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TESTIMONY
OF
MR. JERRY REED
CHIEF LENDING OFFICER
ALASKA USA FEDERAL CREDIT UNION

ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

HEARING
ON
"EXAMINING HOW THE DODD-FRANK ACT HAMPERS HOMEOWNERSHIP"
JUNE 18, 2013

Testimony of
Mr. Jerry Reed
Chief Lending Officer
Alaska USA Federal Credit Union
On behalf of the
Credit Union National Association

Before the
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
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Chairman Capito, Ranking Member Meeks, Members of the Subcommittee:

Thank you very much for the opportunity to testify at today's hearing. My name is Jerry Reed, and I am the Chief Lending Officer of Alaska USA Federal Credit Union, a federally charted credit union, headquartered in Anchorage, Alaska, serving 471,000 members. I am testifying today on behalf of the Credit Union National Association (CUNA), the largest credit union advocacy organization in the United States, representing America's state and federally chartered credit unions and their 96 million members.

Earlier this year, the Consumer Financial Protection Bureau (the Bureau) issued a final "Ability to Repay" rule to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding the borrower's ability to repay a residential mortgage loan and establishing requirements for a qualified mortgage (QM) under the Truth in Lending Act, which is implemented by Regulation Z. On May 29, 2013, the Bureau finalized additional amendments to the rule.[1] The amended rule extends the qualified mortgage definition to loans made by and held in the portfolio of a credit union that originates 500 or fewer first-lien loans per year and has less than $2 billion in total assets, even if the consumer's debt to income ratio exceeds 43%.

[1] http://files.consumerfinance.gov/f/201305_cfpb_final-rule_atr-concurrent-final-rule.pdf

These amendments made needed changes to the QM rule and were well received by credit unions. At the outset, America's credit unions want to commend the Bureau for listening to the concerns of credit unions, and for incorporating many of our concerns into the new rule. The Bureau has always had an open door policy and encouraged credit unions to voice their concerns, for which CUNA is grateful. Nevertheless, credit unions continue to have serious apprehensions about how the QM rule will be implemented and believe that it could have the unintended effect of reducing credit union members' access to credit.

While we appreciate the fact that the Bureau has provided a modest exemption for small volume originators, we question the need to apply this rule to credit unions in the first place, and urge the Bureau to consider exempting credit unions from the rule entirely. Credit unions were created to promote thrift and provide access to credit for provident purposes to their members. The credit union structure and historical performance of credit union mortgage loan portfolios strongly support a full credit union exemption from the QM rule. As not-for-profit financial cooperatives, credit unions are owned by the members that they serve. This fundamental difference between the for-profit and not-for-profit sector of the financial services industry provides a significantly different incentive structure for those managing the institutions. In addition, credit unions are primarily portfolio lenders, typically selling less than a third of their new originations. The fact that most of the loans they make will be held in their own portfolios is further incentive for them to be particularly attentive to the applicant's potential ability to repay.

The value of this difference is clearly seen in the credit unions' historical mortgage lending performance. Prior to the Great Recession, annual net charge-off rates on residential mortgage loans at both banks and credit unions were negligible, less than 0.1%. However, as the recession took hold, losses mounted. At credit unions, the highest annual loss rate on residential mortgages was 0.4%. At commercial banks, the similarly calculated loss rate exceeded 1% of loans for three years, reaching as high as 1.58% in 2009.[2]

Simply put: credit unions have every incentive to evaluate a member's ability to repay because their members are also the owners. It is not in the interests of a credit union or its other

[2] Based on FDIC and NCUA data.

members to lend money to a member likely to default. As a result, credit unions employ strong underwriting standards, consistent with the spirit of the QM rule. Credit unions also have a history of tailoring lending products to meet the needs and demands of their members. Credit unions have proven they can provide credit on fair terms to borrowers who cannot meet QM standards, but are good credit risks nevertheless. Congress and the regulators should encourage financial institutions to offer loan products focused more on the individual. Unfortunately, depending upon how the QM rule is interpreted by the prudential regulators and how it is utilized within the marketplace, the QM rule may stop this from happening. The unfortunate result will be that some members who would otherwise have qualified for a mortgage from their credit union may not receive loans.

Credit unions worry that the QM rule will make it all but impossible for credit unions to write non-QM loans because the standard, designed to be an instrument of consumer protection, may serve as an instrument of prudential regulation, effectively setting a bureaucratic standard for loan quality. Further, we have concerns that there may not be a viable secondary market into which credit unions can sell non-QM loans. If the prudential regulator will not permit credit unions to hold non-QM loans and the secondary market will not accept them, credit unions will not be able to write them. To the extent that happens, credit unions will not be able to meet the mortgage lending needs of a sizeable segment of their membership. In addition to these concerns, we also have specific views and concerns regarding the 43% debt-to-income ratio requirement, the 3% limitation on points and fees, the definition of rural and underserved area, and the bifurcated approach to the QM rule.

An Instrument of Consumer Protection Becomes an Instrument of Prudential Regulation

As this rule is implemented, it is important that Congress and the Bureau work closely with prudential regulators to ensure that this instrument of consumer protection does not become an instrument of prudential regulation. We have significant concerns that the National Credit Union Administration (NCUA) examiners will want to severely restrict the ability of credit unions to keep non-QM loans in their portfolio after the rule goes into effect. The possibility exists that NCUA examiners will determine that mortgages that do not enjoy the benefit of the qualified mortgage rule's safe harbor are a safety and soundness concern. Examiners may also be

critical of credit unions and assess their CAMEL ratings accordingly if credit unions make mortgages that do not meet the QM standards.

The potential for negative supervisory actions are a real concern for credit unions, and will contribute to the decline or elimination of non-QM lending unless Congress and the Bureau send a strong message to examiners.

Bureau Director Richard Cordray has noted the importance for the continued availability of non-QM loans. Recently, he told a gathering at the National Association of Realtors:

> Qualified Mortgages cover the vast majority of loans made in today's market, but they are by no means all of the mortgage market. This point is quite important, and it should not be misunderstood. Those lenders that have long upheld strong underwriting standards have little to fear from the Ability-to-Repay rule. These lenders, including many of our community banks and credit unions, have seen the strong performance of their loans over time. Nothing about their traditional lending model has changed, and they should continue to offer such mortgages to borrowers whom they evaluate as posing reasonable credit risk – whether or not they meet the criteria to be classified as Qualified Mortgages. We all benefit by recognizing and sustaining responsible lending wherever we find it in the mortgage market.[3]

It is important that other regulators follow the lead of the Bureau on this matter. Non-QM loans and the availability of credit to worthy-borrowers should be encouraged and not viewed negatively by examiners.

<u>Recent FHFA Action Raises Concern That a Viable Market May Not Exist for Non-QM Loans</u>

Traditionally credit unions have been portfolio lenders, meaning they hold mortgages they make on their books. However, in recent years, this trend has begun to change as credit unions have sold more mortgages to Fannie Mae, Freddie Mac and other secondary market participants in order to diversify their portfolio and manage interest rate risk, consistent with directives from examiners. In many cases, credit unions retain the servicing rights on loans they sell into the secondary market.

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[3] http://www.consumerfinance.gov/speeches/director-richard-cordray-at-the-national-association-of-realtors/

Selling mortgages into the secondary market allows credit unions to unlock much needed funds in-order to make more mortgages. It also serves an important function of mitigating interest rate risk. When interest rates are low, it is risky for a credit union to hold too many 30-year mortgages in portfolio. We believe credit unions should retain the flexibility they currently have to either hold a loan in portfolio or sell it on the secondary mortgage market based on the needs of the credit union to manage its assets and obligations. While nothing in the rule would prohibit credit unions from selling non-QM loans into the secondary market, if there is a viable secondary market for these loans, we have concerns that the market for these loans may not exist.

In May, the Federal Housing Finance Agency (FHFA) directed Fannie Mae and Freddie Mac not to purchase certain non-qualified mortgage loans after the effective date of the rule.[4] Fannie Mae and Freddie Mac will continue to purchase loans that meet the underwriting requirements stated in their respective selling guides, including loans with debt-to-income ratios above 43 percent; however, other loans issued with terms that are outside the Bureau's QM definition, such as 40-year term loans, or loans with points and fees exceeding the thresholds established by the rule, will not be purchased by Fannie Mae or Freddie Mac. This decision by FHFA may at the very least send a negative signal that creativity in the secondary market is not welcome, thus limiting the ability of credit unions to meet the variable needs of their credit worthy members. We ask the Subcommittee to ensure into the future that Fannie Mae and Freddie Mac will purchase loans originated by a credit union even if they do not meet the QM definition if they otherwise meet GSE standards.

The ability of credit unions to customize their products to meet the needs of their individual members is important because credit unions understand that every member is different; therefore, creating a loan product that fits the needs of the individual or circumstance will, at times, fall outside of the QM boundaries. One need only to look to the origin of credit unions in order to have a better understanding of why being forced to follow the QM rule encounters resistance. Credit unions were created by citizens of similar backgrounds with the mission to extend credit to their member-owners and always look to exhaust every option in order to satisfy a member's needs. This is what makes the credit union experience different.

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[4] http://www.fhfa.gov/webfiles/25163/QMFINALrelease050613.pdf

Nevertheless, the FHFA decision leaves the impression that this kind of individualization should be abandoned. As credit unions evolve with the financial markets and member needs, FHFA has essentially thrown a monkey wrench into credit unions' ability to serve their members, adversely affecting consumer's ability to access credit.

The Bureau Should Expand the Small Loan Originator Exemption to Treat All Credit Union Loans as QM Loans

In addition to ensuring that regulators do not treat loans that do not meet QM standards as unsafe loans and ensuring that the FHFA permits Fannie Mae and Freddie Mac to purchase loans that do not meet QM standards, Congress should encourage the Bureau to treat all mortgage loans made by credit unions as QM loans, as we have urged to the agency.

Ability to repay is one of many factors that determine a loan's performance, but it is a critical factor because, without it, the loan certainly will not perform. The Bureau recognized this when it cited a November 2012 Federal Reserve Board report entitled, "Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks," to make the point that "mortgage loan delinquency and charge-off rates are significantly lower at smaller banks than larger ones."[5] However, we were disappointed that the Bureau did not take into consideration the differences in delinquency and charge-off rates between banks and credit unions when considering which classes of transactions and institutions to exempt from the QM rule.

As most have acknowledged, credit unions did not create or exacerbate the financial crisis; rather, credit unions continued to extend mortgage credit to their members throughout the crisis, while many other lenders retracted their lending. As the financial crisis took hold and secondary markets dried up, credit unions increased their first mortgage originations from $54 billion in 2006 to $60 billion in 2007, $70 billion in 2008 and $95 billion in 2009. Despite this strong lending in a very turbulent economy, credit union net charge-off rates for mortgages remained very low.

[5] Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act, Regulation Z, 12 CFR Prt 1026, Docket No. CFPB-2013-0002, RIN 3170-AA34. Page 28.

Credit unions have proven they can appropriately mitigate risk even while tailoring certain loan products to meet members' needs. Appendix I describes first mortgage loan charge off rates at credit unions and banks over the last seven years. As shown in the chart, credit unions of all sizes have remarkably low net charge-off rates, and bank losses have been more than double those of credit unions. In fact, aggregate credit union mortgage losses **<u>have never</u>** gone above 0.45%. What this demonstrates is that credit unions across the board are already making mortgage loans that their members have the ability to repay – without having to be directed to do so by the federal government – and they should not be subjected to additional regulatory burden that would hinder their ability to meet their members' needs or reduce their members' responsible access to credit. Credit union mortgage loans are not the loans with which the Bureau or others should be concerned. If anything, our regulators and Congress should applaud not-for-profit, member-owned credit unions for their conservative lending practices before, during and after the financial crisis.

As the economy recovers, the credit union model continues to serve credit union members well, but the QM rule has the potential to fundamentally alter that relationship. In fact, had this rule been in effect during the crisis, it is very likely that as the crisis worsened, NCUA examiners would have increasingly frowned on non-QM loans, making it that much more difficult for credit unions to continue to lend when other providers did not.

We believe it is reasonable for this Subcommittee to urge the Bureau to reconsider why credit unions, in light of the strong performance of their mortgage loans, should be subject to this rule in the first place. All loans originated by a credit union, regardless of its asset size, should enjoy qualified mortgage status.

<u>Other Issues</u>

Debt-to-income Ratio

In order for a loan to be considered a "qualified mortgage" the consumer's total monthly debt to total monthly income at the time the loan is made cannot be higher than 43%. The Bureau has taken steps to provide clarity in this area and Director Cordray has indicated his support of non-qualified mortgage loans. However, there is a concern about the way in which non-qualified mortgage loans will be treated by prudential regulators. Credit unions often write mortgage loans for members that have a 45% debt-to-income ratio and may even go as high as a 50% debt-

to-income ratio under certain limited circumstances. Even so, our mortgage losses remain very low.

The Bureau acknowledges that a higher debt-to-income ratio is warranted in some instances and the amended QM rule provides assurances that lenders with less than $2 billion in assets and make 500 or fewer first-lien mortgages per year have the ability to serve a credit worthy borrower. The rule would allow a consumer's debt-to-income ratio to exceed 43% in these limited instances. In short, exempting institutions of $2 billion in assets that originate 500 or fewer first-lien mortgages is not meaningful for the credit union system. Credit unions have proven their worth to the mortgage market in their high performance rates of their first-lien mortgage products. Accordingly, all first-lien mortgages originated by a credit union should enjoy qualified mortgage status.

Points and Fees

For a mortgage to be considered a "qualified mortgage," total points and fees generally may not exceed 3% on a loan of $100,000 or greater. These fees include affiliate and non-affiliate charges such as title insurance, surveys, appraisal fees, underwriting, processing and application fees. While these amounts are indexed for inflation, these limitations may be problematic for some credit unions. As the loan amount decreases, certain fees cannot decrease as some fees are fixed and not dependent upon the size of the loan. The smaller the loan amount, the easier it is for fees to constitute a higher percentage of the total loan. This is especially true as the fees are currently defined as including loan originator compensation, and affiliate fees. Many credit unions work with affiliated title companies, for example, to provide the lowest costs for members on title insurance products. However, since affiliated title company fees under the current rule would be included in the points and fees calculation, it may appear to a consumer that an estimate from a non-affiliated title insurance provider is less expensive than the title insurance under the credit union's affiliate arrangement, which is in fact not the case.

The revised rule the Bureau issued does provide some relief to small financial institutions in regard to this points and fees concern, but we do not believe the rule goes far enough. If the Bureau wants to provide borrowers with an easy way to compare a mortgage loan APR between providers in their market then this proposed change will not accomplish that objective. It will mislead borrowers by not being able to compare APR rates between affiliated and non-affiliated

companies, put affiliated title companies at a competitive disadvantage, and potentially cause borrowers to incur higher closing costs.

Rural and Underserved Areas

While CUNA is disappointed that the Bureau has not already adjusted its definition of rural and underserved areas, we are encouraged that they are still examining "definitions to determine among other things whether these definitions accurately identify communities in which there are limitations on access to credit and whether it is possible to develop definitions that are more accurate or more precise."[6] The Bureau may consider making changes based on the results of this inquiry. We encourage the Bureau to consult with our prudential regulators with regard to their definitions of these terms. The concern CUNA has with the definition in the current rule is that many credit unions make loans to those in rural and underserved communities but the credit union itself may not be based in those communities. Also, underserved individuals may live in areas that would not meet the CFPB’s definition of a “rural” or an “underserved” area. If the definition of rural and underserved does not change, these institutions will be limited in the types of products they can offer their members in these areas.

Bifurcated Approach

QM's that are not "higher-priced" receive the full safe harbor, meaning that they are conclusively presumed to comply with the ability to repay requirements. QM's that are "higher-priced" have a rebuttable presumption that they comply with the ability to repay requirements, but consumers can rebut that presumption.

Under the rebuttable presumption, a court could find that a mortgage originated by a creditor originated as a higher-priced QM, and the consumer can argue that the creditor violated the Ability to Repay rule. To prevail on that argument, the consumer must show that based on the information available to the creditor at the time the mortgage was made, the consumer did not have enough residual income left to meet living expenses after paying their mortgage and other debts.

[6] Ibid, 220-221.

A QM is higher-priced if it is a first lien loan, where, at the time the interest rate on the loan was set, the APR was 1.5% or more over the Average Prime Offer Rate (published weekly by FHLMC), or if it is a subordinate lien loan with an APR that exceeds the APOR by 3.5% or more, using the same test of when the interest rate was set on the loan.

As part of the recently finalized amendments to the Ability to Repay rule, the Bureau has raised the threshold defining which QM loans receive a full safe harbor for loans that are made by small creditors under both a balloon loan and the small creditor categories of QM. The new threshold is now 3.5% (as opposed to 1.5%) for first-lien loans, which is a significant improvement, but only for those that meet the definition of "small creditor," which is under $2B in assets and makes 500 or fewer first-lien loans each year. The balloon loan category requires institutions to meet the definition of "small creditor" and provides that these lenders can make balloon loans for a two-year transition period, even if they are not located in a "rural" or "underserved" area as defined by the Bureau. (The original QM rule provided that only creditors operating predominantly in rural or underserved areas would be eligible for the balloon loan QM exemption).

Conclusion

In conclusion, America's credit unions appreciate the improvements that the Bureau has made to the QM rule; nevertheless, we continue to have significant concerns with respect to how other regulators will use the Bureau's regulation to impact credit union mortgage lending, and we question whether the rule should apply to credit unions in the first place. The Bureau has made great improvements but in other areas the Bureau has not done enough to address credit unions' concerns that being subjected to the rule will actually reduce credit availability. We are hopeful that when the Bureau completes its review of the rural and underserved definition, the changes it makes will reflect our concerns. We urge the Subcommittee to address these issues with the Bureau, NCUA, and FHFA. We further ask this Subcommittee to scrutinize the work of the Bureau and urge them to recognize, under the full extent of the law, the characteristics of credit unions and reflect those in the rulemaking process and, where appropriate, exempt credit unions from their rules. Thank you very much for the opportunity to testify at this hearing.

Appendix I