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Subcommittee on Financial Institutions and Consumer Credit

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Good Morning Chairman Capito, Ranking Member Meeks, and Members of the Subcommittee. Thank you for inviting me to testify at today's hearing to discuss the Consumer Financial Protection Bureau's implementation of mortgage reforms that will prevent future lending abuses and promote stability in the mortgage market.

I am President of the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a nonprofit community development financial institution. For thirty years, Self-Help has focused on creating asset-building opportunities for low-income, rural, women-headed, and minority families, primarily through financing safe, affordable home loans and small business loans. In total, Self-Help has provided $6 billion in financing to 70,000 homebuyers, small businesses and nonprofit organizations and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California, and Chicago.

The Consumer Financial Protection Bureau (CFPB) has released mortgage rules that strike the right balance of protecting consumers while also enabling lenders to comply with these new reforms. Throughout the rulemaking process and in the final result, the CFPB has taken a measured and reasonable approach. As a result, these mortgage rules will provide important legal protections for borrowers and for lenders.

The rules—required by the Dodd-Frank Act of 2010—address head-on a key cause of the mortgage meltdown and ensuing recession: many lenders made high-risk, often deceptively packaged home loans without assessing if borrowers could repay them. Because of these reforms, lenders now must assess a mortgage borrower's ability to repay a loan. The rules' definition of a safe mortgage—known in Dodd-Frank as a "Qualified Mortgage"— also means that restrictions on harmful loan terms such as balloon payments, teaser rates and high fees will extend to families who in the past too often were steered into unfair, harmful financial products. At the same time, the CFPB's rule provides lenders with significant legal protection when they originate Qualified Mortgages, although they are not required to do so.

In assessing the CFPB's Qualified Mortgage definition, my testimony will highlight the same "scorecard" of issues that CRL highlighted in front of this subcommittee at a hearing last summer before the CFPB issued its final rules:

- **Qualified Mortgage definition is broadly defined:** The CFPB's rules adopt the widespread view – including from CRL – that Qualified Mortgages should be broadly defined to encompass the vast majority of the current mortgage market. The rules include four different paths for a mortgage to gain QM status, including one specifically for small creditors holding loans in portfolio and another one that is based on eligibility for purchase or insurance by Fannie Mae, Freddie Mac and the Federal Housing Administration. This multi-faceted approach will maintain access to affordable credit for borrowers.

- **The CFPB used clear, bright lines in the Qualified Mortgage definition:** In addition, the CFPB used specific standards to define which mortgages will be eligible to obtain QM status. The CFPB's first prong for a Qualified Mortgage definition uses a back-end debt-to-income ratio cut-off of 43 percent, and another definition depend on whether the loan is eligible for purchase or insurance by well-established programs. This specificity will enable both lenders and borrowers to know upfront when a mortgage is originated whether it has QM status.

- **Qualified Mortgage definition protects borrowers with the riskiest loans:** On the issue of whether lenders should receive a safe harbor or a rebuttable presumption of compliance when originating a QM loan, the CFPB created a two-tier system. The vast majority of loans will have a safe harbor and others will have a rebuttable presumption. The threshold between the two depends on the loan's annual percentage rate (APR) relative to the average prime offer rate (APOR). Ideally, as consumer groups supported, the new rules would have allowed any borrower with a QM loan to challenge a lender who failed to evaluate if the borrower could afford the loan. However, the CFPB's rules do allow borrowers to hold lenders accountable on the riskiest types of mortgages, those in the subprime market where the problems that led to the housing crisis were concentrated.

As a whole, these rules continue the CFPB's approach of expanding access to credit while ensuring that loans are sustainable for the borrower, the lender and the overall economy.

## I. Harmful Mortgage Features and Lending Practices Were Prevalent in the Pre-Crisis Mortgage Lending Market and Led to Massive Foreclosures.

In the fallout of the foreclosure crisis, the alphabet soup of harmful lending products and practices – such as YSPs, IOs and NINJA loans – is now well known. Many of these features and practices were at one time touted as innovations to serve borrowers. As the foreclosure crisis has made plain, such rhetoric has failed to match reality.

For more than ten years, CRL has produced research highlighting the increased foreclosure risk posed by abusive lending practices. In 2006, which pre-dated the worst of the foreclosure crisis, CRL released a report estimating that abusive and predatory lending would lead to approximately 2.2 million foreclosures among subprime mortgages.[1] At the time, our report was denounced by the mortgage industry as absurdly pessimistic. As we all now know, the system was loaded with much more risk than CRL originally reported.

CRL released a follow-up report entitled *Lost Ground* in 2011 that builds on our pre-crisis research and confirms the link between risky mortgage features and foreclosure rates. For mortgages originated between 2004 and 2008, this research shows that loans originated by a mortgage broker, containing hybrid or option ARMs, having prepayment penalties, and featuring high interest rates (i.e., subprime loans) were all significantly more likely to be seriously delinquent or foreclosed upon than a 30-year fixed-rate mortgage without a prepayment penalty.[2]

CRL's research also demonstrates that African-American and Latino borrowers were much more likely to receive mortgages with these risky features. For example, African-American and Latino borrowers with FICO scores above 660 were **three times** as likely

[1] *See* Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest, *Losing Ground: Foreclosures in the Subprime Market and Their Costs to Homeowners*, (December 2006), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosure-paper-report-2-17.pdf.

[2] *See* Debbie Gruenstein Bocian, Wei Li, Roberto Quercia, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, (November 2011), available at http://www.responsiblelending.org/mortgage-lending/research-analysis/Lost-Ground-2011.pdf.

to have a higher interest rate mortgage than white borrowers in the same credit range.[3] Although the majority of foreclosures have affected white borrowers, *Lost Ground* confirms that African-American and Latino borrowers have faced a disproportionate number of foreclosures and delinquencies than white borrowers within every income range.

The foreclosure crisis could have been prevented, but it wasn't, and it bears revisiting the kind of harmful lending practices that fueled the crisis still affecting communities across the country.

- **2/28s and other ARMs:** Adjustable rate mortgages (ARMs) – including "2/28s" where starter rates reset after the first two years – were widespread in the years leading up to the foreclosure crisis. These 2/28s and other ARMs led to payment shocks for many households who were unprepared for higher monthly payments once the interest rates increased. As of 2009, subprime mortgages with short-term hybrid ARMs had serious delinquency rates of 48 percent compared to 21 percent for subprime fixed-rate mortgages and 36 percent for the total universe of active subprime mortgages.[4] In fact, were it not for the Federal Reserve lowering interest rates to historically low levels following the financial crisis, it's easy to imagine the payment shock from expiring teaser rates leading to an even higher number of foreclosures than has occurred so far.

  A related product called interest-only (IO) ARMs let borrowers make interest only payments during an introductory period, which jeopardized any ability to build equity as well as leading to payment shock for borrowers once the loan started amortizing over a reduced loan life. Going even further, payment option ARMs (POARMs) allowed borrowers to make monthly payments where the amount paid could vary from month-to-month, including payment amounts that did not cover the full interest due. This resulted in negative amortization. Too many lenders structured these loans so that the payments would substantially increase in five years or less when borrowers hit their negative amortization cap, underwrote the loans only to the very low introductory teaser rate, and failed to document income.

- **Prepayment penalties:** Many borrowers facing payment shock from increased interest rates once an introductory period ended also faced penalties when trying

[3] *Id*.
[4] *See* GAO Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources, at 12-13 (August 2010) (available at http://www.gao.gov/assets/310/308845.pdf).

to exit into a new mortgage or to sell the property to avoid these built-in increases. These prepayment penalties are a feature associated with a higher likelihood of default[5] and were present in the great majority of subprime mortgages, and increasingly in Alt-A mortgages (which generally consisted of limited documentation mortgages to higher credit score borrowers), during the mortgage boom.[6] To avoid default, the typical subprime borrower had to sell or refinance before the rate reset. This produced prepayment penalties, generally equal to six months' interest— typically 3.5 percent to 4 percent of the loan balance. Because the average borrower did not have the cash on hand sufficient to cover the prepayment penalties and refinancing fees, they had to pay them from the proceeds of the new loan. This produced ever-declining equity even when home prices were rising. Once home prices declined, foreclosure risk climbed catastrophically.

- **No-doc or low-doc loans:** The practice of failing to document a borrower's income and assets was also prevalent in the subprime and Alt-A market. For example, low-doc loans comprised 52 percent of Alt-A originations in April 2004 and rose to 78 percent at the end of 2006.[7] By 2006, no-doc or low-doc loans made up *27% of **all** mortgages*.[8] These loans without proper documentation were frequently underwritten with inflated statements of the borrower's income.[9] Lawyers representing borrowers in predatory lending cases often found the borrower's tax returns included in the file of those who were nevertheless given "no doc" or "low doc" loans. Unbeknownst to these borrowers, they paid higher interests rate for the "privilege" of receiving a no-

[5] *See*, *e.g.*, Lei Ding, Roberto G. Quercia, Wei Li, Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models*, at 49 (Working Paper: May 17, 2010) (stating "[w]e also found that subprime loans with adjustable rates have a significantly higher default rate than comparable CAP loans. And when the adjustable rate term is combined with the prepayment-penalty feature, the default risk of subprime loans becomes even higher.") (available at http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf).

[6] *See Report to Congress on the Root Causes of the Foreclosure Crisis*, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, at 23 (January 2010) (citing Demyanyk, Yuliya, and Otto Van Hemert. 2008. Understanding the Subprime Crisis. Working paper. St. Louis, MO: Federal Reserve Bank of St. Louis.) (available at http://www.huduser.org/Publications/PDF/Foreclosure_09.pdf).

[7] Rajdeep Sengupta, *Atl-A: The Forgotten Segment of the Mortgage Market*, Federal Reserve Bank of St. Louis Review, January/February 2010, 92(1), pp. 55-71 at 60 (available at http://research.stlouisfed.org/publications/review/10/01/Sengupta.pdf).

[8] *See* Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at 165 (Jan. 2011) [hereinafter FCIC Report], (available at http://fcicstatic.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf).

[9] Over ninety percent of a sample of stated income loans exaggerated income by 5 percent or more and almost 60 percent exaggerated income by over 50 percent. Mortgage Asset Research Institute, Inc, Eighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association at 12 (April 2006), (available at http://www.mortgagebankers.org/files/News/InternalResource/42175_Final-8thAnnualCaseReporttoMBA.pdf).

doc loan, even where they provided full documentation to the broker.

- **Yield Spread Premiums:** The proliferation of mortgages with these harmful features was driven in significant part by the use of yield spread premiums (YSPs) as a way to compensate mortgage brokers. Because YSPs paid mortgage brokers higher payments when a mortgage had a higher interest rate than the borrower qualified for, these YSPs gave mortgage brokers incentives to steer borrowers into loans that were more expensive and less stable than they qualified for. And, by 2006, mortgage brokers accounted for 45 percent of all mortgage originations and 71 percent of all non-prime mortgage originations.[10] In fact, most borrowers who received subprime loans could have qualified for better, more sustainable loans. Many qualified for lower-cost prime loans;[11] those who did not often would have qualified for sustainable, 30-year fixed-rate subprime loans for at most 50-80 basis points above the introductory rate on the unsustainable "exploding" ARM loans they were given.[12] This 50-80 basis point increase is modest compared with the 350 to 400 basis point prepayment penalty (plus additional refinancing fees) that the borrower had to pay to refinance the typical 2/28 loan before the end of the second year.

- **No Escrows for Taxes and Insurance:** Subprime lenders commonly did not escrow for taxes and insurance, attracting borrowers with the deceptive lure of lower monthly payments. This practice increased the risk of default twice a year when the tax and insurance bills came due and produced further equity-stripping cash-out refinancings where the borrower had the equity to cover the bills and refinancing fees and penalties.

On top of these harmful loan features and lending practices, many lenders also failed to determine whether a borrower had an actual ability to repay their mortgage. Proper

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[10] Ren S. Essene & William Apgar, *Understanding Mortgage Market Behavior: Creating Good Mortgage Options for All Americans*, at 8 (Joint Center for Housing Studies, Harvard University Apr. 25, 2007) (citing Mortgage Bankers Association, MBA Research Data Notes: Residential Mortgage Origination Channels (2006) (available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/mm07-1_mortgage_market_behavior.pdf).

[11] For example, a Wall Street Journal study found that 61 percent of the subprime loans originated in 2006 that were packaged into securities and sold to investors "went to people with credit scores high enough to often qualify for conventional [i.e., prime] loans with far better terms." *See* Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy As Housing Boomed, Industry Pushed Loans To a Broader Market*, Wall Street Journal at A1 (Dec 3, 2007). Freddie Mac estimated in 2005 that more than 20 percent of borrowers with subprime loans could have qualified for prime. *See* Mike Hudson & E. Scott Reckard, *More Homeowners With Good Credit Getting Stuck With Higher-Rate Loans*, Los Angeles Times (Oct. 25, 2005), available at http://articles.latimes.com/2005/oct/24/business/fi-subprime24.

[12] January 25, 2007 letter from the Coalition for Fair and Affordable Lending ("CFAL") to Ben S. Bernanke, Sheila C. Bair, John C. Dugan, John M. Reich, JoAnn Johnson, and Neil Milner, at 3. CFAL was an industry group representing subprime lenders.

underwriting is particularly important for mortgages with resetting interest rates or negative amortization or interest-only payments (or all of the above) to ensure that borrowers can afford the larger monthly payments when they kick in down the road. However, for many mortgage lenders, this straightforward underwriting never happened. For example, at the time when Federal regulators proposed that lenders fully underwrite mortgages with ARMs, interest-only and negative amortization features at the fully indexed rate and payment, Countrywide estimated that 70% of their recent borrowers would be unable to meet this standard.[13] This recklessness set borrowers up for failure and, as a result, caused a foreclosure crisis.

The CFPB's rules implementing the Ability to Repay and Qualified Mortgage reforms put in place a system of incentives that will make it difficult for this kind of risky lending to re-emerge in the mortgage market. Overall, these incentives work in two ways. First, while lenders are not required to originate QM loans, they receive a legal presumption of meeting the separate obligation to reasonably determine that a borrower can afford the offered mortgage. Second, QM loans benefit borrowers, because these mortgages are restricted from having many of the risky product features that fueled the subprime lending crisis. The CFPB's Qualified Mortgage definition is explored in more detail below.

## II. Overview of the CFPB's Rulemakings on the Qualified Mortgage Definition.

After an extensive rulemaking process that included the Federal Reserve proposing a rule in 2011 and the CFPB seeking additional notice and comment in 2012, the CFPB has released two rulemakings on the Qualified Mortgage definition this year. The CFPB released its first rulemaking on January 10, 2013.[14] On the same day, the CFPB released a concurrent proposal to obtain additional comment on additional aspects of the definition. These remaining pieces of the definition were finalized in a rulemaking released on May 29, 2013.[15] As part of its implementation process and in response to stakeholder

[13] Countrywide Financial Corporation, "3Q 2007 Earnings Supplemental Presentation," Oct. 26, 2007.
[14] Consumer Financial Protection Bureau, Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408 (January 30, 2013) (rule was issued by the CFPB on January 10, 2013 and printed in the Federal Register on January 30, 2013) (hereinafter "January 2013 Final Qualified Mortgage Rule").
[15] Consumer Financial Protection Bureau, Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 34430 (June 12, 2013) (rule was issued by the CFPB on May 29, 2013 and printed in the Federal Register on June 12, 2013) (hereinafter "May 2013 Final Qualified Mortgage Rule").

feedback, the CFPB has also published notices requesting comment on ways to clarify the rules and provide further guidance.

Throughout the rulemaking process – including the implementation efforts – the CFPB has sought extensive feedback from various stakeholders and has incorporated that feedback into the final rules. The result is a rule that reigns in many of the risky product features and lending practices that harmed borrowers during the subprime lending crisis while also prioritizing access to credit in many of the ways sought by lenders.

### A. Overview of Qualified Mortgage Definition.

In order to create a rule that meets consumer protection goals while also providing flexibility, the CFPB has established four different paths for loans to gain QM status. Each are detailed below:

- **General Definition:** The general Qualified Mortgage definition requires eligible loans to not exceed the points and fees threshold, not have negative amortization or interest-only payments, and a term that does not exceed 30 years. In addition, borrowers must have a back-end debt-to-income ratio at 43% or below. Lenders must collect and verify a borrower's income, assets, debts and other obligations according to standards established in the regulation, which are found in Appendix Q of the regulation, in order to calculate the borrower's debt-to-income ratio.

- **Compensating Factors:** The CFPB also created a temporary definition that allows loans eligible for insurance or guarantee by Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), the Rural Housing Service (RHS), and the Veterans Administration (VA) to gain Qualified Mortgage status. The CFPB created the temporary QM definition in order to "preserve[] access to credit in today's market by permitting a loan that does not satisfy the 43 percent debt-to-income ratio threshold to nonetheless be a qualified mortgage based upon an underwriting determination made pursuant to guidelines created by the GSEs while in conservatorship or one of the Federal agencies."[16] These agency guidelines include additional underwriting standards – often called "compensating factors" – in order to approve a borrower with a debt-to-income ratio above 43 percent.

  This temporary definition is available for a maximum of seven years; however, there are situations where elements of the definition could expire sooner for each

[16] January 2013 Final Qualified Mortgage Rule, at 6506.

of the individual programs. Under the Dodd-Frank Act, the FHA, RHS and VA can issue their own rulemakings defining Qualified Mortgages for the respective agency program, and the CFPB's temporary designation for that agency would expire if and when that occurs. Additionally, the temporary definition for Fannie Mae and Freddie Mac guaranteed loans would also expire if the GSEs exit conservatorship by the Federal Housing Finance Agency (FHFA) before the seven-year period ends. This temporary definition does not require that the GSEs or government agencies actually insure or guarantee loans under this category – only that loans would be eligible under the specified underwriting requirements for one of the GSEs or government agencies.

- **Portfolio Loans Originated by Small Creditors Definition:** This definition is not required in the Dodd-Frank Act, but the CFPB created this designation using its regulatory authority with the goal of preserving access to credit. Under this definition, lenders need to meet two criteria to count as a small creditor: first, have assets of no more than $2 billion and second, originate no more than 500 first-lien mortgages per year. Mortgages originated by an eligible small creditor can obtain QM status if they meet the points and fees threshold, there is no negative amortization, no interest-only payments, and the loan has a term of no more than 30 years. In addition, the lender is also "required to consider the consumer's debt-to-income ratio or residual income and to verify the underlying information."[17] However, borrowers do not need to meet the 43% debt-to-income ratio threshold or use the debt-to-income ratio standards in Appendix Q.

- **Balloon-Loan Definition:** The CFPB also created a Qualified Mortgage definition specific to balloon loans. This designation is required by the Dodd-Frank Act, but the CFPB also used its regulatory authority to establish a two-year transition period that allows all small creditors – regardless of whether they operate in rural or underserved areas – to obtain QM status for balloon loans that are held in portfolio. After the transition period, the balloon loan definition only applies to those lenders who operate in rural or underserved areas under a definition that CFPB will continue to study. Both during the transition period and afterwards, balloon loans must meet the points and fees threshold, have no negative amortization, "have a term of at least five years, a fixed-interest rate, and meet certain basic underwriting standards; debt-to-income ratios must also be considered but are not subject to the 43 percent general requirement."[18]

[17] May 2013 Final Qualified Mortgage Rule, at 35487.
[18] January 2013 Final Qualified Mortgage Rule, rule at 6409.

An aspect of the QM definition that is consistent across all four of these categories is the requirement that loans not exceed the points and fees thresholds established by the CFPB. The points and fees definition established by the CFPB is addressed in the next subsection.

### B. The Qualified Mortgage Points and Fees Threshold Prevents a Return to High Fee Lending While Also Facilitating Lender Compliance.

One borrower protection included across the four Qualified Mortgage definitions is a limit on the amount of points and fees the loan can have. Points are another name for upfront fees paid by the borrower, which encompass a number of items including yield spread premiums, origination fees and discount points. These costs are often expressed as a percentage of the borrower's loan amount where one point is equal to one percent of the loan amount. The points and fees component of the Qualified Mortgage definition ensures that higher fee loans – where lenders and originators would have less of an incentive to determine that a borrower has an ability to repay the loan over time because they receive so much compensation up-front – cannot benefit from the liability protections that come with QM status.

The statutory language in the Dodd-Frank Act states that the points and fees cannot exceed 3% of the loan balance, but there are other provisions in the statute and CFPB's rules that make this threshold larger than just 3% in practice. First, the Qualified Mortgage rules allow lenders to exclude up to two bona fide discount points that reduce the interest rate the borrower pays from the overall points and fees calculation. Second, fees paid by the borrower to independent third-parties are not included in the definition. Both of these exceptions allow for a substantial increase in the amount of fees a borrower can pay and still have the loan considered a QM. Third, the CFPB's rule also accommodates smaller loans by having higher points and fees thresholds for loans under $100,000. Only loan amounts of $100,000 or more have a points and fees threshold of 3%, and the CFPB set the below thresholds for smaller mortgages:

- **3%:** loan balance is $100,000 and above (i.e., $6,000 for a $200,000 loan)
- **$3,000:** loan balance is greater than or equal to $60,000 and less than $100,000
- **5%:** loan balance is greater than or equal to $20,000 and less than $60,000
- **$1,000:** loan balance is greater than or equal to $12,500 and less than $20,000
- **8%:** loan balance is less than $12,500

Three parts of the points and fees definition – loan originator compensation (including yield spread premiums), settlement services paid to companies affiliated with the lender, and loan level price adjustments – are addressed in greater detail below.

### 1. Yield spread premiums are included the points and fees definition, but commissions to individual retail and mortgage broker loan officers are excluded.

The CFPB has closely considered the issue of how to count loan originator compensation in the definition of points and fees, and the final regulations issued on May 29, 2013 address this issue in detail. In this final rule the CFPB requires including all yield spread premiums (YSPs) in the points and fees definition, plus any upfront payment that borrowers pay directly to lenders and mortgage brokers. YSPs are the payments that lenders make to mortgage brokers, which are indirectly funded by the borrower through an increased interest rate. In addition, the CFPB used its exception authority to exclude all commissions paid to individual mortgage broker and retail loan officers from the points and fees definition.

The inclusion of YSPs in the points and fees definition is a significant reform that will help prevent a return to the kind of abusive lending practices that dominated during the subprime lending boom. Prior to passage of the Dodd-Frank Act, YSPs were not included in the definition of points and fees used to calculate whether a loan counted as a high-cost HOEPA loan. The Dodd-Frank Act amended this definition to include YSPs, and the CFPB's regulations have implemented this reform. This is an appropriate change, because the underlying premise of a YSP is that it allows the borrower to pay a mortgage broker through an increased interest rate as a substitute for compensating the mortgage broker in cash up-front.[19]

Since YSPs and upfront payments are direct alternatives for one another, these payments must count equally in the points and fees definition. As a result, a loan with 1.75% paid by the borrower to the brokerage upfront will be treated the same as a loan with 1.75% paid by the lender to the brokerage.

If the CFPB had, instead, chosen to fully or partially exclude YSPs from the points and fees definition, this would have created an improper incentive for originators to use YSPs instead of upfront payments paid directly by the borrower. Such a structure would result in less transparent transactions that make it harder for consumers to comparison-shop and, and a result, often result in higher cost transactions.

While other reforms in the Dodd-Frank Act also aim to curb steering abuses, the points and fees limit is an essential reform to prevent a return to high fee lending. Because mortgage brokers are independent businesses (and not employees of the creditor), they can choose which lenders to do business with and can base this decision on who pays the

[19] *See Nat'l Assoc. of Mortgage Brokers v. Fed. Reserve Bd.,* 773 F.Supp. 2d 151, 158 (D.D.C 2011).

highest YSP compensation. Lenders must compete for broker business, and they compete by bidding up payments to brokers, which inflates broker payments through reverse competition. Some brokers specialize in offering subprime loans that generated the greatest compensation. Prohibitions on loan term-based compensation would not prohibit such a result, as the DC District Court concluded in upholding the Federal Reserve's originator compensation rules.[20] Additionally, anti-steering rules do not require brokers to develop business relationships with lower cost lenders. Counting YSPs in points and fees is a necessary counterweight to this continued ability for brokers to steer borrowers into loans that benefit the brokers more than the borrowers.

The CFPB's May 29th rulemaking also provided that all commissions paid by mortgage brokers or retail lenders to their respective individual employee loan officers are excluded from the points and fees definition. The CFPB interpreted the statutory language as including these payments in the definition of points and fees, but the agency used its rulemaking authority to exclude them. The CFPB had proposed to exempt payments by mortgage broker companies to their employees because of concerns about double counting the compensation paid to the mortgage broker company by the borrower or the lender but had not proposed to exempt payments by retail lenders to their employee loan officers. In the May 29, 2013 rule, however, the CFPB decided to treat employees of both types of entities the same because "there were significant operational challenges to calculating individual employee compensation accurately early in the loan origination process, and that those challenges would lead to anomalous results for consumers. In addition, the Bureau concluded that structural differences between the retail and wholesale channels lessened risks to consumers."[21] CRL supports this decision by the CFPB.

### 2. Settlement services provided by companies affiliated with the lender are included in the points and fees definition.

In conformance with the statutory language in place since HOEPA was first passed in 1994, the CFPB's rulemakings also established that settlement services provided by

[20] In upholding the Federal Reserve's 2010 loan originator compensation rule, the District Court noted that the prohibition on term-based compensation by itself did not eliminate all incentives for abuse by mortgage brokers: "Thus, proposed regulation § 226.36(d)(1), which prevents any compensation model based on the terms of the transaction, by itself, ensures that creditors' employees have no direct monetary incentive to direct consumers toward loans with higher rates of more adverse terms. … The same is not true, however, for mortgage brokers. Although § 226.36(d)(1) prevents mortgage brokers from receiving compensation tied to the terms of a loan, it does not prevent them or their employees from creating incentives for a loan officer to guide consumers toward certain loans and or to certain lenders." *See Nat'l Ass'n of Mortgage Brokers*, 773 F.Supp.2d at 175.

[21] May 2013 Final Qualified Mortgage Rule, at 35430.

companies affiliated with the lender are included in the points and fees definition. Some settlement service providers – such as companies that provide title insurance – are affiliated with lenders, while others are independent and unaffiliated with any individual lender. It has been reported that 74% of the market uses unaffiliated providers. Because one of the underlying purposes of the QM points and fees definition is to include all compensation received by the lender, the QM points and fees definition differentiates between service providers that are affiliated with a lender and those that are not. Accordingly, if a title insurer is affiliated with the lender used by the borrower, then the fees paid by the borrower for that title insurance are included in the points and fees calculation.

Title insurance, which is one type of settlement service, is included in most mortgage transactions, but borrowers typically have limited control over the price charged for this service. A 2007 report by the U.S. Government Accountability Office found that "because consumers generally do not pick their title agent or insurer, title agents do not market to them but to the real estate and mortgage professionals who generally make the decision."[22] As a result, the GAO concluded that borrowers end up "in a potentially vulnerable situation where, to a great extent, they have little or no influence over the price of title insurance but have little choice but to purchase it."[23]

Given this market dynamic where borrowers overpay for title insurance because businesses are competing to drive up prices instead of driving them down, the points and fees definition provides needed pressure to reduce these costs for borrowers. Including title insurance costs in the points and fees definition where the lender has an affiliation with the company supplying the title insurance reasonably targets the transactions with the most potential for up-charging.

### 3. Loan Level Price Adjustments are included in the points and fees definition.

On the issue of Loan Level Price Adjustments (LLPAs), the CFPB's regulation determined to not create an exemption for these charges out of concern that it would disadvantage smaller lenders that held loans in portfolio. Fannie Mae and Freddie Mac use LLPAs to price loans they determine to have a higher risk, and these LLPAs result in a fixed fee for mortgages with specified characteristics.[24] For example, Fannie Mae and

[22] *Title Insurance: Actions Needed to Improve Oversight of the Title Insurance Industry and Better Protect Consumers*, United States Government Accountability Office, GAO-07-401 (April 2007).
[23] *Id*.
[24] Fannie Mae, Loan-Level Price Adjustment (LLPA) Matrix and Adverse Market Delivery Charge (AMDC) Information, (September 20, 2012) (available at https://www.fanniemae.com/content/pricing/llpa-

Freddie Mac have an LLPA of 0.75% (75 basis points) for mortgages to purchase a condominium where the down payment is less than 25%. In evaluating comments arguing that these charges should be excluded from the points and fees definition, the CFPB concluded that the way Fannie Mae and Freddie Mac use LLPAs "is better viewed as a fundamental component of how the pricing of a mortgage loan is determined rather than a third party charge."[25] As a result, the CFPB found that "allowing creditors to exclude points charged to offset LLPAs could create market imbalances between loan sold on the secondary market and loans held in portfolio."[26] In other words, allowing this exception would give some loans – but not others – a type of discount in how they price the riskiness of a loan. If the LLPA is, as is generally the case, paid for through a higher interest rate rather than in points and fees up-front, they are not counted under the CFPB's rules.

## III. Qualified Mortgage Definition and Future Mortgage Lending.

Taken as a whole, the CFPB's rules for the Qualified Mortgage definition are a reasonable approach to implement the reforms in the Dodd-Frank Act. In reaching this assessment, CRL looks to three different factors: 1) whether QM is defined broadly, 2) whether the definition uses clear, bright line standards, and 3) whether it provides borrowers with the ability to raise a challenge when a lender failed to reasonably determine whether the borrower could afford the offered mortgage.

### A. Qualified Mortgage Definition is Broadly Defined.

The CFPB has drafted a QM rule that will cover the vast majority of the current mortgage market. This will prevent a dual mortgage market from developing, because a broad range of families capable of owning a home – including lower-income borrowers and borrowers of color – will be able to take advantage of mainstream Qualified Mortgages that are restricted from having risky product features instead of being pushed into more expensive loans with abusive features and high fees.

The breadth of the CFPB's rule is evident when considering that the Bureau adopted four different ways that a loan can gain Qualified Mortgage status. Among these is the definition relying on whether a loan is eligible to be guaranteed or insured by Fannie

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matrix.pdf); Freddie Mac, Single-Family Seller/Servicer Guide, Exhibit 19: Postsettlement Delivery Fees (September 14, 2012) (available at http://www.freddiemac.com/singlefamily/pdf/ex19.pdf).

[25] January 2013 Final Qualified Mortgage Rule, at 6430.

[26] *Id.*

Mae, Freddie Mac or a government agency program. This definition incorporates the compensating factors used by the GSEs or government agencies in order to lend to borrowers with debt-to-income ratios above 43%. The CFPB designed the rule in this way to "help ensure access to responsible, affordable credit is available for consumers with debt-to-income ratios above 43 percent and facilitate compliance by creditors by promoting the use of widely recognized, federally-related underwriting standards."[27] Since loans guaranteed by Fannie Mae and Freddie Mac and insured by FHA and other government programs constitute approximately 90% of the current mortgage market, this definition on its own will cover the overwhelming majority of future mortgage lending.

In addition to covering current mortgage lending, the CFPB's rule also has the potential to bring additional private capital into the market. As described in the CFPB's rulemaking, "[t]he temporary exception has been carefully structured to cover loans that are eligible to be purchased, guaranteed, or insured by the GSEs (while in conservatorship) or Federal agencies regardless of whether the loans are actually so purchased, guaranteed, or insured; this will leave room for private investors to return to the market and secure the same legal protection as the GSEs and Federal agencies."[28] For example, if a private investor securitizes loans according to the standards in Desktop Underwriter – which adheres to Fannie Mae's underwriting guidelines – then these loans can obtain QM status even though they are not sold to the GSEs.

Lastly, the definition focused on smaller creditors holding loans in portfolio also provides flexibility for these lenders to exceed the 43% debt-to-income ratio cutoff that is the CFPB's general definition. In its rulemaking, the CFPB addressed the aligned incentives that small creditors holding loans in portfolio generally have to make affordable loans to borrowers:

> Small creditors also have particularly strong incentives to make careful assessments of a consumer's ability to repay because small creditors bear the risk of default associated with loans held in portfolio and because each loan represents a proportionally greater risk to a small creditor than to a larger one. In addition, small creditors operating in limited geographical areas may face significant risk of harm to their reputations within their communities if they make loans that consumers cannot repay.[29]

As a result of these aligned incentives and concerns that smaller lenders might restrict their lending if required to comply only with the general definition that has a 43% debt-

[27] *Id*., at 6533.
[28] *Id*., at 6534.
[29] May 2013 Final Qualified Mortgage Rule, at 35485.

to-income ratio threshold, the CFPB concluded that creating a separate definition tailored to these lenders was appropriate. The CFPB concluded that "[b]ecause there are thousands of small creditors as defined by § 1026.43(e)(5) in the United States, the Bureau believes that § 1026.43(e)(5) is likely to preserve access to affordable, responsible mortgage credit for hundreds of thousands of consumers annually."[30] These definitions, as a whole, demonstrate that the CFPB's rules not only cover the vast majority of the current market, but will also provide flexibility for mortgage lending moving forward.

Two additional points bear mentioning in terms of the breadth of the CFPB's definition. First, it's important to put CoreLogic's analysis of the Qualified Mortgage rule conducted earlier this year in proper context, because CoreLogic's conclusions are often taken out of context and faulty assumptions in their methodology are often not mentioned. CoreLogic's analysis found that when factoring in the definition relying on eligibility for guarantee or insurance by Fannie Mae, Freddie Mac, and the government agencies, "the near- and intermediate-term impacts of the rule are **very small**."[31] When assessing the general definition that uses a 43% debt-to-income ratio cutoff, the CoreLogic analysis claims that 52% of 2010 originations would be covered by this definition. However, CoreLogic made several unnecessary assumptions resulting in an overly conservative analysis. First, it excludes all loans with credit scores below 640, although the Qualified Mortgage definition does not impose any credit score requirements. Second, it assumes that borrowers who received loan products with prohibited features would not be able to access QM-eligible loan products in the future – in fact, borrowers will be able to get safer mortgages instead. Unfortunately, this 52% figure is often taken out of context (i.e., the eligible for guarantee or insurance prong of the Qualified Mortgage definition is ignored) and the weaknesses in their assumptions are not mentioned.

Second, while there is limited data on the amount of points and fees charged to borrowers in recent years, it is clear that the vast majority of recent mortgages would not exceed the points and fees thresholds required under the QM definition. As described earlier, the statutory points and fees definition excludes a number of origination costs from being counted in points and fees, such as upfront mortgage insurance premiums, up to two bona fide discount points, third party closing costs, and commissions paid to individual loan officers employed by mortgage broker and retail companies.

Of the remaining charges eligible to be included in the points and fees definition, several sources confirm that the origination charges paid directly to lenders constitute a small

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[30] *Id.*

[31] Sam Khater, *The Mortgage Market Impact of Qualified Mortgage Definition*, CoreLogic, The MarketPulse, Volume 2, Issue 2 (February 12, 2013)(available at http://www.corelogic.com/downloadable-docs/MarketPulse_2013-February.pdf) (emphasis added).

percentage of overall loan balances. Freddie Mac provides weekly reports on the average fees charged to borrowers, and the figure for the week of June 13, 2013 was 0.7%, well under the 3% limit.[32] This figure is confirmed by an industry comment filed with the CFPB, which also finds that the origination charges paid by borrowers (up-front points and fees and more than two discount points) were – for all loan sizes – less than 1%.[33]

This leaves considerable room in the points and fees calculation for other possible fees, such as mortgage broker compensation and settlement services paid to a company affiliated with the lender. The industry comment mentioned above determines that if **all** settlement services are provided by companies affiliated with the lender for every loan in the sample, then 5.6% of all loans would exceed the points and fees limit. However, not all lenders use affiliated settlement service providers; the Mortgage Bankers Association reports that there is 26% market share for affiliated settlement service providers.[34] As a result, it's appropriate to discount the comment's estimates by 74%, since loan level data on this sample is not available. This would result in 1.46% of all loans in the study sample exceeding the points and fees threshold when taking affiliate service providers into account, meaning that practically 99% of all loans in this sample would meet the QM points and fees limits. And, even this 99% figure is understated, because any of these remaining loans could meet the points and fees limit by using settlement service providers that are not affiliated with the lender, as most loans do, or by financing some of the fees into the interest rate.

### B. The CFPB Used Clear, Bright Lines in the Qualified Mortgage Definition.

In addition to providing a broad QM definition, the CFPB also used clear, bright lines in establishing all four of the QM definitions. For example, the first prong of CFPB's definition for a QM loan includes a back-end debt-to-income ratio cut-off of 43% as one element of the definition. In establishing this threshold, the CFPB noted that that using a specific debt-to-income ratio cutoff "provides a well-established and well-understood rule that will provide certainty for creditors and help to minimize the potential for disputes and costly litigation over whether a mortgage is a qualified mortgage."[35] The CFPB also pointed to the fact that "[a] specific debt-to-income ratio threshold also provides additional certainty to assignees and investors in the secondary market, which

[32] Freddie Mac, Weekly Primary Mortgage Market Survey (PMMS) (available at http://www.freddiemac.com/pmms/).
[33] AB Schnare Associates LLC, Ex Parte Comment on CFPB-2013-002, at 5 (April 5, 2013) (available at http://www.regulations.gov/#!documentDetail;D=CFPB-2013-0002-0933.).
[34] Mortgage Bankers Association, *Ensuring Housing Recovery: The Challenge of the Ability to Repay and Qualified Mortgage Rule to Credit Availability and Affordability for Homeowners*, at 18 (February 28, 2012) (available at http://www.fdic.gov/regulations/reform/MBA2-28-12.pdf).
[35] January 2013 Final Qualified Mortgage Rule, at 6505-06.

should help reduce possible concerns regarding legal risk and potentially promote credit availability."[36] Additionally, the CFPB's definition relying on whether the loan is eligible for purchase or insurance by well-established programs also results in clear, bright line standards.

The CFPB's final rules provide substantial clarity on these definitions, which will enable both lenders and borrowers to know upfront when a mortgage is originated whether it has QM status. Furthermore, the CFPB is also working to refine and clarify these definitions through their implementation process. This includes publishing further guidance to clarify issues such as how requested put-backs on Fannie Mae, Freddie Mac and government agency mortgages will impact Qualified Mortgage status.

### C. Qualified Mortgage Definition Protects Borrowers with the Riskiest Loans.

Leading up to the CFPB's final rule in January of this year, there was considerable discussion from various stakeholders on whether QM status should provide lenders with a safe harbor or a rebuttable presumption of compliance with their obligation to reasonably determine whether a borrower can afford to repay a mortgage. CRL and other consumer groups supported a QM rule that provided a rebuttable presumption of compliance so all borrowers would have the ability to challenge whether a lender had appropriately fulfilled its Ability to Repay obligations. Lenders generally supported a rule that provided all QM loans with a safe harbor of compliance, meaning that no borrower receiving a QM loan could raise a legal challenge.

The CFPB's final rule establishes a two-tier system where the vast majority of loans will have a safe harbor and others will have a rebuttable presumption, and the threshold between the two depends on the loan's annual percentage rate (APR) relative to the average prime offer rate (APOR). A loan's APR is a figure that represents the overall cost of the loan, including both the interest rate as well as some specified fees. The APOR is a calculation that reflects the APR for a prime mortgage, and these figures are released on a weekly basis.

While this provision gives the vast majority of loans a safe harbor of compliance, the CFPB's rules do allow borrowers to hold lenders accountable on the riskiest types of mortgages. For the general definition using a 43% debt-to-income ratio threshold and the definition based on eligibility for purchase or insurance by Fannie Mae, Freddie Mac and government agencies, the dividing line between a safe harbor and a rebuttable

[36] *Id.*, at 6527.

presumption is 1.5% above APOR for a first-lien mortgage and 3.5% above APOR for a subordinate lien mortgage. Those loans above the thresholds have a rebuttable presumption of compliance whereas those loans below the thresholds have a safe harbor of compliance. The CFPB adjusted these figures upward for loans obtaining QM status under both the definition for small creditors holding loans in portfolio and for the definition for balloon loans, resulting in both first-lien and subordinate lien mortgages having a safe harbor up to 3.5% above APOR.

As stated at the outset, the CPFB's Qualified Mortgage definition has hit the right balance of protecting consumers and facilitating compliance with these rules. The broad definition using clear, bright lines – in addition to providing borrowers in the riskiest mortgages with the opportunity to raise a legal challenge when necessary – will create incentives to avoid future subprime lending abuses and unnecessary foreclosures. At the same time, the four QM standards will also ensure that there is access to responsible credit and that lenders are able to comply with these standards.

Thank you for the opportunity to testify today, and I look forward to answering your questions.