Written Testimony of
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Introduction

Thank you Chairman Capito, Ranking Member Meeks, and members of the Subcommittee for this opportunity to testify about the Bureau's Ability-to-Repay/Qualified Mortgage rule. We are honored to represent the Bureau here this morning to present an overview of the rule, our rulewriting process, and some of the policy considerations that shaped its development.

During the years preceding the mortgage crisis, too many mortgages were made to consumers without regard to their ability to repay the loans. Loose underwriting practices by some creditors—including failure to verify the consumer's income or assets (so called "no-doc" loans) and qualifying consumers for mortgages based only on their ability to pay low "teaser" interest rates that would allow monthly payments to jump to potentially unaffordable levels after the first few years—contributed to a mortgage crisis that led to the nation's most serious recession since the Great Depression.

The Dodd-Frank Act protects consumers from such irresponsible practices by requiring creditors to make a reasonable, good faith determination based on verified and documented information that consumers have a reasonable ability to repay their mortgages. The provision effectively extends to most of the mortgage market a 2008 Federal Reserve Board rule that prohibits creditors from making "higher-priced mortgage loans" without assessing consumers' ability to repay the loans. The Dodd-Frank Act also established a presumption of compliance with the ability-to-repay requirement for a certain category of loans called "qualified mortgages." The Board proposed a rule to implement these requirements before authority passed to the Bureau to finalize the rule. In January, the Bureau issued a final rule to implement the statute and provide further clarity as to what will be required of creditors. The rule will take effect on January 10, 2014.

In developing the final rule, the Bureau considered the record, including nearly 2,000 comment letters. We also received additional information and new data pertaining to the proposed rule. For this reason, we reopened the comment period to further encourage dialogue and gather feedback on the new data. We also reached out to stakeholders to gain a better understanding of potential impacts on small creditors, for example, by holding a roundtable.

With the help of public feedback and our data analysis, we concluded that, in today's market, access to credit remains so constrained that some consumers, even those with strong credit, may have difficulty refinancing or buying a home. For this reason, we designed the rule not just to ensure more responsible lending by curtailing certain problematic practices, but also to

encourage creditors to provide responsible loans to consumers in all segments of the covered market. We recognized that, while providing transition mechanisms and certain bright-line standards can help industry adjust to the new rule, it was also important to provide flexibility for a range of reasonable underwriting practices as the mortgage market changes over time. So the rule strikes a careful balance between providing bright lines to give certainty and clarity to creditors while also allowing flexibility for the mortgage market to evolve and innovate in ways that encourage the provision of responsible credit. We know that there is much work to do as industry works to implement the rule. However, we believe that the broad positive feedback we have received in response to the rule—and to our processes for rulewriting and implementation support—suggest that the rule will help the market over time reach a more sustainable equilibrium for both consumers and providers of responsible credit.

Ability-to-Repay Determinations

The final rule implements the statutory requirement that creditors make reasonable, good faith determinations of consumers' ability to repay their mortgages at the time the loan is made. While the final rule describes certain minimum requirements for creditors making such determinations, it does not dictate that they follow particular underwriting models. Rather, the Bureau believes that—subject to certain floors created by the Act—it is entirely appropriate for creditors to employ a variety of standards to evaluate their customers' repayment ability.

At a minimum, the rule requires creditors to evaluate the borrower's income, savings, other assets, and debts. Creditors must generally use reasonably reliable third-party records to verify the information they use to evaluate these factors, which means creditors can no longer make "no-doc" loans. The rule also provides that monthly payments must generally be calculated by assuming the loan is repaid in substantially equal monthly payments during the loan term. For adjustable-rate mortgages, the monthly payment must be calculated using the higher of the fully indexed rate or an introductory rate. This means that creditors can no longer qualify borrowers based only on low introductory "teaser" rates.

The final rule also provides special rules to encourage creditors to refinance "non-standard mortgages"—which include various types of mortgages which can lead to payment shock that can result in default—into "standard mortgages" with fixed rates for at least five years that reduce consumers' monthly payments.

By rooting out reckless and unsustainable lending without dictating specific underwriting models, we believe the rule protects consumers and strengthens the housing market while preserving flexibility for creditors.

Qualified Mortgages

The final rule also implements the statutory provision creating a category of loans called "qualified mortgages" that are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements because they are subject to additional safeguards.

The Act did not specify whether the presumption of compliance for qualified mortgages is conclusive (*i.e.*, creates a safe harbor) or whether it can be rebutted by the consumer. The final rule provides a safe harbor for loans that satisfy the definition of a qualified mortgage and are not "higher-priced" (which is similar to the pricing threshold defined by the Board's 2008 rule). The final rule provides a rebuttable presumption for higher-priced qualified mortgages, but defines with particularity the grounds for rebutting that presumption, to provide additional certainty to creditors and consumers. The line the Bureau is drawing is one that has long been recognized as a rule of thumb to separate prime loans from subprime loans and we believe it strikes the appropriate balance between providing certainty to creditors making qualified mortgages and extending important protections to consumers in riskier loans.

Although Congress defined some of the criteria for these qualified mortgages, it also recognized that it may be necessary for the Bureau to prescribe further specifics. As such, the final rule implements the statutory criteria, which generally prohibit loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years from being qualified mortgages. "No-doc" loans also cannot be qualified mortgages. Qualified mortgages also cannot have upfront costs in points and fees above the level specified by Congress.

The rule also establishes general underwriting criteria for qualified mortgages. For example, the rule requires that the loans be underwritten based on the highest monthly payment that will apply in the first five years of the loan. Most importantly, the rule provides that the consumer's total monthly debts—including the mortgage payment and related housing expenses such as taxes and insurance—cannot add up to more than 43 percent of the consumer's monthly gross income. The appendix to the rule details the calculation of debt-to-income for these purposes. The Bureau believes that these criteria will protect consumers by ensuring that creditors use a set of underwriting requirements that generally safeguard affordability. At the same time, these criteria provide bright lines for creditors who want to make qualified mortgages.

In defining the boundaries of qualified mortgages, the Bureau did not intend to stigmatize loans that fall outside those boundaries or to signal that responsible lending can or should take place only within the qualified mortgage space. Quite the contrary, the final rule makes clear that the Bureau expects over time to see markets develop for non-qualified mortgages. At the same time, we recognize that, in light of the current state of the mortgage market, creditors and investors remain concerned about managing risks and may initially be reluctant to make loans that are not qualified mortgages, even if such loans were responsibly underwritten.

The final rule therefore provides for a second, temporary category of qualified mortgages that have more flexible underwriting requirements so long as they satisfy the general product feature requirements for a qualified mortgage (no negative amortization, interest-only, or balloon payments and meet the loan term restriction and points and fees cap) and also satisfy the underwriting requirements of Fannie Mae or Freddie Mac (the government sponsored entities, or GSEs) or certain federal agencies. This temporary provision will phase out over time as the various federal agencies issue their own qualified mortgage rules and, at the latest, after seven years. The temporary provision for GSE loans also will expire if GSE conservatorship ends. The Bureau will continue to observe the health of the mortgage market going forward to ensure the availability of responsible credit outside the qualified mortgage space.

Small Creditors

The Bureau recognizes that, with few exceptions, community banks and credit unions did not engage in the type of risky lending that led to the mortgage crisis. At the same time, the Bureau knows these institutions may be more likely to retreat from the mortgage market if the regulations implementing the Dodd-Frank Act are too burdensome, which could restrict access to credit for some borrowers. For this reason, the Bureau tailored the final rule to encourage small creditors to continue providing certain credit products, while carefully balancing consumer protections.

For example, the final rule implements a special provision in the Dodd-Frank Act that would treat certain balloon-payment loans as qualified mortgages if they are originated and held in portfolio by small creditors operating predominantly in rural or underserved areas. This provision is designed to assure credit availability in rural areas, where some creditors may only offer balloon-payment mortgages. Loans are only eligible if they have a term of at least five years, a fixed interest rate, and meet certain basic underwriting standards; debt-to-income ratios must be considered but are not subject to the 43 percent general requirement. The Bureau significantly expanded the definition of rural and made other adjustments to the original proposed rules to make it easier for small creditors to continue making responsible balloon loans going forward.

In addition, at the same time it issued the final rule, the Bureau proposed amendments to the rule to accommodate mortgage lending by smaller institutions—particularly for portfolio loans made by small creditors—including those operating outside of what are designated as rural or underserved areas. The proposal generally would treat these loans as qualified mortgages even if the loans exceed the 43 percent debt-to-income ratio, as long as the creditor considered debt-to-income or residual income before making the loan, and as long as the loans meet the product feature and other requirements for qualified mortgages. This proposed provision would cover institutions that hold less than $2 billion in assets and, with affiliates, extend 500 or fewer first lien mortgages per year. The Bureau estimates that approximately 9,200 small institutions, such as community banks and credit unions, would likely be affected by the proposed definition. The Bureau expects to issue a final rule on this aspect of the proposal shortly.

The Bureau has also made an agency-wide commitment to provide implementation support, in part because we realize that such efforts are particularly important to small creditors that do not have large legal and compliance teams. We recognize that a smooth, efficient process will ultimately benefit consumers and the market as a whole. For example, at the same time we issued the final rule, we published a plain-English summary of the rule on our website. We have also published a compliance guide designed particularly for smaller institutions who will need to update their policies and procedures and provide training for staff on the ability-to-repay rule. We are also publishing clarifications to the rule as needed to respond to questions and inquiries from various stakeholders in an effort to ease implementation burdens. We are coordinating with other agencies to develop examination procedures and are developing videos, checklists, and other tools that may be useful to creditors as they prepare for the implementation date.

Policy Considerations

As outlined above, several policy considerations helped to shape development of the ability-to-repay rule, and in particular the definition of qualified mortgage. That definition was the most complex part of the rulemaking, in part because the creation of a general ability-to-repay requirement that carries potential liability for both creditors and assignees has caused some anxiety in the market. Although we found no evidence that the existing ability-to-repay requirement under the 2008 Federal Reserve Board rule has caused a significant increase in litigation, we recognized that concerns about the liability regime in the Dodd-Frank Act might cause creditors to tend to constrain their lending, particularly in the first few years after the rule takes effect.

The first consideration was to protect consumers by ensuring that certain practices such as "no-doc" loans and underwriting based solely on initial "teaser" rates would not return in future credit cycles. The general ability-to-repay requirements are designed as common sense measures to ensure that creditors use reliable information in their underwriting process and calculate monthly payments appropriately, while leaving flexibility as to how various factors are considered in the underwriting process. We also considered consumer protections carefully in the context of qualified mortgages, where the statute left flexibility for the Bureau to determine appropriate documentation and underwriting requirements. We believed it was important to ensure that creditors consider consumers' individual financial situations with regard to debts, income, and assets before extending qualified mortgages, too.

The second consideration was how to ensure access to responsible credit in all parts of the market, particularly given anxiety levels regarding litigation risk. Several features of the rule are designed to address this concern, including calibrating the strength of the presumption of compliance with the ability-to-repay requirements based on whether a qualified mortgage exceeds the threshold for "higher-priced." We believe the safe harbor will help to provide greater certainty to creditors operating in the prime market, and that the rebuttable presumption will create strong incentives for more responsible lending in the non-prime space as well. At the same time, the rebuttable presumption also preserves certain consumer remedies in the unlikely event that a qualified mortgage loan did not leave the consumer with sufficient residual income to meet monthly living expenses.

The general definition of qualified mortgage is also structured in a way to encourage responsible credit in all parts of the market over time. We do not believe that it is possible by rule to define every instance in which a mortgage is affordable, given that underwriting is a highly complex and individualized process. We were also concerned that an overly broad definition of qualified mortgage could stigmatize non-qualified mortgages or leave insufficient liquidity for such loans, which would curtail access to responsible credit for consumers.

Accordingly, we defined the general category of qualified mortgages, including the bright-line 43 percent debt-to-income ratio, in order to provide greater protection to consumers and certainty to creditors, while also allowing room for the market to grow for non-qualified mortgages. We also created the temporary definition of qualified mortgage based on eligibility for purchase or guarantee by the GSEs and several federal agencies, primarily to make it easier for creditworthy

consumers with debt-to-income ratios above 43 percent to access credit over the next several years while the industry adjusts to the new rulemaking requirements. Our changes to the balloon-payment qualified mortgage provisions and several elements of the concurrent proposal that we issued in January, particularly the proposal to extend qualified mortgage status to certain portfolio loans by small creditors, are also designed to address access to credit concerns.

The third major consideration was to attempt to balance the desire for short-term certainty with the need for long-term flexibility that can benefit consumers and responsible creditors alike. Because we do not believe it is possible to define by rule every instance in which a mortgage is affordable, we sought to structure the rule in a way that allows room for a range of reasonable underwriting models used by different types of creditors in today's market. We were concerned that as the mortgage market strengthens, the rule should function to provide appropriate safeguards without becoming a straightjacket. We balanced these considerations in many places, both in leaving flexibility for reasonable underwriting practices under the ability-to-repay standard and in crafting different types of qualified mortgages that use different sets of safeguards to ensure that affordability is being appropriately considered.

Conclusion

In carrying out our statutory requirement to issue the Ability-to-Repay/Qualified Mortgage rule, we have worked hard to strike the appropriate balance between ensuring more responsible lending, providing certainty to the mortgage market, enhancing access to responsible credit, and preserving flexibility for the mortgage market to evolve and innovate over time. We have been encouraged by the largely positive feedback to the rule. While we are proud of the work that we have done, we understand that much work remains for the market to adjust to our rule, other regulatory initiatives, and changes in economic conditions. For that reason, we are committed to continuing to observe the health of the mortgage market to ensure that our rules are working to help speed the recovery from the financial crisis while preserving access to credit.

Thank you for asking us to testify today. We would be happy to answer your questions.