insurance premiums and up two bona fide discount points depending on the extent of the rate reduction.

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[2] The general calculation used to arrive to this number relies on FHFA's Average Loan Size Data (Q2 2010 most recent available), reflecting that the average loan size in the United States at the end of the 2nd Quarter of 2010 was $193,800. ABA would propose using 80% of this amount, rounding off to the nearest $10,000.

QM Safe Harbor

As mentioned previously, the ABA's recommendation would establish more rigorous standards than the proposed QM safe harbor. Our recommendations are proposed in lieu of both of the QM safe harbor proposals from the Board. It would include standards proposed to satisfy the general ability to repay standard, the presumption of compliance, and also include the standards proposed for the general QM safe harbor.

Under ABA's recommendation, a creditor or assignee must evidence that a loan satisfies these standards (or satisfies the requirements of the balloon safe harbor or the non standard mortgage safe harbor) to be deemed to be in the safe harbor to comply with the ability to repay requirement. Requirements for satisfaction of the standards are contained in the commentary to the rule and should be made part of the rule.

In order to assure a workable safe harbor, documentation such as a written application signed by the borrower should be prescribed. Documentation would show how the loan was underwritten by the lender to qualify the borrower and restate the required product standards. A creditor or assignee may demonstrate compliance with these standards with evidence of written and/or automated compliance using physical or electronic records, which include: (1) borrower's written signed application; (2) creditor or assignee's worksheets; (3) third party records; (4) evidence of use of a widely accepted standards such as FHA or GSE guides; and/or (5) evidence of use of third-party automated systems, as appropriate, such as DU© or LP©. (The definition of third party record requires clarification to ensure that electronic records are permissible.)

Finally, a creditor or assignee should be allowed to use assets to compensate for income under the underwriting factors set forth below, to the extent creditor or assignee can demonstrate repayment ability using such compensating factors. Also, the final rule needs to retain flexibility in assessing consumer credit histories. The rule and commentary must permit flexibility in deciding particular credit criteria to address self employed borrowers and latitude for the use of rental records, etc., in lieu of standard scoring or credit criteria for borrowers with "thin" credit files.

ABA Recommended QM Qualification Standards:

In order for a loan to qualify for the QM safe harbor, the loan ***must not:***

1. Result in an increase in principal balance post closing (no negative amortization);
2. Allow deferment of principal or a balloon payment (except if balloon payments may occur under a balloon payment qualified mortgage);
3. Have a term exceeding 30 years (except in conjunction with a loan modification to provide a borrower a loan with a lower monthly payment than he or she may otherwise face);[3]

[3] As a general matter, the rule should clarify that modifications of existing loans should not be subject to the same ability to repay requirements to avoid depriving borrowers of beneficial modifications.

4. Have total points and fees that exceed 3 percent of the total loan amount with (i) appropriate adjustments for smaller loans; (ii) appropriate exclusions for third party fees regardless of affiliations; (iii) exclusions of employee compensation to avoid double counting and (iv) the exclusions otherwise excluded in the proposal, as examples, certain up-front mortgage insurance premiums and up two discount points.

In order for a loan to qualify for the QM safe harbor, a creditor ***must*** underwrite the mortgage:

1. Based on the *highest rate during the first five years;*
2. Using a payment schedule that fully amortizes the loan over the loan term and takes into account any mortgage related obligations;
3. Consider the following :
    a. The consumer's current or reasonably expected income or assets, other than the value of the dwelling that secures the loan. *Creditor must verify the amounts of income or assets it relies on to determine consumer's ability to repay transaction;*[4]
    b. The consumer's current employment status if creditor relies on income from the consumer's employment in determining repayment ability. *Creditor may verify consumer's employment orally if creditor prepares record of oral information;*
    c. The consumer's monthly payment on the covered transaction, calculated in accordance with paragraph (c)(5) of this section;[5]
    d. The consumer's monthly payment for mortgage related obligations, derived from the general standard for ability to repay;
    e. The consumer's monthly payment on any simultaneous loan that creditor knows or has reason to know will be made, calculated in accordance with paragraph (c)(6) of this section. *Creditor's policies and procedures must require the consumer to state the source of the down payment;*
    f. The consumer's current debt obligations. *If creditor relies on a credit report to verify debt and a consumer's application states an obligation not shown in report, creditor need not independently verify such obligation. Creditor may look to FHA and other guides to define debt;*
    g. Consumer's monthly debt-to-income ratio or residual income. *Creditor must consider debt-to-income or residual income and use widely accepted governmental and non-governmental standards in defining income and debt including FHA and other guides.*

[4] Creditor may verify the consumer's income using a tax-return transcript issued by the Internal Revenue Service (IRS). Examples of other records the creditor may use to verify the consumer's income or assets include: (i) Copies of tax returns the consumer filed with the Internal Revenue Service or a state taxing authority; (ii) IRS Form W–2s or similar IRS forms used for reporting wages or tax withholding; (iii) Payroll statements, including military Leave and Earnings Statements; (iv) Financial institution records; (v) Records from the consumer's employer or a third-party that obtained information from the employer; (vi) Records from a Federal, state, or local government agency stating the consumer's income from benefits or entitlements; (vii) Receipts from the consumer's use of check cashing services; and (viii) Receipts from the consumer's use of a funds transfer service.

[5] (A) The fully indexed rate or any introductory interest rate, whichever is greater; and (B) Monthly, fully amortizing payments that are substantially equal.

ABA believes that these expanded QM standards would better protect consumers than either of the standards set forth in the proposed rule's alternatives. Combining our suggested standard with a firm safe harbor would result in a legal design that would afford creditors with the confidence they need to lend, and would properly shield borrowers, as the statute intends.

Balloon-Payment Qualified Mortgages

The Board is exercising its discretionary authority provided under the Dodd-Frank Act to propose an exception to the definition of a "qualified mortgage" for a balloon-payment loan made by a creditor that meets the criteria set forth in the Act. According to the Board, this "niche" exemption is meant to accommodate community banks that make short-term balloon loans as a means of hedging against interest rate risk. Under this option, a small creditor can make a balloon-payment qualified mortgage if the loan term is five years or more, and the payment calculation is based on scheduled periodic payments, excluding the balloon payment.

Under this exemption, the Board sets forth a qualifying element, contained in the statute and the proposal, where a creditor may access this exemption only if, during the preceding calendar year, the creditor extended more than 50% of its total covered transactions that provide for balloon payments in one or more counties designated by the Board as "rural" or "underserved." Under proposed §226.43(f)(2), the proposal sets out the criteria for a county to be designated by the Board as ''rural or underserved'' for purposes of this section.

It is very important to note that there is no settled definition for what constitutes "rural" and what constitutes "undeserved." These terms generally carry definitions that are melded or constructed based on concepts that rely on administrative considerations, socio-economic factors, population numbers, or other factors. Policymakers have wide latitude in choosing among dozens of definitions that are currently employed by the Federal agencies. In this regard, DFA specifically leaves the definition of "rural" or "underserved" subject to regulatory discretion. Policymakers at the Bureau will therefore need to determine what definition of "rural" and "underserved" best fits the purposes and objectives of this legislation.

ABA has concerns with the restrictive effects of the definitions selected under the proposed rule. ABA members have analyzed and measured the proposed definition, and are of the opinion that the standard chosen by the Board, as set forth under proposed § 226.43(f)(2), is overly constrictive. As crafted, this definition would rule out a great majority of lenders that operate in rural and underserved communities every day, but due to technicalities of the standard selected, fall outside of the definition set forth by the Board. In this sense, we note that the Board's preamble discussion (see, e.g., 76 F.R. 27471) does not effectively explain why these definitions were chosen, how they were selected among the panoply of other definitions that apply to this segment, and what the impact of this definition would be vis-à-vis the other definitions that exist.

ABA is committed to ensuring that these rules are well calibrated to fit our communities' needs. As with the other provisions of this rule, we caution that inaccuracies in the regulatory definitions may lead to needless constrictions of credit based on arbitrary, and in this case, somewhat random, decision-making. We believe that the Board's definitions must be more expansive, and must be based on coherent policy conclusions that take into account the Congressional objectives of ensuring that safe and affordable mortgage credit is made available to all qualifying consumers.

To assist policymakers on this matter, ABA has formed a working group composed of member banks that specialize in rural and underserved markets to analyze this element of the rule. This group is exploring the multiple measures and definitions that exist to define "rural" and "underserved," and will offer recommendations based on their ongoing deliberations. ABA will submit supplemental comments to the Bureau when this process is complete.

Fair Lending Concerns

As discussed elsewhere in these comments, the thrust of these rules is to codify mortgage underwriting standards and then discourage creditors from making mortgage loans outside of those standards. By design, therefore, these ability-to-repay rules narrow the alternatives that lenders have to create financial products and therefore reduce the diversity of business lines and the ability to tailor financial products to consumers' specific needs.

Overall, ABA believes there is strong evidence that this law will reduce overall credit availability. This result raises concern. Although ABA is worried about credit constriction in general, ABA is additionally concerned that in all instances of reduced credit, the greatest impact may fall on credit-challenged and less affluent populations. These proposed regulations will establish lending boundaries that will directly impact many in need of credit.

Going forward, ABA asks that regulators be cognizant of this point and remain vigilant of the real world impact that these new provisions will have on communities all across America. Our members have expressed great worries about the fair lending implications brought about by these additional laws; they understand that low-to-moderate income families and minorities are likely to suffer disproportionately. Both lenders and policymakers must remain alert to this point.

Select Answers to Board's Solicitation for Comment

The Board states that it does not believe that amending the definition of "mortgage originator" to Regulation Z's definition of "loan originator" is necessary at this time, and is soliciting comments on the decision of foregoing such changes on this rulemaking.

- ABA agrees with the Board that there is no need to amend the definitions of mortgage loan originator at the present time. We observe that the efforts pertaining to the recent rulemaking on MLO compensation are causing widespread confusion for banks across the country. Although ABA will urge that the Bureau engage in immediate clarifications to a myriad of open questions, those issues are separate from those discussed in this rulemaking. More specifically, the matters that require most urgent interpretation in the MLO compensation rule do not involve the types of definitional details raised by the Board. We do not believe that the Bureau should spend any time engaging in piecemeal adjustments to other regulatory subdivisions of TILA as it implements these extremely important rules.

The Board solicits comment on whether it should exercise its discretionary authority to replace "annual percentage rate" with "transaction coverage rate" as the loan pricing benchmark for higher-priced covered transactions in all these instances. The Board also solicits comment, and supporting data, on whether it should exercise its authority under TILA Sections 105(a) and 129B(e) to incorporate a special, separate coverage threshold in the proposed definition of "higher-priced covered transaction" for loans secured by non-principal dwellings, and what rate threshold would be appropriate for such loans.

- As per previous proposals, the Board is again seeking to replace the APR as the index that a creditor compares to the average prime offer rate (APOR) to determine whether the transaction triggers TILA's higher priced mortgage loan rules. The proposed change would provide that a creditor determine whether a transaction is an HPML by using a brand new metric, dubbed the "transaction coverage rate," rather than the current annual percentage rate, and compare that to the APOR. The proposed "transaction coverage rate" would, according to the Board, be a modified version of the transaction's annual percentage rate, and would be more comparable to the APOR. This new figure would not be disclosed to consumers. It would serve only to determine whether a loan qualifies as an HPML loan.

  This proposed reformulation for HPML triggers is not required by the statutory amendments, and in public comments to previous proposals, this formula has been deemed convoluted and unnecessary by practically every segment of the real estate lending industry. ABA advises that the Bureau refrain from making any changes to the HPML triggers until the Bureau can properly analyze the impact of these changes, on their own merit, and until it can properly coordinate these changes with the other high-cost changes that are being mandated by DFA.

  We have described, in previous comments to the Board, the tremendous burdens that this definitional change will have on banks, so we reiterate them here. We request that the Bureau recalculate the impact of these regulations upon financial institutions—they will reveal the very high burdens that these amendments would cause. Analyzing only the changes to HPML triggers, banks will be required to make very broad system adjustments at many levels. As we have expressed before, the technology systems that ensure proper compliance with regulations and that generate the proper disclosures for individualized transactions are integrated rather than isolated. A change to the HPML triggers will force a change in compliance software. These changes must be identified, incorporated into existing systems, and tested to ensure that they respond adequately to all product lines. As the Board recognizes in the preamble, this must be accompanied by training and educational costs. The proposed amendment will impose new guidelines with investors and lending partners, which will require an additional set of implementation resources. Since the HPML triggers define the market segments that banks are able to serve, this change redefines the scope of our product offerings—the proposed change will require a reconsideration of most product lines and their pricing. Fair lending and CRA considerations also would have to be reanalyzed and adjusted.

ABA suggests that the change to a "transaction coverage rate" must be better calibrated and coordinated in light of all the other changes being imposed under DFA.

The Board solicits comment on what amount of credit should be assumed as drawn by the consumer for purposes of the payment calculation for simultaneous HELOCs. For example, should the Board require creditors to assume a full draw (i.e., requested amount to be used) of the credit line, a 50% draw, or some other amount instead of the actual amount to be drawn by the consumer? The Board also solicits comment on whether it would facilitate compliance to provide a safe harbor where creditors assume the full credit line is drawn at consummation.

- ABA believes the standard should be to use the full draw amount—or the fully amortized amount of the credit limit—as this provides a fair reflection of the consumer's potential credit obligation at the time of consummation. If the consumer does not qualify with the fully drawn amount, the consumer would not be precluded from getting the loan, but would simply be afforded safeguards to protect against overextension. Using the "full draw amount" standard will force consumers to decrease the line amount to an amount that they would be able to service in the event the line is fully drawn.

Conclusion

ABA appreciates the opportunity to comment on these ability-to-repay and QM proposals. We believe that these rules are among the most important provisions of DFA's consumer protection provisions. The changes contained in this proposal are significant, and if not correctly crafted, will lead to serious disruptions in the availability of mortgage credit. We urge that the Bureau recognize the harsh consequences resulting from non-compliance with these new provisions, and that policymakers understand that the market will overwhelmingly adopt QM as the limit and extent of their lending under the new "ability to pay" regime. It is critical that the Bureau provide lenders with clear, understandable rules, and a safe harbor to properly shield lenders when they make safe loans. A final rule that does not give lenders clarity in standards and a safe harbor will not prove sufficient to achieve the stated goal of promoting a robust mortgage lending market for all borrowers and to satisfy our nation's reasonable housing finance expectations.

We look forward to working with you on this endeavor.

Sincerely,

Robert R. Davis

Robert R. Davis