Testimony of

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On behalf of the

Independent Community Bankers of America

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Hearing on

"How Prospective and Current Homeowners Will Be Affected by the CFPBs Qualified Mortgage Rule"

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Chairman Capito, Ranking Member Meeks, members of the Subcommittee, I am Jack Hartings, President and CEO of The Peoples Bank Company and Vice Chairman of the Independent Community Bankers of America. I am also a member of the Consumer Financial Protection Bureau's Community Bank Advisory Council. I am pleased to represent ICBA and nearly 7,000 community banks across America at this important hearing on the Consumer Financial Protection Bureau's Ability-to-Repay/Qualified Mortgage Rule. We appreciate your raising the profile of this critical issue, which has the potential to drive many community banks with fewer resources out of the mortgage market, curtail access to mortgage credit and hamper the housing recovery.

Reform of QM is a key plank of ICBA's Plan for Prosperity: A Regulatory Relief Agenda to Empower Local Communities (the "PFP"). We appreciate the opportunity to discuss the PFP solution: Safe harbor QM status for all community bank loans held in portfolio. As explained below, this solution supports continued access to community bank credit without compromising consumer protection or safety and soundness.

The Peoples Bank Company is a $400 million asset bank in Coldwater, Ohio. We serve a community of about 5,000 and have been in business for 108 years. We survived the Great Depression and numerous recessions before and since – as have many other ICBA member banks – by practicing conservative, commonsense lending. We make sure loans are affordable for our customers and they have the ability to repay. Loans are underwritten based on sound practices using our personal knowledge of borrowers and their circumstances.

Mortgage lending has always had a significant place in the community bank business model that is focused on relationship lending. Community banks are locally owned, typically closely held institutions deeply rooted in their communities and funded primarily by local deposits. They have a vital stake in the success of their local economies because the fortunes of the local bank and the local economy are closely linked. Community banks thrive by cultivating long-term, cross-generational relationships with local families, farmers and small business owners and by serving the full spectrum of their financial needs. To sustain this business model and retain valuable customer relationships, community bankers must be able to meet the mortgage needs of their customers. Providing residential mortgages helps community bankers cement relationships with small business clients, for example, and opens up additional lending opportunities.

Mortgage lending by community banks represents approximately 20 percent of the national mortgage market.[1] However, in small towns and rural communities the local community bank is often the main source of mortgage credit. As the recent FDIC Community Banking Study

[1] The Federal Reserve's analysis of Home Mortgage Disclosure Act (HMDA) data indicates that banks with assets under $10 billion account for 18 percent of home loan originations. See "Community Banks and Mortgage Lending," Remarks by Federal Reserve Governor Elizabeth Duke, November 9, 2012. However, HMDA data does not capture institutions that operate exclusively outside of metropolitan areas. Therefore, we estimate that the community bank mortgage market share is slightly larger than 18 percent.

showed, in one out of every five counties in the United States, the only physical banking offices are those operated by community banks.[2] These markets are often neglected by larger national mortgage lenders that are driven by volume and margins, because the markets may not generate enough real estate lending activity. These communities will be hit the hardest by any policy changes that curtail community bank lending or even drive them out of the mortgage lending business.

What's more, the approximately 20 percent market share of community banks understates the significance of their mortgage lending. For example, community banks make a larger share of their home purchase loans to low- or moderate-income borrowers or borrowers in low- or moderate-income neighborhoods. Further, compared to larger banks, community banks make a larger share of home purchase loans than loans for other purposes such as refinancing or home improvement. For this reason, community bank mortgage lending plays a more significant role in the housing market than their percentage of market share would suggest.

The Qualified Mortgage Rule

There is no question that the new Qualified Mortgage (QM) rule will adversely impact my mortgage lending. This is true even though The Peoples Bank Company is currently a "small creditor" under the QM rule because we make fewer than 500 mortgage loans annually and have less than $2 billion in assets. As a small creditor, our QM loans are not subject to the 43 percent debt-to-income ratio and have a higher trigger for the "high cost" QM category, which has weaker liability protections. However, many community banks fail either the loan volume or the asset test. Even though my asset size is well below the $2 billion, in 2012 I made 493 mortgage loans, which is just at the annual loan threshold. We believe this threshold is far too low and is not consistent with the asset threshold. I will return to this point later in my testimony.

Even though The People's Bank is a small creditor, the QM rule poses a daunting challenge, will change the way that we lend, and reduce access to credit in our communities. Non-QM loans will be subject to significant legal risk under the Ability to Repay (ATR) rule. The liability for ATR violations is draconian, including enforcement actions by the CFPB and state attorneys general for up to three years following the violation, statutory damages and a private right of action potentially giving rise to class action suits. Non-compliance with ATR could also serve as a defense to foreclosure if the loan is deemed not to be a QM loan. While non-QM products may make sense for certain large lenders, community banks like mine simply do not have the legal resources to manage this degree of risk. As a result, certain loans we made in the past to accommodate customers will not be made in the future. Examples include:

[2] FDIC Community Banking Study, December 2012. Page 3-5.
(http://www.fdic.gov/regulations/resources/cbi/study.html)

Low Dollar Amount Loans

Applying the QM standards to low dollar loans in particular often yields perverse results. Consider, for example, a $75,000 loan with an 80 percent loan-to-value ratio and a cash-out feature to a customer with a lower credit score. Low dollar loans with these characteristics are common in many parts of the country for purchase or refinance. This is a conforming loan that I could sell to Freddie Mac, and doing so would make it (by definition) QM. But selling this loan to Freddie Mac would cost the borrower over $4,100 in Freddie Mac fees alone and approximately $5,500 in total fees. No borrower wants to pay over 7.3 percent in closing fees. In the past I would accommodate this customer, who could be a good credit risk, by holding the loan in my portfolio, thereby avoiding the Freddie Mac fee. But my closing fee would still, of necessity, exceed $3,000, which is the ceiling on QM loans in this dollar range. With the QM rule in the effect, the only way I can serve this customer is by selling the loan and charging a significantly higher fee. Paradoxically, the fee cap will cause this customer to pay a higher fee for a Freddie Mac loan, or to lose access to credit altogether.

Balloon Payment Mortgages

Though not offered by my bank, balloon loans are a staple of community bank mortgage lending. Community banks make balloon loans to manage their interest rate risk on loans that are not eligible for sale into the secondary market, such as loans collateralized by unique properties without adequate comparables or loans to farmers or small business owners whose debt-to-income ratios fall outside of secondary market parameters, despite their personal net worth and means to repay the loan. These loans are made typically for 3 or 5 years, and repriced and renewed when they come due. However, balloon loans are explicitly excluded from QM status unless they are made in rural or underserved areas under unreasonably narrow definitions of "rural" and "underserved." Though the CFPB has suspended application of the rural definition for small creditors until 2016, this deferral does not provide community bankers with the certainty required for long-term business planning. A permanent statutory clarification is needed regarding the status of small creditor balloon loans.

"Higher priced mortgage loans"

Community bank loans often meet the regulatory definition of "higher priced mortgage loans." When a loan cannot be securitized, as many community bank loans cannot, it must be funded through retail deposits which include higher cost certificates of deposits, and this results in a higher interest rate. The regulatory definition is heavily weighted toward the pricing that Fannie Mae and Freddie Mac set based on their ability to access capital and funding markets that are not available to community banks. In addition, in today's historically-low interest rate environment, it is more likely that a reasonably-priced loan will meet the Federal Reserve's definition of "higher priced." Almost half of community bank survey respondents (44 percent) said that more

than 70 percent of their loans were “higher priced.” “Higher priced” loans – even when that pricing is aligned with the lender’s cost of funds, risk, and other factors – are excluded from the conclusive presumption of compliance (or “safe harbor”) protections under QM and instead carry only a “rebuttable presumption of compliance,” a much weaker protection which exposes the lender to unacceptable litigation risk for the life of the loan. A higher price trigger for the safe harbor applies for loans made by community banks that meet the definition of “small creditor” – 3.5 percent above average prime rate offer (APOR) – though we have recommended that the CFPB adopt an alternative rate threshold that takes into account a community bank’s cost of funds.

While I cite three examples above, there are additional examples of safe, legitimate loans that will fail the definition of QM, even under the broader terms available to “small creditors,” and therefore not be made by community banks.

QM Does Not Obviate Ability-to-Repay (ATR)

QM compliance, as outlined above, doesn’t tell the full story of the impact of ATR. While we intend to limit our lending to QM loans, which are presumed compliant with ATR, we are still compelled to analyze each loan for ATR compliance. This analysis, which is costly and time consuming, is a necessary backstop. If a presumed QM loan is later determined not to be QM because, for example, the closing fees were not properly calculated and exceed three percent or the income verification was incomplete or faulty, we need assurances that the loan is at least ATR compliant. The liability for ATR violations, as noted above, is draconian. There is too much at stake to neglect ATR compliance.

In addition, we have every expectation that our prudential regulators will want to see clear, third-party documentation of the eight ATR underwriting factors. If such documentation is deemed insufficient, an asset may be downgraded and subject to higher capital. At this point, we simply don’t know how the prudential regulators will approach ATR/QM, but there is a clear history of examiners applying rules that are not supposed to affect smaller institutions. In short, we cannot bear the risk making loans that are not ATR compliant. Even if a loan satisfies the QM criteria, we will not extend it if it fails the ATR criteria. We welcome QM as a safe harbor from ATR liability, but it does not provide any compliance relief.

The new ATR rules are very prescriptive on how we evaluate credit and calculate the debt-to-income ratio. Consider the difficulty of applying just one of the eight ATR factors, an applicant’s credit history. Many first time homebuyers, the very people needed to spur a housing recovery, do not have sufficient credit history, sometimes because they’ve been living with their parents and have not had to make rent or utility payments. If such a borrower has saved for a 20 percent down payment and has sufficient income, we may consider him or her a good credit risk. What’s more, the loan may even be a QM loan because QM does not require credit history. But the loan

would not be ATR compliant because the borrower has no credit history, and ATR must serve as a check on our QM lending.

Community banks need a solution that will provide for more clarity and simplicity in QM designations without tortuous analysis. This certainty will relieve us of the 6 factor QM analysis as well as the 8 factor ATR analysis. ICBA’s recommended solution would set down a bright line: QM status for any community bank loan held in portfolio. I will elaborate on this solution later in the testimony.

QM/ATR analysis is particularly challenging for community banks. While large, conventional lenders typically take a “check list” approach to granting credit, community banks, by contrast, are committed to working with their customers to provide customized loans under exceptional circumstances. This is the source of our competitive advantage in an industry that is rapidly consolidating. However, QM/ATR, both the rules and their anticipated application by examiners, provide a strong disincentive to making exceptions and thereby erode the community bank advantage. I believe many community bankers will shift to using a correspondent lender for all residential mortgage loans, allowing someone else to assume the significant compliance burden.

Small Creditor Definition Should Be Expanded

The QM rule has two criteria for a “small creditor”: assets of less than $2 billion and fewer than 500 first-lien, closed end mortgages originated in the last year. However, many banks that exceed either or both of these thresholds have all the attributes of authentic community banks, including deep roots in the community, local deposit funding, personalized service, and strong, conservative underwriting. What’s more, the loan volume test is not consistent with the asset test. The Peoples Bank Company is well below the asset threshold with assets of approximately $400 million. Our loan volume varies considerably depending on demand. In 2012 we had total originated mortgages of 493, which is uncomfortably close to the threshold. While I don’t have data comparing loan volume to asset size, I do not believe that my bank is atypical.

I would like to grow my bank’s mortgage lending to serve more customers and small communities and meet growing demand as the housing market recovers. I’m confident that I can grow without changing the community-based character of my bank. But the prospect of crossing the loan volume threshold and losing “small creditor” status is a strong disincentive to growth and makes the alternative of selling to a larger lender more appealing.

Without “small creditor” status, my loans will be subject to a 43 percent debt-to-income limitation, a lower price trigger for “high cost” QM status which carries higher liability risk, and restrictions on balloon loans (which I do not currently offer but may in the future). Consider

some examples of safe, legitimate and commonly-offered loans that are denied QM status under the 43 percent DTI limitation:

- Young or start up small business owners or farmers are typically not incorporated so all of their business-related debt appears on their credit reports and must be included in the DTI calculation. These individuals often borrowed to purchase their businesses or farms and are highly leveraged as a result. Their entrepreneurial initiative, which spurs job creation and community development, should be encouraged. Forty-three percent is not a realistic or feasible DTI limitation for such individuals.
- Highly compensated individuals can incur high debt and still have a high disposable income for mortgage payments and other housing expenses. An individual earning $200,000 with a 48 percent DTI would still have $104,000 left over for living expenses. High earners often have second homes or other assets that justify their higher debt. Their purchasing helps drive economic growth. The 43 percent DTI limitation will reduce credit availability for high income individuals whose participation is needed to support the housing market recovery.

This committee should also take a very careful look at the QM rule's potential impact on minority and underserved communities. According to a recent Federal Reserve analysis of Home Mortgage Disclosure Act data, in 2010 roughly one third of loans made to African American and Hispanic borrowers would not meet the QM rule's DTI limitation.[3] In particular, ICBA is very concerned about the fate of these borrowers once QM status for federal loan programs, which many of these borrowers take advantage of, expires after 7 years or when Fannie Mae and Freddie Mac are restructured, whichever comes first.

ICBA urges this committee to support our request to the CFPB to raise the loan volume threshold. The problem could be easily addressed by disregarding loans sold into the secondary market in applying the threshold. This change would place my bank well below the threshold.

A Clean Legislative Fix is Needed

ICBA's Plan for Prosperity solution to the threat of QM is simple, straightforward, and will preserve the community bank lending model: Safe harbor QM status for community bank loans held in portfolio, including balloon loans in rural and non-rural areas and without regard to their pricing. When a community bank holds a loan in portfolio, it holds 100 percent of the credit risk and has every incentive to ensure it understands the borrower's financial condition and to work with the borrower to structure the loan properly and make sure it is affordable. Withholding safe harbor status for loans held in portfolio, and exposing the lender to litigation risk, will not make

[3] "Mortgage Market Conditions and Borrower Outcomes: Evidence from the 2012 HMDA Data and Matched HMDA-Credit Record Data." Neil Bhutta and Glenn B. Canner, Federal Reserve Division of Research and Statistics. November 2013.

the loans safer, nor will it make underwriting more conservative. It will merely deter community banks from making such loans in the many counties that do not meet the definition of rural.

Introduced Legislation

ICBA is very pleased that the solution discussed above has been included in four bills introduced by members of this committee:

- The Protecting American Taxpayers and Homeowners Act (H.R. 2767), introduced by Chairman Jeb Hensarling and Representative Scott Garrett, would delay implementation of the CFPB's ability-to-repay rules for one additional year and provide QM status to any mortgage originated and held in portfolio; among other mortgage reform provisions.
- The CLEAR Relief Act (H.R. 1750), introduced by Representative Blaine Luetkemeyer, a former community banker and bank examiner, would (i) accord QM status to mortgages originated and held in portfolio for at least three years by a lender with less than $10 billion in assets; among other mortgage reform provisions.
- The Portfolio Lending and Mortgage Access Act of 2013 (H.R. 2673), sponsored by Rep. Andy Barr (R-KY), would accord QM status to any residential mortgage loan held in the originator's portfolio.
- The CFPB Rural Designation Petition and Correction Act (H.R. 2672), also sponsored by Rep. Barr, would create a process in which individuals could petition the CFPB in order to have the rural status of a county reassessed. This process would help to more accurately identify rural counties and to ensure individuals in those communities have their mortgage needs met.

We are grateful to the sponsors of the above bills.

Thank you again for the opportunity to testify today. ICBA looks forward to working with this committee to reform the CFPB mortgage rules in order to preserve community bank mortgage lending.