Testimony of Rick Judson

On Behalf of the
National Association of Home Builders

Before the

House Financial Services Committee's Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"The Impact of Dodd-Frank's Home Mortgage Reforms: Consumer and Market Perspectives"

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Introduction

Chairman Capito, Ranking Member Maloney and members of the Financial Institutions and Consumer Credit Subcommittee, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on the definition of a "qualified mortgage" (QM) included in the ability-to-repay standard currently being developed by the Consumer Financial Protection Bureau (CFPB). We appreciate the invitation to appear before the committee on this important issue, which will have a wide-ranging impact on the mortgage finance system and the availability of mortgage credit.

My name is Rick Judson and I am NAHB's First Vice Chairman of the Board and a home builder from Charlotte, North Carolina. NAHB represents over 140,000 members involved in a wide variety of housing activities, including the development and construction of single-family for-sale housing; the development, construction, ownership, and management of affordable and market-rate multifamily rental housing; and the development and construction of light commercial properties.

Importance of Availability of Mortgage Credit

NAHB believes a housing finance system that provides adequate and reliable credit to home buyers at reasonable interest rates through all business conditions is critical to our nation's economic health. Home buyers and builders continue to confront challenging credit conditions weighed down by strict underwriting requirements and an uncertain future regulatory environment. According to an NAHB Housing Market Index survey conducted in January 2012, 69 percent of builders report that qualifying buyers for mortgages is a significant problem for them.

While mortgage rates have fallen to record lows and housing affordability is at a record high, access to mortgage credit is limited to those home buyers with pristine credit histories who can qualify for government-backed programs. Presently, FHA, VA, Fannie Mae and Freddie Mac account for more than 90 percent of mortgage originations. Furthermore, borrowers are increasingly relying on government housing programs (FHA, VA and USDA) for home purchases. A recent study shows that Ginnie Mae securities, which are backed by government insured or guaranteed mortgages, accounted for more than 50 percent of the purchase market in 2011.[1] A reasonable ability-to-repay standard is critical to an adequate flow of mortgage credit in the future, particularly in convincing private capital to return to the housing market, and to extending safe mortgage credit to home buyers.

Homeownership Still Matters – Consumer Demand is on the Rise

[1] Amherst Securities, *The Coming Crisis in Credit Availability*, May 30, 2012, p. 5

NAHB estimates that 2.1 million household formations have been postponed for economic reasons. Household formations (e.g., adult children leaving parents' households, singles leaving shared housing arrangements, etc.) are the largest component of demand for additions to the housing stock. With the recent positive signs indicating a recovery in the housing market, many of these consumers will come back into the market.

According to a poll[2] conducted on behalf of NAHB earlier this year, home owners and non-owners alike consider owning a home essential to the American Dream. The survey results show that Americans see beyond the immediate housing market to the enduring value of homeownership. About three-in-four voters say owning a home is worth the ups and downs of the housing market, and almost all of the home owners said they are happy with their decision to own a home.

Even in today's market, people who don't own say they want to buy a house. More than two-thirds of those who do not currently own a home say it is their goal to be a home owner one day. However, saving for a downpayment and closing costs was cited as one of the biggest barriers to homeownership.

These key findings were supported by independent studies. For example, a survey by The Tarrance Group that was presented in May at the Woodrow Wilson International Center for Scholars found that despite the bursting of the housing bubble, an overwhelming majority of Americans still feel that homeownership is both important to them and a part of the American Dream. A majority also said homeownership should be a national priority.[3]

Background

In response to the financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or the Act) which authorized significant changes to mortgage lending practices, including the ability-to-repay standard which will set the ground rules for mortgage financing going forward.

The ability-to-repay provisions set minimum standards for mortgages by requiring lenders to establish that consumers have a reasonable ability to repay at the time the mortgage is consummated, and state that certain high-quality, low-cost loans (defined as "Qualified Mortgages") are presumed to meet this standard. The Federal Reserve Board (Fed) issued proposed QM rules in May 2011, but the responsibility for the final rules has now shifted to the Consumer Financial Protection Bureau (CFPB) as mandated by the Dodd-Frank Act. The CFPB has announced that it will publish a final rule by the end of this year and prior to the January 2013 statutory deadline.

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[2] This national survey of 1,500 likely 2012 voters was conducted January 2-5, 2012 by Public Opinion Strategies of Alexandria, Va., and Lake Research Partners of Washington, D.C. It has a margin of error of +2.5%.
[3] http://www.wilsoncenter.org/article/new-national-poll-americans-still-want-to-be-homeowners

Proposed Options to Comply with the Ability-to-Repay Standard

The Fed's proposal provides four options for complying with the ability-to-repay requirement.

1. General Ability-to-Repay Standard

A creditor can meet the general ability-to-repay standard by:

- Considering and verifying the following eight underwriting factors: current or reasonably expected income or assets; current employment status; the monthly payment on the mortgage; the monthly payment on any simultaneous mortgage; the monthly payment for mortgage-related obligations; current debt obligations; the monthly debt-to-income ratio, or residual income; and credit history.
- Underwriting the payment for an adjustable-rate mortgage based on the fully indexed rate.

2. Qualified Mortgage

A creditor can originate a "qualified mortgage," which provides special protection from liability based on the alleged failure to comply with the "ability-to-repay standard." Consistent with the Dodd-Frank Act, the Proposed Rule defines a QM as a mortgage that meets the following requirements:

- The loan does not provide for negative amortization, interest-only payments, or a balloon payment, or have a loan term exceeding 30 years.
- The total points and fees do not exceed 3% of the total loan amount (with exceptions for smaller dollar amount loans).
- The income or assets relied upon in making the ability-to-repay determination are considered and verified.
- The underwriting of the mortgage (1) is based on the maximum interest rate that may apply in the first five years, (2) uses a payment schedule that fully amortizes the loan amount over the loan term, or the outstanding principal balance over the remaining term as of the date the rate adjusts to the maximum, and (3) takes into account any mortgage-related obligations.

The Fed explained in the preamble to the proposed rule that it is not clear under the Dodd-Frank Act whether Congress intended to establish a safe harbor or a rebuttable presumption of compliance.[4] Due to statutory ambiguity, the Fed proposed two alternatives for meeting the QM standard.

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[4] 76 Fed. Reg. 27396 (May 11, 2011).

Alternative 1 would operate as a legal safe harbor and define a "qualified mortgage" based on the criteria listed in the Act and outlined above.

Alternative 2 would provide a rebuttable presumption of compliance and would define a "qualified mortgage" as including the criteria listed under Alternative 1 as well as additional underwriting requirements from the general ability-to-repay standard. Thus, under Alternative 2, the creditor would also have to consider and verify:

- The consumer's employment status,
- The monthly payment for any simultaneous mortgage,
- The consumer's current debt obligations,
- The monthly debt-to-income ratio or residual income, and
- The consumer's credit history.

3. Balloon-Payment Qualified Mortgage

A creditor operating predominantly in rural or underserved areas can originate a balloon-payment qualified mortgage. This option is meant to preserve access to credit for consumers located in rural or underserved areas where creditors may originate balloon loans to hedge against interest rate risk for loans held in portfolio. Under this option, a creditor can make a balloon-payment qualified mortgage with a loan term of five years or more by complying with the requirements for a qualified mortgage and underwriting the mortgage based on the scheduled payment, except for the balloon payment.

4. Refinancing of a Non-Standard Mortgage

A creditor can refinance a "non-standard mortgage" with risky features into a more stable "standard mortgage." This option is meant to preserve consumers' access to streamlined refinancings that materially lower their payments. Under this option, a creditor complies by:

- Refinancing the consumer into a "standard mortgage" that has limits on loan fees and that does not contain certain features such as negative amortization, interest-only payments, or a balloon payment;
- Considering and verifying the underwriting factors listed in the general ability-to-repay standard, except the requirement to consider and verify the consumer's income or assets; and
- Underwriting the "standard mortgage" based on the maximum interest rate that can apply in the first five years.

Proposed Points and Fees in a Qualified Mortgage

The Dodd-Frank Act defines a QM as a loan for which, among other things, the total points and fees do not exceed three percent of the total loan amount. Consistent with the Act, the proposed rule revises Regulation Z to define "points and fees" to now include: (1) Certain mortgage insurance premiums in excess of the amount payable under Federal Housing Administration (FHA) provisions; (2) All compensation paid directly or indirectly by a consumer or creditor to a loan originator; and (3) the prepayment penalty on the covered transaction, or on the existing loan if it is refinanced by the same creditor. The proposal provides exceptions to the calculation of points and fees for: (1) Any bona fide third party charge not retained by the creditor, loan originator, or an affiliate of either (2) certain bona fide discount points.

The proposed rule did not include an exemption for fees paid to creditor-affiliated settlement services providers because 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.

NAHB Position

NAHB Supports Balancing Consumer Protections and Mortgage Credit Availability

NAHB believes that loans should be prudently underwritten and adequately disclosed. Stronger requirements related to borrower's ability-to-repay are needed to diminish the rate of borrower defaults. Such changes will also help reduce the probability of additional damaging economic consequences associated with widespread foreclosures that we have witnessed over the last few years due to previous breakdowns in the mortgage process. NAHB believes it is critical that mortgage lending reforms are imposed in a manner that causes minimum disruptions to the mortgage markets, while ensuring consumer protections. Great care must be taken to avoid further adverse changes in liquidity and affordability.

In early 2007, NAHB, concerned with the state of housing finance, passed policy and began working with other stakeholders in the housing and mortgage lending/investment industries as well as Congress and federal, state and local financial institution regulators to find and implement effective solutions to problems in the mortgage markets. NAHB believes it is extremely important that all such efforts ensure that the regulation of mortgage products and practices does not unnecessarily disrupt the mortgage lending process, limit consumer financing options or increase the cost or reduce the availability of responsible mortgage credit.

NAHB encouraged then, and adamantly supports today, continued mortgage market innovation to improve housing affordability and expand homeownership opportunities as long as these loans have appropriate features and are prudently underwritten to ensure that the form of financing is appropriate for the borrower, the market and that consumers are fully aware of the features and risks of the loan.

NAHB believes that it is essential that the definition of the QM loan and the ability-to-repay standards are well structured and properly implemented. While much attention has been paid to the definition of the "Qualified Residential Mortgage" (QRM), which is another mortgage rule mandated by the Dodd-Frank Act, the QM is more important given that the ability-to-repay standard will most likely govern the types of mortgages made in the future. The importance of the QM rule cannot be overemphasized. It will set the foundation for the future of mortgage financing, as all mortgages will be subject to the ability-to-repay requirements.

As the various agencies craft new rules governing the future of mortgage financing, it is important to remember that these decisions will determine the future of the mortgage market for years to come. NAHB urges the CFPB and policy makers to consider the long-term ramifications of these rules on the market, and not to place unnecessary restrictions on the housing market based solely on today's economic conditions. Overly restrictive rules will prevent willing, creditworthy borrowers from entering the housing market even though owning a home remains an essential part of the American Dream.

NAHB Supports a Broad QM Definition

NAHB has joined with 32 other housing, banking, civil rights and consumer groups to urge the CFPB to issue broadly defined and clear QM standards. A narrowly defined QM would put many of today's sound loans and creditworthy borrowers into the non-QM market, which would undermine prospects for a housing recovery.

A narrowly defined QM would expose lenders and investors to a high risk of an ability-to-repay violation and even a steering violation. As a result of these increased risks, these loans are unlikely to be made. In the unlikely event they are made, they will be far costlier, burdening families least able to bear the expense. Beyond that, these higher-priced loans would not be required to include important protections that are embedded in QM to restrict loan practices and features that drove the highest failures in the mortgage boom.

A review of the legislative history of the QM provision indicates that it was meant to be broad. The statutory language does not indicate that the QM was meant to be narrow or that Congress wanted to establish a market for non-QM loans[5].

Creating a broad QM, which includes sound underwriting requirements, excludes risky loan features, and gives lenders and investors reasonable protection against undue litigation risk, will help ensure revival of the home lending market.

NAHB Recommends Establishing a Strong Safe Harbor

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5 Barnett Sivon & Natter, P.C, *Congressional Intent Regarding the Qualified Mortgage Provision,* May 18, 2012

The proposed rule establishes various compliance options for determining whether the creditor has met the ability-to-repay requirements. The Dodd-Frank Act provides special protection from liability for creditors who make QMs.

As noted previously, the Fed determined that the Dodd-Frank Act is unclear on whether the QM protection is intended to be a safe harbor or a rebuttable presumption of compliance. The Fed determined that there are sound policy reasons for interpreting a QM as providing either a safe harbor or a presumption of compliance. Due to the statutory ambiguity and competing concerns the Fed proposed two alternatives for the QM standard.

The first alternative defines the QM based on the criteria listed in the Dodd-Frank Act and would operate as a safe harbor and an alternative to complying with the general ability-to-repay standard. Under this alternative, the creditor would not be required to consider and verify the borrower's employment status, the payment of any simultaneous loans that the creditor is aware of or has reason to know about, the borrower's current obligations or credit history. In addition, this alternative does not include requirements to consider the borrower's debt-to-income ratio or residual income.

The second alternative defines a QM to include the requirements listed in the Dodd-Frank Act as well as the other underwriting requirements that are in the general ability-to-repay standard. This definition provides a presumption of compliance that could be rebutted by the consumer. The drawback of this approach is that it provides little legal certainty for the creditor, and thus, little incentive to make a QM. NAHB is concerned that the second alternative may reduce credit liquidity if conservative lenders establish criteria stricter than the presumption's standards to minimize litigation risk.

After carefully considering the proposed alternatives for the QM, NAHB supports the creation of a bright line safe harbor to define the QM to best ensure safer, well documented, and underwritten loans without limiting the availability or increasing the cost of credit to borrowers. NAHB supports a QM safe harbor definition that promotes liquidity by providing consumers stronger protections than those proposed by the Fed and provides lenders definitive lending criteria that reduces excessive litigation exposure. The safe harbor should incorporate specific ability-to-repay standards.

To strengthen the safe harbor definition, NAHB suggests the CFPB evaluate the eight general ability-to-repay underwriting criteria and other general underwriting factors that are based on widely accepted underwriting standards. The final rule should provide creditors with discretion to responsibly adapt debt-to-income or residual income requirements based on changing markets, and not impose a rigid numerical standard. This should be sufficiently objective to make sound underwriting and credit decisions. NAHB recommends that the regulators work with NAHB and other industry stakeholders to develop a workable safe harbor.

NAHB believes this construct would provide the strongest incentive for lenders to operate within its requirements and allow lenders the ability to provide sustainable mortgage credit to the widest array of qualified borrowers. Just as important, the safe harbor will protect consumers by allowing focused litigation to determine whether the safe harbor requirements have be met. This should provide strong incentives for lenders who best serve consumers while maintaining clear avenues to enact severe penalties for lenders who do not.

It is important to note that the establishment of a safe harbor under the QM does not eliminate lender liability in any meaningful way. Failure to meet stringent underwriting requirements under the QM will result in the loss of the safe harbor. All penalty provisions under the Dodd-Frank Act would apply, as would traditional lender liability claims such as the duty of good faith and fair dealing.

Consumers must have access to a responsible and sustainable housing credit market so as we strengthen lending regulations to avoid past excess we must be prudent to not create an environment where mortgage loans are subject to unnecessary heightened litigation risks. Excessive litigation risks and severe penalties for violating the ability-to-repay standards would cause uncertainty resulting in liquidity issues for the entire population and could cause low to moderate income and minority populations to suffer disproportionally.

NAHB Supports Reinstating the Affiliate Exception to Increase Consumer Choice

The current definition of points and fees discriminates against lenders with affiliates for no apparent reason. NAHB strongly supports reinstating the affiliate exception so it allows consumers access and choice in determining their mortgage providers.

NAHB supports H.R. 4323, the Consumer Mortgage Choice Act which would amend the definition of points and fees to remove affiliated title charges, clarify exclusion of loan officer compensation and clarify escrow charges.

Both home builders and lenders have a strong interest in establishing and maintaining long term positive relationships with consumers who are looked to for repeat business and referrals, which is not possible unless consumers are satisfied with their experiences. Consumers will only refer their friends and relatives when they believe they have been treated fairly and received excellent value for their investment.

As part of the effort to build strong consumer relationships, many home builders and lenders have established settlement service affiliates, such as mortgage and title companies. Collectively, these relationships have successfully facilitated home purchases for consumers by obtaining mortgages and providing settlement services for hundreds of thousands, perhaps millions, of consumers over a span of more than a decade.

These affiliates have been formed primarily to improve the likelihood that the financing of the home buying process occurs as promised and in a timely manner. These affiliates provide economic benefits to the consumers that far outweigh the income received from the partnerships in the business. Therefore, consumers directly benefit from affiliated relationships.

In the conditions that have prevailed during the past few years, where mortgage financing has become unstable and uncertain, these relationships have taken on greater importance. The affiliate relationship fosters a high degree of accountability between the companies, which leads to well-coordinated, efficient transactions that decrease the likelihood of any "surprises" for the consumer.

Many times affiliated settlement service providers are more efficient because they have integrated platforms that facilitate communication and enable them to achieve a quicker, more streamlined closing process. In a December 2010 Harris Survey of recent and prospective buyers, respondents said that using affiliates saves them money (78%), makes the home buying process more manageable and efficient (75%), prevents things from "falling through the cracks" (73%) and is more convenient (73%) than using separate services. This response is consistent with data from similar surveys in 2008 and 2002.

Requiring affiliate fees and points to be included in the 3 percent cap creates a disincentive for lenders to establish affiliated relationships, which as mentioned above, provide measurable benefits to consumers. For this reason NAHB strongly urges excluding fees and points from affiliated firms in the 3 percent cap, thereby giving equal treatment to affiliated and non-affiliated settlement service providers.

NAHB Supports Inclusion of Mortgage Insurance in the Proposed Rule

Mortgage insurance (MI) has provided consumers access to well underwritten, lower downpayment loans making homeownership a reality for many consumers including low- and moderate-income families. MI also provides many benefits to the housing finance industry including shared risk in the event of default and an additional and independent underwriting evaluation. Existing data reveals that loans carrying MI experience lower default rates primarily because of this additional underwriting step, or extra eyes, to the origination process.[6]

NAHB Supports Balloon Payments in Rural Areas

NAHB supports an exception to the definition of a QM for a balloon-payment made by a creditor that meets the criteria set forth in the Dodd-Frank Act. Consumers in rural and underserved areas must have access to credit and in their communities sometimes the only source of credit available may originate from community banks. Because community banks typically hold these loans in portfolio a balloon mortgage is necessary to provide the banks a means of reducing interest rate risk.

NAHB Supports Incentives to Refinance Non-Standard Mortgages

[6] Coalition for Sensible Housing Policy, *Proposed Qualified Residential Mortgage Definition Harms Creditworthy Borrowers While Frustrating Housing Recovery*, July 11, 2011, p. 13.

NAHB supports the proposal to exempt creditors of refinancing a non-standard mortgage, under certain limited circumstances, from the requirement to verify income and assets in determining whether a consumer has the ability to repay a covered transaction. This flexibility in underwriting will be an important resource for consumers who have been affected by the housing crisis and assist those homeowners who are in financial need that have behaved responsibly in handling their mortgage and other financial obligations avoid foreclosure.

Fair Lending Concerns

While NAHB supports the general principle of ability-to-repay, we are concerned the proposed QM requirements could have a disparate impact on minority consumers, who are less likely to be offered mortgage products under the QM's more stringent underwriting requirements. These results may run afoul of existing fair lending requirements including the Fair Housing Act.[7] The impact of these requirements on the availability of mortgages to minority borrowers has not been adequately examined under the proposed regulations.

Because mortgages originated under the QM will be disproportionately offered to more affluent consumers, the availability of safe mortgage products may actually decline in many minority communities. The General Accountability Office acknowledged that the QM criteria may increase the cost and restrict the availability of mortgages to lower income and minority borrowers.[8] These criteria will necessarily limit lender's discretion and therefore consumers most eligible for a QM will be disproportionately more affluent. Thus, in certain communities, lenders' lack of discretion will necessarily have a disparate impact on minority consumers.

Further, the ability of lenders to offer products outside of the qualified mortgage will be limited by the penalties for failure to comply with the ability-to-repay standards. Section 1416 of the Dodd-Frank Act allows for special statutory damages in addition to actual damages. This severe penalty may lead to the resurgence of "redlining" by lenders—denying mortgages to minority communities based on their racial composition. It is well-accepted that "the practice of denying the extension of credit to specific geographic areas due to the income, race, or ethnicity of its residents," may violate federal civil rights laws, including the Fair Housing Act.[9]

These concerns run counter to the CFPB's stated charge to promote access to affordable loan products. Notably, the administration's Housing Finance Reform Report, issued in February 2011, emphasized the need to maintain housing finance availability to creditworthy borrowers in a

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[7] The Fair Housing Act prohibits businesses engaged in residential real estate transactions, including "[t]he making… of loans or providing other financial assistance…secured by residential real estate," from discriminating against any person on account of race. 42 U.S. C. § 3605(a), (b)(1)(B).

[8] The report also examined five QM criteria to determine whether loans made over the past nine years would still be made under the criteria. The report determined that 25 to 42 percent of past mortgages would not meet an illustrative 41 percent debt service-to-income ratio. *See Potential Impacts of provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market,* GAO Report to Congressional Committees, 19-32 (July 2011).

[9] *See United Cos. Lending Corp. v. Sargeant,* 20 F. Supp. 2d 192, 203 n. 5 (D. Mass. 1998) (citing S. Rep. No. 103-169, at 21 (1993)); *Swanson v. Citibank, N.A., et al.,* 614 F.3d 400, 405 (7th Cir. 2010) (holding that plaintiff had properly stated a Fair Housing Act claim for bank's refusal to underwrite her loan).

variety of communities[10]. The report states that the administration will "work with Congress to ensure that *all* communities and families—including those in rural and economically distressed areas, as well as those that are low- and moderate-income—have the access to capital needed for sustainable homeownership . . ."[11] In other words, the federal government will continue to ensure that lenders are meeting their legal obligations to serve all communities. Thus, it is important that the CFPB reconcile the potential effect of the QM requirements with their intent and mandate to further affordable housing and fair lending goals.

Because the CFPB has taken on the bulk of oversight for a wide range of fair lending statutes, it will bear the brunt of the fair lending impacts of the qualified mortgage requirement. Therefore, prior to finalizing this rule, the CFPB should carefully consider the likelihood that the QM requirements could result in an influx of challenges under fair lending laws.

Conclusion

The Dodd-Frank Act authorized significant changes to mortgage lending practices. The ability-to-repay rules and the standards for a qualified mortgage may be the most important as it will form the foundation for mortgage lending for years to come. The QM rule is enormously complex and interlinks with numerous other regulatory standards.

NAHB urges policy makers to consider the long-term ramifications of these rules, and not to place unnecessary restrictions on the housing market. NAHB strongly believes that the ability-to-repay standard must balance both consumer and industry interests. Consumers must have access to affordable credit and responsible lenders should be able to operate in an environment without excessive litigation.

Thank you for the opportunity to participate in this important and timely hearing. NAHB looks forward to working with all stakeholders to develop an effective as well as safe and sound means to provide a reliable flow of housing credit under all economic and financial market conditions.

[10] *See Reforming America's Housing Finance Market, A Report to Congress A Report to Congress* (February, 2011).
[11] *Id.* at 21.