Comments of the National Consumer Law Center

(on behalf of its low income clients)

and the National Association of Consumer Advocates

on

Truth in Lending (Regulation Z)

Supplemental Comments on Ability-to-Pay and Qualified Mortgages

77 Fed. Reg. 331200 (June 5, 2012) and 76 Fed. Reg. 27390 (May 11, 2011)

Docket No. CFPB-2012-0022

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July 9, 2012

Thank you for the opportunity to submit supplemental comments on behalf of the low income clients of the National Consumer Law Center[1] and the National Association of Consumer Advocates[2] ("NACA"), on the new ability-to-repay requirements that generally will apply to consumer credit transactions secured by a dwelling and the definition of a "qualified mortgage." We previously submitted detailed comments on this topic.[3] Supplemental information we have submitted to the Bureau is provided in exhibits attached to these comments.

These comments make the following points:

- The ability-to-pay rule provides essential protection and this rule is important to the long term safety and stability of the mortgage market.

[1] Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness. NCLC publishes a series of consumer law treatises including Truth in Lending and Foreclosures. These comments were written by Alys Cohen, Lauren Saunders, and Diane E. Thompson.

[2] The National Association of Consumer Advocates (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

[3] NCLC et al., Comments to the Consumer Financial Protection Bureau and the Federal Reserve Board, Regulation Z: Docket No. R- 1417, RIN 7100-AD75, 76 Federal Register 27390 (May 11, 2011), "Proposed Rule on Ability to Pay and Qualified Mortgage" (submitted July 22, 2011), *available at* http://www.nclc.org/images/pdf/foreclosure_mortgage/predatory_mortgage_lending/comment-ability-to-pay-qm.pdf.

- The definition of a Qualified Mortgage (QM) must be broad, designed to encompass the vast majority of the market and to encourage lending that meets that definition.
- The QM definition should not encompass patently unaffordable loans.
- Loans that meet the QM definition should not receive an irrebuttable safe harbor.

The Consumer Financial Protection Bureau specifically solicited comments on the data obtained from the FHFA and other data that might help to establish ability-to-repay standards. The data make clear that the real estate crash and foreclosure crisis were preceded by two major trends in home lending: a substantial increase in high DTI lending, even where history demonstrated that such a practice leads to high default rates, and increasing delinquencies on low DTI loans. The ability to pay and QM rule must vigorously respond to those findings and prevent future excesses of a similar nature.

The CFPB also specifically solicited comments on the litigation risk posed by the Qualified Mortgage (QM) standard generally. We will discuss below the minimal litigation risk posed by borrower litigation. This topic is addressed as part of the discussion regarding the importance of defining the QM standard as a rebuttable presumption and not a safe harbor. The more significant litigation risk is posed by put-back or repurchase litigation. Such litigation is unlikely to be frequent for loans that meet the QM standards, regardless of whether the rule is drafted as a rebuttable presumption or a safe harbor.

1. The Ability-to-Pay Rule Will Provide Essential Protection

The ability-to-pay requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is an absolutely critical protection needed to correct the abuses that led to the mortgage crisis that devastated millions of families and our entire economy. This rule will provide essential protections against future abuses by putting the flesh on the ability-to-pay requirement by defining the type of mortgage that is likely to be affordable and should be the norm in the mortgage market.

This rule is being written at a time when the housing market and the economy are still struggling. Memories of past abuses are still relatively fresh and the biggest immediate problem may seem to be reviving the mortgage market. Many in industry are calling for a light regulatory hand and lax rules.

That would be a short sighted approach. The mortgage market will recover at some point, whether sooner or later. Even with a crisis of this magnitude, it can be shocking how short memories can be. The devastation of the savings and loan crisis of the 1980s, caused by investors looking for high returns and ignoring the inevitably accompanying risks, did not stop investors during the internet bubble of the 1990s from believing that high returns from speculative companies would continue indefinitely, and neither of those two previous collapses was heeded by those in the 2000s who sought ever higher returns in the mortgage market by encouraging riskier mortgages.

When things are going well – as they will be in the mortgage market at some point – regulators, creditors and investors let their guard down and that is when abuses take hold. Indeed, the data from FHFA make the point with vivid clarity:[4] Until 2005, for the years surveyed, roughly half of all mortgages were made at DTIs below 32%. Between 2005 and 2008, however, lenders pushed DTIs up above historical levels, even though the historical evidence was always clear that higher DTIs led to higher default rates. Lenders also did this even though delinquencies, beginning with the 2004 vintage, were exploding on all DTIs, above the roughly 4% ceiling that had been accepted by many in the industry as the acceptable rate of delinquency. Clearly, lenders were pushing the envelope on affordability in ways that went beyond DTIs. The result of this double whammy—increasing delinquencies on even low DTI loans and an increasing percentage and volume of loans made under high DTIs—led to catastrophic rates of default in 2007. The rules put in place now must prevent a repeat of this cycle.

2. The QM Definition Must Be Designed to Encompass the Vast Majority of the Market

The elements required to meet the definition of a "Qualified Mortgage" (QM) are the primary protection against abusive lending. Although the ability-to-pay requirement applies outside the scope of QM loans as well, the privileged legal protection for QM loans (a presumption of compliance that is rebuttable) makes the scope of QM lending the key tool in providing affordable home loans. Those requirements should be the standard in the mortgage market and should apply to the vast majority of loans. Consequently, the QM definition must be designed to be broad and not narrow.

A narrow QM definition would leave most loans outside of the essential protections of Dodd-Frank and would undermine the purpose of the QM provisions of Dodd-Frank. The entire purpose was to provide incentives for lenders to make loans that meet those requirements. Those incentives will exist only if QM loans are the norm, not the exception. A narrow QM definition will render the QM protections largely meaningless.

A broad QM will protect both creditors and borrowers. Creditors will know the basic rules that they must follow and can lend with confidence. Borrowers will receive loans that comply with the basic rules of an affordable loan.

3. The QM Definition Should Not Encompass Patently Unaffordable Loans

[4] *See* Consumer Financial Protection Bureau, Notice of Reopening of the Comment Period, 77 Fed. Reg. 33,120, 33,122-123 (June 5, 2012).

a. Making Unaffordable Loans In the Name of Providing Access to Credit Hurts Everyone

The current mortgage crisis shows that there is a price to be paid for making unaffordable loans. The unaffordable loans made in the early part of the last decade are still stalking our economic system. The gains in homeownership made by that too-easy extension of credit have all been wiped out, and the process of readjustment has taken with it much more than was ever gained through the provision of unaffordable credit. Overreaching has resulted in a net loss for homeowners, investors and communities. The tight credit conditions we are experiencing now are the rebound hangover from the binge of unregulated lending leading up to the crisis. Lack of regulation not only destroyed wealth; it destroyed the economic markets that provide necessary and appropriate capital.

b. Examples of Patently Unaffordable Loans

We must not repeat those mistakes. Loans meeting the QM standard should meet realistic affordability standards. For example, loans should not qualify as QM based on reserves or prior housing payments alone, without protections. Both of these standards by themselves are subject to abuse and could lead to loans that are unaffordable on their face being made as QM loans. Housing payments alone are not predictive of affordability. Homeowners often can and do scrape by for six or seven months on their mortgage payments, hoping for a refinancing to lower payments at an affordable amount. Allowing a refinancing to qualify as a QM based solely on prior housing payments, regardless of the level of the new payment or the borrower's income and related DTI would encourage a return to asset-based lending for homeowners, a per se predatory practice.[5] **S**treamlined refinancing programs have resulted in some predictably unaffordable loans.

Loans made on reserves alone are even more susceptible to abuse of vulnerable populations. For example, a middle-aged homeowner with an annual income of $70,000 who became permanently disabled would receive approximately $1866/month in Social Security Disability (SSD) benefits. If Social Security delayed approval of that homeowner's SSD application for 10 months, the lump sum back disability payments received by that homeowner would be large enough to look like there were twelve months of reserves to cover a mortgage with a monthly payment of $1000, at a front-end DTI of 54%. ven modest pre-existing medical bills and health insurance costs could reduce this borrower's nominally sufficient residual income of $866 to zero for the homeowner receiving such benefits.

Retirement accounts, in particular, can mean the difference between living in abject poverty and surviving modestly in retirement; they should never be the primary basis for underwriting. With seniors increasingly forced to work into their 80s and 90s now as a result of insufficient savings and unaffordable mortgage payments, the federal government should not endorse the use of retirement

[5] OCC Advisory Letter 2003-2, Guidelines for National Banks to Guard against Predatory and Abusive Lending Practices 2 (2003) (describing the requirements of "basic principles of loan underwriting" as including a full analysis of the borrower's ability to repay).

accounts as an indicator of affordability. Nor should younger workers who are temporarily employed be encouraged to borrow against those retirement accounts. Relying on reserves, by themselves, as a measure of affordability is foolhardy in the extreme.

c. The Importance of Residual Income

As demonstrated by the FHFA data, relying on DTI alone is not enough to ensure lending based on ability to repay. The explosion of the default rates on GSE loans in 2004, even for loans with a DTI less than 32% shows clearly that DTI alone is inadequate. Residual income standards should be incorporated into the basic QM definition.

d. The Importance of Housing Counseling

As early as 1997, the OCC documented that high-quality housing counseling could dramatically improve outcomes for loans that had other risky characteristics and were made at comparatively high DTIs.[6] The quality of counseling was particularly important. Banks that required comprehensive counseling with qualified housing counselors saw lower delinquencies than banks that allowed homeowners to meet the counseling requirement via a self-study course. More recent data continues to support that finding.[7]

Some expansion of the QM definition could be supported where the homeowner receives pre-purchase or pre-refinancing counseling from a HUD-accredited counseling agency. Such counseling would need to incorporate a full review of the homeowners current income and debt service ability as well as a review of the history of housing payments and other debt service over a 12 to 24 month timeframe.

e. QM Standards Should Reference the Maximum Payment over the Life of the Loan

Under 15 U.S.C. § 1639c(b)(3)(B)(i), the Bureau has broad authority to "revise, add to, or subtract from the criteria that define a qualified mortgage . . . ." The Bureau should exercise this authority to require that affordability of adjustable rate mortgages is pegged to the maximum payment over the life of the loan, not the five year limit set in 15 U.S.C. § 1639c(b)(v).

Any time limit is by definition arbitrary and invites gamesmanship. If the limit is set at five years, we will see the emergence of unaffordable 6-24 mortgages, and if the limit is set at six years, unaffordable 7-23 mortgages will become the new rage. Particularly for homeowners on fixed or

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6 OCC Advisory Letter 97-7, Affordable Mortgage Portfolios 4 (1997), *available at* http://www.occ.gov/static/news-issuances/memos-advisory-letters/1997/advisory-letter-1997-7.pdf.

7 Neil S. Mayer, et al., *Has Foreclosure Counseling Helped Troubled Homeowners?: T*he Evaluation of the National Foreclosure Mitigation Counseling Program, Urban Institute (Jan. 24, 2012), *available at* http://www.urban.org/publications/412492.html.

limited incomes, such as the disabled or seniors, the maximum payment over the life of the loan is the relevant measure of risk.

This position is neither new nor radical. In fact, it is the position adopted by the Office of the Comptroller of the Currency in 1997 in its review of delinquencies on "Affordable Mortgage Portfolios." The OCC then noted as a matter of course that banks should evaluate the credit risk associated with adjustable rate mortgages with reference to the lifetime cap, i.e., the maximum payment over the life of the loan. This assessment of the credit risk posed by the maximum cap was described as what banks should do "at a minimum."[8] Had banks followed that guidance then, we would not have seen a market collapse on 2007 of the scale we experienced. The CFPB should match the OCC's vision in this instance.

We note that other commentators have asked the CFPB to consider the impact of utility and transportation expenses on ability to repay.[9] The impact of these expenses on housing affordability has been recognized for low-income renters and homeowners in programs administered by the Department of Veterans Affairs[10] and the Department of Housing and Urban Development for many years. Including such expenses in regional residual income standards as part of an affordability analysis is sensible and prudent, particularly for borrowers with limited residual income.

4. The Rule Should Not Offer Creditors an Irrebuttable Safe Harbor

In writing the definition of a QM loan, the CFPB will do its best to define the contours of loans that are likely to be affordable. But it is impossible for the CFPB to define affordability with perfect precision, for every homeowner, every creditor, every type of mortgage and every mortgage practice that might arise far out into the future. Creditors should be encouraged to make mortgages that meet the definition of a qualified mortgage, and those that do are entitled to a presumption that the loans meet the ability-to-pay requirement. But it would be a terrible mistake to create a safe harbor that is irrebutable, regardless of whether the loan was foreseeably unaffordable by the creditor.

We cannot anticipate now all of the ways in which irresponsible lending practices could arise within the contours of the QM definition. When predatory lending became a problem in the 1990s, the Home Ownership Equity Protection Act (HOEPA) did its best to attack those practices. But the HOEPA reforms were powerless to protect consumers from the new wave of mortgage "innovations."

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[8] OCC Advisory Letter 97-7, Affordable Mortgage Portfolios 4 (1997), *available at* http://www.occ.gov/static/news-issuances/memos-advisory-letters/1997/advisory-letter-1997-7.pdf.

[9] *See* Comments filed by the National Resources Defense Council.

[10] 38 C.F.R. § 36.4340(e).

Even more important than the details of any specific rule is getting the incentives right. Rulewriters will always be several steps behind the market. But if the incentives are in the right place, the rule will do its job even as new, unanticipated developments arise. The essential incentive for the mortgage market is the rule that *every* mortgage must be evaluated for affordability. A safe harbor that deems certain types of mortgages affordable no matter the circumstances will not build in incentives for creditors to ensure affordability.

If the QM rule provides a safe harbor, some creditors will focus on only the letter but not the spirit of the rule. It will leave the door open to known types of abusive lending and will predictably encourage the emergence of adjustable rate mortgages timed to reset at the end of six years instead of five. Creditors will find other ways of evading the protections of the QM definition that we cannot anticipate right now. The spirit of the rule is true ability to pay. If we want creditors to comply with that spirit, the ability to pay requirement must apply even to loans that meet the QM definition.

As we described in greater length in our previous comments:

- ***Both the statutory language and the legislative history of the QM provision demand a rebuttable presumption, not a safe harbor.*** There is no statutory authority to create a safe harbor. The sole prompt for the safe harbor proposal was a phrase in a vestigial caption left over from proposed legislation in 2007. The concept of a safe harbor was buried in 2009 and the Bureau does not have the legal authority to resurrect it. Even if the Bureau did have such authority, it would be unwise and contrary to the purpose of the law to adopt it. Dodd-Frank created a finely tuned balance of market incentives and market discipline, and a safe harbor would upset that balance.

- ***The rebuttable presumption will be difficult for homeowners to satisfy.*** Even if a loan is unaffordable from the start, exceedingly few homeowners will even find an attorney to assist them. When they do, the facts will need to paint a pretty severe picture to overcome the presumption. If a consumer claims that a loan is unaffordable, and if the loan meets the QM standard, the homeowner will have the burden to demonstrate that the loan was not reasonably reviewed for affordability. Litigation burdens are very difficult to overcome, as the paucity of litigation under the existing higher cost mortgage rules demonstrates. This is especially true when a party has satisfied the presumptive requirements of a statute. For example, TILA provides a rebuttable presumption that the borrower has received the required notice of the right to cancel when the borrower signs an acknowledgment of receipt at closing.[11] Courts have often required homeowners to do more than assert the non-receipt of the documents, even at the pleading stage.[12] Borrowers typically only prevail ultimately in

[11] 15 U.S.C. § 1635(c).

[12] *See, e.g., In re* Perks, 2011 WL 1298555 (Bankr. N.D. W. Va. Mar. 31, 2011); Fortune v. AM. Window & Siding Sys., Inc. (*In re* Fortune), 2010 WL 4053107 (Bankr. D. Kan. Oct. 13, 2010); *In re.* Hastings, 2010 WL 3909207 (Bankr. N.D. Ala. Sept. 30, 2010); Sias v. Washington Mut. Bank, 2010 WL 2103448 (E.D. Tenn. May 20, 2010); Lee V. Countrywide Home Loans, Inc., 2010 WL 1487131 (N.D. Ohio Apr. 13, 2010); Douglas v. Wilmington Fin., Inc., 2009 WL 3852458 (N.D. Ill. Nov. 18, 2009); St. Hill. v. Tribeca Lending Corp., 2009 WL 691977 (E.D. Pa. Mar. 17, 2009); Abbott v. Washington Mut. Fin., Inc., 2008 WL 756069 (E.D. Pa. Mar. 20, 2008); Strang v. Wells Fargo, 2005 WL 1655886 (E.D.

rebutting the presumption of receipt when they can establish a chain of custody of their closing documents akin to that required in criminal drug cases.[13] The QM standard may create an even higher bar because the presumption will reference an agency determination of a complex process, the ability to repay test. Unlike the TILA acknowledgment of receipt, an ability to repay determination involves many interrelated components. Courts are likely to give great weight to the CFPB's determination of what is an affordable loan, and will be unlikely to impose further requirements. Moreover, as the Ninth Circuit has noted, "presumptions are not rebutted by allegations; they are rebutted by evidence."[14] And the evidence of the lender's determination of a consumer's ability to repay will all be in the lender's hands.

- ***Creditors will face no significant litigation risk from borrowers under a rebuttable presumption.*** Consumer litigation under Truth in Lending is grossly outweighed by the numbers of foreclosures. These issues are explored in detail in Appendix A. Even if the homeowner prevails, Congress capped the damages at a relatively small amount in comparison to the value of the mortgage. Attached as Appendix F is a step-by-step review of one example.

- ***A safe harbor could insulate creditors from knowingly making unaffordable loans.*** A safe harbor would shut the court house door to borrowers. Once there was a determination that a loan met the QM standards, there would be no redress for the homeowner, even if the creditor made the loan with full knowledge that the borrower could not afford it. There are many possible examples of these loans. For example, homeowners with limited residual income and high medical bills might have no residual income, even at a 31% DTI. In that circumstance, if QM only required a 31% DTI, without residual income, the creditor would be free to engage in the purest form of asset-based lending and the homeowner would have no redress. Similar results would apply for any of the many possibilities in which a creditor extended credit, knowing that the borrower could not reasonably be expected to repay, unless the QM definition specifically identified the precise circumstances posed by that case. Such micromanagement of credit decisions serves no one's interest and would be cumbersome to implement. With an irrebuttable safe harbor, creditors would be encouraged to ignore obvious warning signs so long as they were not listed as a criteria in the Bureau's rule. Predictably unaffordable loans would come with total legal insulation.

Pa. July 13, 2005); Hershey v. Deutsche Bank Nat'l Trust Co., 2005 WL 1420813 (D. Minn. June 16, 2005); Williams v. G.M. Mortg. Corp., 2004 WL 3704081 (E.D. Mich. Aug. 18, 2008); Parker v. Long Beach Mortg. Co., 534 F. Supp. 2d 528 (E.D. Pa.); Sewell v. Option One Mortg. Corp., 2007 WL 4355393 (E.D. Pa. Dec. 12, 2007); Oscar v. Bank One, N.A., 2006 WL 4018853 (E.D. Pa. Feb. 17, 2006); Evans v. Ameriquest Mortg. Co., 2003 WL 734169 (Mich. Ct. App. Mar. 4, 2003).

[13] *See, e.g.,* Cooper v. First Gov't Mortg. & Investors Corp., 238 F. Supp. 2d 50 (D.D.C. 2002) (homeowner produced lockbox in discovery; homeowner had placed all documents in lockbox after closing); *In re* Jaaskelaninen, 391 B.R. 627, 642-43 (Bankr. D. Mas. July 7,2008), *rev'd on other grounds*, 407 B.R. 449 (D. Mass. 2009) (after reviewing detailed chain of custody of closing documents presented by borrowers noting that perfect chains of custody cannot be required in TIL cases because "*A lender would never be satisfied with any chain of custody.*" (italics in original).

[14] Balderas v. Countrywide Bank, N.A.. 664 F.3d 787, 790 (9th Cir. 2011).

- ***A safe harbor could reduce the rights that consumers currently have under UDAP and other state laws to challenge reckless and bad faith underwriting.*** A safe harbor under Dodd-Frank would make it much more difficult for homeowners to raise state legal claims, such as fraud, where a creditor can show it has satisfied the QM definition. A court might be inclined to view the satisfaction of such a standard as the last word on affordability (either as a matter of preemption or of persuasiveness). Moreover, some states have statutes or developed case law that provide that any loan that satisfies the Truth in Lending Act per se complies with state law. Accordingly, it is essential that a rebuttable presumption be preserved so that unsustainable loans are not immune if they are unfair, deceptive or unconscionable.

Conclusion

The purpose of the Dodd-Frank mortgage reforms was to encourage sustainable lending products and practices. Sound product design and sensible underwriting are the twin pillars of sustainable lending. The first pillar is built by strong requirements for presumptively safe mortgages designed to encompass the bulk of the market. The second pillar sustains the first: the Qualified Mortgage designation will earn the trust of both consumers and investors if it is not merely a formulaic set of rules but is undergirded by the essential, flexible requirement that loans must be based on ability to pay. A rule that combines specific requirements with the backstop of a flexible principle will provide the best security for the mortgage market for the long run.

Exhibits

Exhibit A: NCLC and Center for Responsible Lending, "Qualified Mortgage: Rebuttable Presumption: A Perspective on Litigation Risk by the Numbers" (Oct. 11, 2011).

Exhibit B: NCLC and Center for Responsible Lending, "Dodd Frank: When Congress Meant Safe Harbor It Wrote the Statutory Text as a Safe Harbor" (Oct. 2011).

Exhibit C: NCLC, "Any Safe Harbor Under the Dodd-Frank Qualified Mortgage Provision Will Insulate Creditors From Abusive—Even Bad Faith—Behavior" (Dec. 21, 2011).

Exhibit D: NCLC, "Qualified Mortgage: Proposed Procedure for Implementing the Rebuttable Presumption" (Mar. 12, 2012).

Exhibit E: Letter from NCLC, et al. to CFPB Director Richard Cordray (March 12, 2012) (response to the joint comment submitted by CRL, CFA, the Leadership Conference, and the Clearinghouse).

Exhibit F: NCLC, "Methodology for Calculating Damages For Dodd-Frank Ability to Repay Requirement" (July 9, 2012).

Exhibit A

QUALIFIED MORTAGE

Rebuttable Presumption: A Perspective on Litigation Risk by the Numbers

Introduction

One of the crucial and defining issues facing the CFPB in implementing Dodd-Frank's much needed mortgage reforms is whether the existence of a "Qualified Mortgage" will create a rebuttable presumption of compliance with the Ability to Repay (ATR) rule in private litigation, or whether it will grant complete immunity (a "safe harbor") for non-compliance – even willful or reckless non-compliance. The facts and the law clearly support a rebuttable presumption. Moreover, industry claims that litigation risk necessitates a safe harbor do not hold up to scrutiny.

The industry's demand for the Safe Harbor choice is simply a rehash of the same overheated rhetoric that has accompanied virtually every proposal for consumer protection reform for decades. Now, as in the past, the predictions of credit constriction, increased costs and excessive exposure to liability are without sound basis in the evidence, or in common sense.

In the past, excessive credulity among regulators was one of the factors that enabled an industry to act recklessly, without meaningful accountability. That, in turn, led to a mortgage crisis, which, in turn led to a full-blown crisis that threatens to last as long as a decade.[1] Warnings from the ground – from consumers, community advocates, and the lawyers who were seeing the loans being made – were dismissed as "anecdotal" while the industry's predictions were neither subjected to meaningful rigorous scrutiny, nor objectively and rigorously back-tested against the actual results.

The CFPB owes its very existence to a determination that an agency should be established whose primary mission was the well-being of consumers and a fair and competitive market. It was given an extensive research mandate to assure that it had the capacity to exercise independent, evidence-driven decisions. In this context, that means putting the likely litigation exposure as a result of a rebuttable presumption in the context of a $12 trillion mortgage market. To provide accountability, Congress struck a careful balance between assuring that consumers had a realistic ability to enforce their statutory rights and protecting the industry against excessive risk. That balance was to cap damages. Further, the statute gave a litigation advantage to the industry for responsible loans in order to discourage risky loan products, terms and practices that led to their massive losses and triggered the crisis. The cap on damages also provides sufficient protection to allow room for responsible innovation.

We discuss elsewhere the fact that the statute mandates that this be a litigation advantage – a rebuttable presumption, not the free pass that a safe harbor would provide.[2]

Litigation Exposure from Homeowners: In Perspective

The mortgage industry faces many types of risk. It took a market risk in opting to forego sensible loan design and sensible underwriting. It lost that bet – with significant collateral damage to the world economy. It faces litigation risk on many fronts – of which homeowners are actually a relatively quiet front. The litigation risk resulting from one claim available to homeowners – a capped claim at that – is a drop in the bucket. (The primary component of homeowners' damage claims for ability to repay violations is capped at three years worth of paid fees and interest.[3])

While comprehensive statistics are not available on mortgage-related litigation, the experience of the lawyers who represent homeowners is that most homeowner litigation is not proactive. Even when the litigation would be initiated by a consumer, it tends to be in reaction to an impending or existing foreclosure.[4] Consequently, the volume of foreclosure filings provides a reasonable proxy to put homeowner litigation in perspective. Furthermore, the litigation from the past few years would represent a high-water mark, since that also represented a high-water mark of industry irresponsibility and overreaching in its lending practices.

In relation to the size of the mortgage market and the apogee of mortgage litigation, the added risk from a Truth in Lending Act (TIL) claim is vanishingly small.

Number of home loans made 2005-2010 [5]	63,900,000
Number of homes entering foreclosure during crisis (est) [6] *(Q107-Q211)*	8,000,000
Number of cases involving existing TIL rebuttable presumption in last 5 years, per MBA comment[7]	59
As percentage of homes entering foreclosure, above	**.00074%**
Number of cases involving existing TIL rebuttable presumption scheduled for trial, per MBA comment[8]	35
As percentage of homes entering foreclosure	**.00044%**

Another reasonable proxy for exposure to a TIL claim used in relation to foreclosure litigation would be rescission claims – one of the most important tools homeowners have to contest bad mortgage practices. Again, in context, the likely litigation risk is minimal overall.

Number of foreclosures initiated in 2010 (by OCC/OTS reporting servicers)[9]	1,400,000
Number of cases involving Truth in Lending & foreclosure 2010[10]	904
Number of such cases also involving TIL rescission	660
2010 rescission cases as percentage of 2010 foreclosures filed	**.047%**

The scarcity of lawyers to represent homeowners suppresses the incidence of consumer protection litigation in relation to the size of the market.

It is impossible to make any realistic projections concerning litigation exposure to homeowner claims without taking into account the great disparity between the industry's access to representation and the homeowners' access to representation. Access to the courts in our adversarial system, to be meaningful, requires access to lawyers. This is particularly so in complex matters like mortgage-related cases and foreclosures. The foreclosure crisis has brought the imbalance in access to representation into harsh light, as a number of local and state reports have found.[11]

- In Maine, legal services providers found that only 6% of requests for help in connection with foreclosure "received the level of attention necessary to resolve the problem," leaving 94% of those requesting help without access to that kind of representation.[12]

- The Brennan Center for Justice report, *Foreclosures: A Crisis in Legal Representation*,[13] found that the majority of homeowners in foreclosure went without representation.
    - Stark County, Ohio – 86% of foreclosure defendants in 2009 were unrepresented.
    - Queens County, NY, 84% of defendants in foreclosure proceedings involving non-prime loans "proceeded without full representation from November 2008 to May 2009. In Staten Island, 91% were unrepresented and 92% in Nassau County were unrepresented.

- In New Jersey, 94% of 2010 foreclosure cases were uncontested.

Even for that very small percentage of homeowners facing the loss of their homes who are able to find attorneys, the overwhelming majority evaluate claims carefully, and generally pursue the clearest cases of wrongdoing, for the simple reason that they are often uncompensated if they do not succeed with the claim.[14]

The MBA's effort to quantify the difference in cost between a safe harbor and a rebuttable presumption fixed on a difference in attorneys fees of about $20,000 per case. It assumed lawyers were paid $300/hour, and a roughly 40% increase in billable hours for a rebuttable presumption over a safe harbor.[15] It is unclear whether that is intended to be the institution's attorney, or the homeowner's attorney or both combined. But whichever it is, context is important here, too:

- If it includes the homeowner's attorney fees (because TIL is a fee-shifting statute), that assumes that the case is resolved in favor of the consumer. The overall exposure must be discounted to reflect the $0 liability for the homeowners' attorneys fees when the homeowner does not prevail.

- If it includes (or reflects entirely), the cost of the institutions' representation, it should also be remembered that those costs are controllable. Many homeowners' lawyers report that institutions' lawyers often engage in a litigation strategy of attrition – especially when the attorney for the homeowner will not be able to be fully recompensed for the time they put in.

- Mortgage-related litigation by homeowners commonly involves multiple claims and thus much of the legal work related to these claims would also apply to other state or federal claims.

.The MBA purports to highlight the impact of that estimated $20,000 difference in a given case to the 2010 "average production profit per loan" of $1,054.[16] Here, too, such estimates must be put in context. Even amidst the record-high foreclosure rate, the majority of mortgages are still performing. Applying that $1,054 average production profit per loan to the 7.84 million home loans originated in 2010[17] suggests a total production profit of some $8.27 billion dollars just for 2010 loans.[18]

The Experience of States with Anti-Predatory Lending Laws Fails to Support Predictions of Excessive Litigation

Some state anti-predatory lending laws included both assignee liability and substantive rules which involved non-"bright-line" substantive standards. Their experience demonstrates that they did not have a detrimental impact on responsible lending, nor expose the creditors to undue litigation risk.

When the original version of Georgia's Fair Lending law included uncapped assignee liability, the rating agencies balked. However, the secondary market was satisfied when the exposure was capped, and therefore quantifiable. Here, the damages for this particular violation are capped for all parties – creditors as well as assignees.

North Carolina's 1999 anti-predatory lending law included an anti-flipping provision applicable to all home loans originated in the state. The homeowner must show that a refinancing provided no "reasonable, tangible net benefit" in light of "all the circumstances" and that the lender "knowingly or intentionally" made the non-compliant loan.[19]

CRL analyzed the North Carolina subprime market for the five years after the law became effective, 1999-2004, for its impact on litigation. It analyzed court filings in state, federal and bankruptcy courts involving the top 10 subprime originators during that period. It found **zero instances of flipping claims**.[20]

The NC experience is particularly appropriate to consider because flipping claims, like ability to repay, claims are inherently individual inquiries that depend on the circumstances in a particular case. Exposure to class actions, thus, would likely only occur in rare cases – and cases where such exposure was unequivocally warranted.

The Real Litigation Exposure Comes from Commercial Litigation, Not from the Incremental Difference between a Rebuttable Presumption and a Safe Harbor in Homeowners' Ability to Repay Claims.

Though comprehensive data is not available, what evidence there is suggests that in both incidence and magnitude, the real exposure to litigation risk does not lie in the difference between a safe harbor and a rebuttable presumption on ability to repay claims for borrowers.

- A survey of 2008 subprime-mortgage related litigation by Navigant Consulting identified 576 case filings of which 55% were investor or commercial contract claims, compared to 24% borrower-class actions. [21]

- Mortgage Daily News has a Litigation Index, which lists litigation in some 39 categories. In the 2Q11 report, it identified 190 cases (which could be classified in multiple categories.) Categories most likely to include claims over conduct that would be covered by the ATR rules are "compliance" and "suitability." Of 22 "compliance cases," only 2 appear to involve individuals, and 0 cases involved "suitability." (In fact, *only 10 suitability cases were reported since January, 2007*.) By comparison, 50 cases involved shareholder lawsuits and class actions, 27 related to MBS, and 27 related to secondary marketing, warehouse lending, and repurchasing.[22] Its "foreclosure" category includes "servicer-related litigation, foreclosure lawsuits and cases against foreclosure rescue services." The 2Q11 report cites only 67 cases, of which 34 involved governmental actions, and it appears that none of them involved origination claims by the homeowner.[23]

When measured against the magnitude of the commercial and investor claims, there can be no real economic justification for acting contrary to Congress' intent in creating a meaningful, enforceable right.

Investor losses from the crisis were pegged at $700 billion late last year, and one estimate put the banks' potential losses from put-back litigation on those mortgages at $134 billion.[24]

A review of SEC 10-Q filings for the second quarter of 2011 from major financial institutions confirms that the scale of investor and commercial litigation is where the real litigation exposure lies. Bank of America, for example, reports $11.6 billion in outstanding reps and warranties claims as of June 30, 2011. None of the significant litigation listed appears to relate to consumer-party mortgage origination claims in the 10-Qs from B of A, Wells, Citi, or JP Morgan Chase.

A Safe Harbor is Not Necessary to Restart Mortgage Credit, as Neither Existing Nor Pending Ability to Pay Rules are Responsible for the Current Constrained Credit Market

One of the arguments advanced for a safe harbor that the Bureau must scrutinize most carefully is that it is necessary to restart the current constrained credit market. But until the economy stabilizes, the foreclosure crisis abates, the housing overhang slows, other regulatory issues like capitalization rules are resolved, the cautious market will continue. Enacting a safe harbor will not jump start originations, but it will do a great deal to undermine the goal of a more sane and sensible mortgage process when the market does restart.

The evidence tying ability-to-pay rules to a decrease in responsible, sustainable credit is scant to non-existent. The MBA comment letter implies a connection between the decline in "higher-cost" loans and the release of the UDAP rules for high-cost loans in July, 2008.[25] These rules, which included a general ability to repay provision, went into effect in October, 2009. Of course, the financial crisis also exploded in late summer and early fall of 2008, a far more cogent explanation. While underwriting standards have tightened, it is the frightening consequences of the loose ones used earlier in the decade that caused that, not the higher-cost rules. The combination of the change in underwriting driven by experience, not rules, and the decline in home values are estimated to have reduced the volume of originations by about a third in 2010.[26]

But volume is also down because the demand has slowed. HMDA data shows that 2010 applications for first-lien, owner-occupied loans are down nearly 50% from 2007, and 14% from 2009.[27] The stubbornly high unemployment rate, declining incomes, and the need for households to deleverage from record high debt burdens are obvious explanations for reduced demand.[28]

Conclusion

This is the Bureau's premier opportunity to demonstrate that it can and will be an objective, evidence-based regulatory agency. Part of the problem of the past regulatory paradigm was an unwillingness to scrutinize the real evidence and logic behind industry allegations. The Bureau was created to do things differently.

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[1] *See, e.g.* Carmen M. Reinhart & Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* at 224 (2009).

[2] *See* Comments to the Consumer Financial Protection Bureau and the Federal Reserve Board, Reg. Z, Docket No. R-1417 on the *Proposed Rule on Ability to Pay and Qualified Mortgage* by the Center for Responsible Lending, National Consumer Law Center, Consumer Federation of America, and National Association of Consumer Advocates, pp. 7-14 (July 22, 2011).

[3] The components of damages include statutory damages (capped at a very modest $4000), and enhanced damages of "an amount equal to the sum of all finance charges and fees paid by the consumer, unless the creditor demonstrates that the failure to comply is not material." The enhanced damages, in practice, will be the major exposure, but the return of finance charges paid by the consumer is capped at three years. Thus if a claim is raised in defense to foreclosure after six years, the consumer would still be entitled to damages of only three years of interest. In theory, actual damages are available, but because of restrictive judicial interpretations of actual damages, this potential exposure is vanishingly small. For a more in-depth discussion of damages, the cap, and the statutory defenses available to holders, *see* Comments to the Consumer Financial Protection Bureau and the Federal Reserve Board, Reg. Z, Docket No. R-1417 on the *Proposed Rule on Ability to Pay and Qualified Mortgage* by the Center for Responsible Lending, National Consumer Law Center, Consumer Federation of America, and National Association of Consumer Advocates, pp. 17-20 (July 22, 2011).

[4] In non-judicial foreclosure states, for example, the consumer would have to take the affirmative steps to contest it. *Cf.* Melanca Clark and Maggie Barron, *Foreclosures: A Crisis in Legal Representation*, p. 13-14 (Brennan Center for Justice 2009).

[5] Sum of home purchase, refinance and home improvement home loan activity reported under HMDA for 2005-2010, Robert B. Avery, et al, *The Mortgage Market in 2010: Highlights from the Data Reported Under the Home Mortgage Disclosure Act* , Table 3, p. 52 (forthcoming). The Board estimates that HMDA data covers 90-95% of FHA lending and 75-85% of other first lien home loans. Id at 1, note 2.

[6] CRL calculations based on MBA National Delinquency Survey, scaled to account for MBA's 85% market coverage.

[7] Comment of Mortgage Bankers Association, Proposed Rule, Docket No. R-1417 (Ability to Repay and Qualified Mortgage), Exhibit 2, Table 2. (July 22, 2011) http://www.federalreserve.gov/SECRS/2011/September/20110913/R-1417/R-1417_072211_83618_591648672754_1.pdf . (cases involving existing rebuttable presumption relating to delivery of notice of right to cancel.)

[8] *Id.* at 26.

[9] Sum of 2010 quarterly figures from OCC and OTS Mortgage Metrics Report, First Quarter 2011, Table 38, p. 43.

[10] NCLC calculation from Westlaw Search, October 6, 2011. Of the 904 cases, 352 were *pro se.*

[11] *Cf.* Melanca Clark and Maggie Barron, *Foreclosures: A Crisis in Legal Representation*, p. 14, (Brennan Center for Justice 2009) ("the foreclosure process has become a 'quasi-monopolistic system where

financial institutions have traditionally controlled, and still control…'", quoting a federal judge in Cleveland.).

[12] Nan Heald, *Justice for Some, Report on Unmet legal Needs in Maine.*

[13] Melanca Clark and Maggie Barron, *Foreclosures: A Crisis in Legal Representation*, p. 12-17, (Brennan Center for Justice 2009).

[14] Unfortunately, some foreclosure prevention scams misuse – or mislead homeowners into inappropriate use of TIL claims, just as some foreclosure law firms representing the secured parties abuse the process. Regulators and AGs have sought to curb both kinds of misdeeds, but the real cure for these abuses will come when the foreclosure crisis is behind us.

[15] MBA Comment letter Comment of Mortgage Bankers Association, Proposed Rule, Docket No. R-1417 (Ability to Repay and Qualified Mortgage), p. 8 (July 22, 2011).

[16]MBA Comment letter Comment of Mortgage Bankers Association, Proposed Rule, Docket No. R-1417 (Ability to Repay and Qualified Mortgage), p. 8-9 (July 22, 2011).

[17] Sum of home purchase, refinance and home improvement home loan activity reported under HMDA for - 2010 = 7,844,209. Robert B. Avery, et al, *The Mortgage Market in 2010: Highlights from the Data Reported Under the Home Mortgage Disclosure Act* , Table 3, p. 52 (forthcoming).

[18] *See also* Kathleen Madigan, *Like the Phoenix, U.S. Finance Profits Soar* (March 25, 2011) (finance sector accounted for 30% of operating profits in last quarter of 2010, while accounting for only 10% of the value added in the economy.) http://blogs.wsj.com/economics/2011/03/25/like-the-phoenix-u-s-finance-profits-soar/

[19] N.C. G. S. Ch. 24, § 10.2.

[20] *"Flipping" Prohibitions in N.C. Elicit No Substantial Litigation*, Center for Responsible Lending, Policy Paper No. 5 (May 7, 2004), http://www.responsiblelending.org/north-carolina/nc-mortgage/research-analysis/S-P_research0504_1.PDF The absence of any such litigation despite the existence of good remedies and assignee liability was sufficient reassurance for rating agencies, so that no credit enhancements were required for such loans.

[21] Jeff Nielsen, et al, Subprime Mortgage and Related Litigation, *2008: Seeking Relief* (Navigant Consulting 2009). Securities cases composed 38%, and commercial cases, including put-back litigation and reps and warranties, composed 17%.

[22] Mortgage Daily, Second Quarter 2011 Mortgage Litigation Index 190, Sept. 26, 2011, http://www.mortgagedaily.com/LitigationIndex2Q092611.asp (This is a subscription service.)

[23] *Id*.

[24] Jonathan R. Laing, *Banks Face Another Mortgage Crisis*, Barrons Online (November 20, 2010), http://online.barrons.com/article/SB50001424052970203676504575618621671054514.html#articleTabs_panel_article%3D1

[25] MBA Comment letter Comment of Mortgage Bankers Association Proposed Rule, Docket No. R-1417 (Ability to Repay and Qualified Mortgage), p. 18-19 (July 22, 2011).

[26] Robert B. Avery, et al, *The Mortgage Market in 2010: Highlights from the Data Reported Under the Home Mortgage Disclosure Act* , 3, 24 (forthcoming) (estimated that roughly 2.3 million additional first lien, owner-occupied loans would have been made on top of the 4.5 million that were originated.)

[27] *Id.*, p. 6, 53, Table 4.

[28] *See, e.g.* Robert Pear, *Recession Officially Over, U.S. Incomes Kept Falling,* New York Times, (October 9, 2011) (reporting 9.8% drop in income from start of recession to June, 2011), http://www.nytimes.com/2011/10/10/us/recession-officially-over-us-incomes-kept-falling.html?_r=1&ref=recessionanddepression. The unemployment and income declines come on top of a a debt-to-disposable income ratio of American households that grew from 60% in 1980 to 133% in 2007,

Dean Baker, *Dangerous Trends: The Growth of Debt in the U.S. Economy*, at 4, Fig 1 (2004); Stephen Roach, *Comment: America's Inflated Asset Prices Must Fall*, Financial Times, January 8, 2008.

Exhibit B

Dodd-Frank:
When Congress meant "safe harbor," it wrote the statutory text as a safe harbor

In our comments to the Ability-to-Repay and Qualified Mortgage proposed rule, we discussed both legislative history and statutory construction rules that make clear that 15 U.S.C. § 1539c(b), *Presumption of ability to repay,* creates a rebuttable presumption, and does not create the complete immunity of a "safe harbor" for qualified mortgages.[1]

This position is further supported by other provisions in Dodd-Frank that demonstrate that when Congress intended a safe harbor, it enacted statutory text that clearly and unambiguously bestowed the immunity of a safe harbor. As we noted in our comments, captions do not have legal significance: it is the statutory text itself that controls.[2]

- Most closely analogous are the genuine safe harbors created within Title X for certain disclosures.

Section 1032(d) – "Safe harbor" for model disclosure forms.
This safe harbor provision creates an unambiguous conclusive (i.e. "irrebuttable") presumption.

> "Any covered person that uses a model form included with a rule issued under [CFPB's UDAAP authority to prescribe disclosures] **shall be deemed to be in compliance** with the disclosure requirements of this section with respect to such model form."

Section 1032(e)(2) – "Safe harbor" for certain trial disclosures.
Similarly, Congress delegated to the CFPB the authority to create a conclusive presumption "safe harbor" for trial disclosures. To facilitate the process of using trial disclosures in an effort to facilitate improvements,

> "…the Bureau may establish a limited period during which a covered person conducting a trial disclosure program **shall be deemed to be in compliance with, or may be exempted from,** a requirement of a rule or an enumerated law.

By deeming such qualifying disclosures to be in compliance, Congress demonstrated that it knew how to create a genuine "irrebuttable" or "conclusive" presumption when it so intended, and did so in the unambiguous fashion that statutory construction principles regarding presumptions require.[3]

- Congress also explicitly delegated the authority to the FRB to create a "safe harbor" by creating exemptions from supervision in Title I.

Section 170 – Captioned "Safe harbor." Though the "safe harbor" caption for Section 170 does not, standing alone, create a safe harbor, this provision is nonetheless an instructive comparison. The actual text of this section gives the FRB authority to promulgate regulations setting forth the criteria for complete exemptions from FRB supervision for certain nonbank financial institutions. This stands in contrast to the actual text of Section 1412 which contains no language specifically delegating authority to the CFPB to completely exempt otherwise liable parties from being accountable to consumers due to the failure to comply with the Ability to Repay requirements

Just as with the text of 15 USC 1639c(b), other provisions of Dodd-Frank use the term "presumption" without the qualifying adjective of "rebuttable." (*See, e.g.* 12 U.S.C.§ 5390(a)(11)(H)(ii)(I), on orderly liquidations, which specifies a "presumption" of insolvency within 90 days preceding the appointment of the receiver.) As we explained in our comments, statutory construction principles dictate that a "presumption" is an evidenciary rule that means a rebuttable presumption, absent specific direction to the contrary.[4]

These additional provisions of Dodd-Frank demonstrate that Congress knew how to create a genuine safe harbor when that was its intent, and that it also knew how to delegate to an agency the authority to create a safe harbor. In the case of the qualified mortgage, it did neither.

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[1] See Comments to the Consumer Financial Protection Bureau and the Federal Reserve Board, Reg. Z, Docket No. R-1417 on the *Proposed Rule on Ability to Pay and Qualified Mortgage* by the Center for Responsible Lending, National Consumer Law Center, Consumer Federation of America, and National Association of Consumer Advocates, pp. 6-14 (July 22, 2011).

[2] *Id*. at 8.

[3] *Id.* at 12-14.

[4] *Id.*. The use of the term "safe harbor" in the caption to Dodd-Frank Section 1412 cannot serve as that specific direction to the contrary in light both of the law that captions do not carry legal significance, and of the legislative history of that section, which had at one time included a safe harbor that was dropped in the final law.

Exhibit C

National Consumer Law Center

December 21, 2011

Any Safe Harbor Under the Dodd-Frank Qualified Mortgage Provision Will Insulate Creditors from Abusive -- Even Bad Faith -- Behavior.

The goals of Dodd-Frank's ability to repay provisions cannot be achieved with a "safe harbor" for "qualified mortgages" irrespective of whether the QM definition includes flexible or bright line underwriting standards. It is the safe harbor's virtual insulation from accountability, not the definition of QM, that would upset the delicate balance struck by Congress in the statute itself.[1]

Dodd-Frank's ability to repay provisions were enacted to give both consumers and investors confidence that the norm in the mortgage market will be sound loan design and sound underwriting. Underwriting is by definition an individualized determination. The key to achieving those twin goals is that there be workable mechanisms for accountability. The law was explicitly designed to make the consumer's right to enforce the Ability to Repay ("ATR") provisions central to assuring that accountability. The concept of a safe harbor is in direct conflict with the goal of an effective, enforceable ATR rule. There is no short-cut to protect homeowners, investors and the market that involves a safe harbor.

- A safe harbor, with or without bright lines for the underwriting elements of the QM definition, will encourage and enable new product "innovations" specifically designed to push the envelope on compliance and exploit the loopholes.
- A safe harbor will insulate creditors from accountability even for abusive loans, where there was unquestionably no reasonable, good faith determination that the homeowner would be able to repay the loan according to its terms.
- A safe harbor would create a serious risk that homeowners whose loans were made without regard to ability to repay would be *less able* to hold the reckless or bad faith lender accountable than they are today. It would also undermine state law, all contrary to the purpose of Dodd-Frank.
- The rebuttable presumption is already a difficult evidentiary burden for homeowners, and provides a significant litigation advantage to lenders. Industry assertions about litigation risk without a safe harbor are hyperbolic and without empirical support.

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[1] *See* Comments on the Proposed Rule on Ability to Repay and Qualified Mortgage of the Center for Responsible Lending, National Consumer Law Center, Consumer Federation of America and National Association of Consumer Advocates, pp. 7 - 20 for discussions of the legal analysis requiring that QM status give a rebuttable presumption and the statutory balance struck to protect the industry from excessive litigation risk.

- Residual income is a crucial component of reasonable underwriting standards. CFPB should use its research capacity to establish sensible residual income guidelines that take into account appropriate regional differences in the cost of basic household expenses.

- Pleading standards are a necessary component to ensure the rule functions as intended. CFPB should clarify that consumers' initial pleading burden is simply that the loan is unaffordable, or courts may impose insurmountable pleading burdens.

A Safe Harbor Will Undermine, or Even Eliminate, Affordability Protections for Many Homeowners, Irrespective of Whether there is a Flexible or Bright Line Definition of "Qualified Mortgage."

Congress in Dodd-Frank and elsewhere in TIL not only made consumer-enforcement an essential vehicle for accountability, but built in special provisions to assure that the right was meaningful. Proactive private litigation over mortgages by consumers occurs in a vanishingly small fraction of mortgage transactions. Consequently, in this and other remedial provisions, Congress assured that the right may be asserted by the consumer by including the right to raise the ATR claim defensively when foreclosure threatens after the statute of limitations for affirmative actions has run. In Dodd-Frank, Congress carefully calibrated the balance of consumer and lender interests by capping the damages available to that which could be awarded in an affirmative action within the statute of limitations. A safe harbor would upset that balance

A safe harbor is incompatible with the goals of Dodd-Frank's ATR provision, as well as its language and intent.[2] A safe harbor will make it virtually impossible for a consumer to demonstrate unreasonableness or bad faith: the QM checklist, not the actual ability-to-repay, will be the focus of any review – whether the underwriter's, potential investor's, or ultimately a court's review. Neither a flexible definition nor a bright line definition of QM will cure that fundamental flaw.

A flexible definition of QM similar to the FRB's proposed "Alternative 2" definition, which requires that a creditor merely "consider" debt-to-income or residual income, for example, while allowing creditors room to set their own eligibility and pricing standards, could be extremely problematic if it also gave blanket immunity regarding ATR compliance regardless of the facts in an individual case. The proposed Commentary provision permits such consideration to be in accordance with "widely accepted governmental or non-governmental" standards. As underwriting standards over the past decade demonstrate, "widely accepted standards" provide no assurance of a reasonable determination of an ability to pay. For example, despite recent experience with HAMP demonstrating that loan modifications with a DTI of 31% perform much better than loan modifications with a higher DTI, the new GSE modification protocol allows for

[2] Id.

contracts with a DTI (for housing debt) of up to 55%. DTI ratios of 50-55% were also “widely accepted” during the underwriting crisis.

A safe harbor would preclude challenging even a predictably unaffordable loan. Allowing a flexible safe harbor definition of ATR would immunize virtually any underwriting decision, no matter how unreasonable or bad faith.

But, on the other hand, a bright line standard with no flexibility is equally problematic, and also undermines the statutory provision that gives each applicant the right to have their own ability to repay assessed as an individual. Emphasizing the importance of individualized underwriting, the recent Census report that more accurately measures disposable income found that nearly 1 in 3 Americans are “either in poverty or in the fretful zone just above it.”[3] A bright line DTI low enough to protect many applicants would unnecessarily reduce access to families who could, under individualized underwriting, demonstrate the capacity to carry higher DTIs.[4] Yet it would be an extraordinarily difficult task to set additional “bright line” standards with compensating factors to balance those competing goals in any individual situation, and would be too untested in normal market conditions to be sufficiently trustworthy to justify a safe harbor.[5]

(We discuss below the need for additional residual income guidance irrespective of whether the standards are flexible or bright line.)

It is impossible to predict all types of new products that might comport with a QM definition, but still pose foreseeable and avoidable risks for homeowners if ATR rules allow for a safe harbor. But one predictable product under a safe harbor that insulates lenders from liability for loans that are, or are likely to become, unaffordable even when that outcome is foreseeable at consummation, is the 5/25 hybrid ARM.

With the QM standards requiring underwriting for ARMs to the maximum rate within 5 years, 5/25 hybrid ARMs will become a standard offering. If a creditor provides a 5/25 ARM, for example, to a homeowner on a fixed income whose initial payments at a teaser rate are at the ceiling of affordability (as we saw happen in recent years with many 2/28s and 3/27s), that

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[3] Jason DeParle, Robert Gebeloff and Sabrina Tavernise, *Older, Suburban and Struggling, “Near Poor” Startle the Census* New York Times, (November 18, 2011).

[4] *Cf.* U.S. Gov’t Accountability Office, GAO-11-656, Mortgage Reform; Potential Impacts of Provisions in the Dodd-Frank Act on Homebuyers and the Mortgage Market 26 (2011) Table 5 at p. 72. (comparing eligibility of borrowers in certain groups if a 41% DTI rule had been in effect for QM).

[5] In the event that bright lines for the individualized underwriting criteria are adopted, they should incorporate measures of long-term sustainability. For example, NCLC suggests that the standard could require specific front- and back-end DTIs, but with the following safeguards: a residual income analysis (see below for more detail); individual institution loan-product exemptions based on default or foreclosure rates; provision of the income verification and residual income analysis to the homeowner and to the investor (with personal information deleted for the latter); and a life of the loan affordability analysis.

homeowner could not raise unaffordability in defense to foreclosure. It is a Catch-22: the foreseeable unaffordability occurs at the 5-year reset, yet the QM definition requires only a 5-year underwriting horizon.[6] Dodd-Frank's right to raise ATR claims as a defense to foreclosure at any time would be meaningless in such a circumstance.

In Appendix A below, we describe how a hypothetical 5/25 teaser loan which exceeds the limits of affordability would fare under a safe harbor vs a rebuttable presumption in private litigation.

The Rebuttable Presumption Will Be Difficult for Homeowners to Satisfy, and Provides More than Adequate Protection to the Lenders from Undue Litigation Risk.

Supporters of a safe harbor argue that a rebuttable presumption will provide homeowners with an unending number of opportunities to challenge the affordability of mortgage loans. In fact, few homeowners will even find an attorney to assist them, and when they do, the facts will need to paint a pretty severe picture to overcome the presumption, as the paucity of litigation under HOEPA and the Federal Reserve Board's higher cost mortgage rules demonstrate. And, of course, Congress already made the decision as to how to protect lenders from excessive litigation risk by capping the damages for violating the ATR provisions–and at a relatively small amount, in comparison to the value of the mortgage.[7]

The history of litigation under another rebuttable presumption created by TILA may be illustrative. TILA creates a rebuttable presumption that the disclosures have been delivered to the homeowner if the creditor can produce a signed acknowledgment of receipt. Although many courts have found that a homeowner's credible testimony can rebut this presumption, more homeowners fail to rebut this relatively simple presumption than succeed in demonstrating to a court's satisfaction that they did not receive the disclosures.[8]

A rebuttable presumption regarding the creditor's good faith and reasonable determination of affordability will be much harder for homeowners to rebut, involving as it necessarily will, facts

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[6] *See* Proposed OSC §226.43(e)(2)(iv)-4. The five year time frame for the affordability analysis under the statutory QM definition assumes a rebuttable presumption, as we explained in our comments, *see note 1* . If the rule were to adopt a safe harbor, not contemplated by the law, it would be appropriate to expand the statute's five-year horizon to the life of the loan, or the latest possible reset date under the loan terms.

[7] The comments submitted by CRL, NCLC, CFA and NACA in response to the proposed ATR and QM rule provided an example of how the cap on damages protects lenders from excessive liability. On a $177,300 loan, predictably unaffordable from the outset, the maximum total damages (which would be credited against the outstanding balance, not refunded, in the ordinary course of events) would be just over 28% of the original balance, only $50,300 of finance charges and paid interest, plus $4000 statutory damages**, but the holder would still have a lien on the home for the remaining principal balance of over $100,000.** *See* Consumer Comments, 19-20.

[8] Indeed, MBA comments on the qualified mortgage included a survey of cases over the past five years involving the rebuttable presumption, and cited only 59 cases, only 35 of which were scheduled for trial. In a period when estimates are that some 8 million homes entered foreclosure, which is precisely when homeowners would raise claims to save their homes, this is an absurdly low incidence of litigation.

not known or ascertainable to the homeowner prior to litigation.[9] To assist courts, homeowners, and creditors, the Bureau could provide examples of indicia of an unaffordable loan to guide the rebuttal process. For example, it could use its research capacity to identify the number of payments someone is likely to be able to pay before defaulting on an unaffordable loan, to establish guidelines regarding loans that reset after 5 years, guidelines for how to identify low residual income, or the range of experiences with various debt to income ratios. Actual knowledge of additional expenses also should be relevant.

A Safe Harbor Could *Reduce* the Rights that Consumers Currently Have Under State laws to Challenge Reckless and Bad Faith Underwriting.

In those comparatively rare cases where homeowners currently suffering under foreseeably unaffordable loans find access to knowledgeable legal counsel, the more common legal claims to challenge their loan terms are state laws such as UDAP or unconscionability. A safe harbor under Dodd-Frank would make it much more difficult for homeowners to raise state legal claims where a creditor can show it has satisfied the Qualified Mortgage definition – whether a flexible or bright-line definition. A court might be inclined to view the satisfaction of such a standard as the last word on affordability, no matter the reality of the loan, due to the doctrine of conflict preemption (recently reaffirmed by Dodd-Frank). Even if the courts were ultimately to rule otherwise, the experience of the last 15 years demonstrates that a great deal of litigation time and expense would be devoted to litigating that issue, and not the real merits of the case. This, in and of itself, can have a chilling effect on the availability of lawyers to represent consumers, who often receive no compensation until and unless the case is favorably resolved. Moreover, some states have statutes or developed case law that provide that any loan that satisfies the Truth in Lending Act per se complies with state law. Accordingly, it is essential that a rebuttable presumption be preserved so that homeowners facing unsustainable loans have an opportunity to seek the redress intended by the statute.

Whether the Definition of QM Includes Flexible or Bright-Line Standards, Residual Income Guidance is Important

The Bureau should provide further guidance on how to incorporate residual income, either into an underwriting review or an affordability analysis. The impact of residual income in determining affordability is not well studied, though the comparative delinquency rates of VA loans suggests that it is important.[10] More research should be done on what the key factors

[9] In fact, this rebuttable presumption would be even more difficult for consumers to rebut than is the existing rebuttable presumption in TIL regarding delivery of the cancellation notice, which has not proven to expose lenders to excessive litigation risk. The consumer, of course, knows whether or not he or she received a notice, or, if one was given, compliance can be determined on the face of the document. That makes it easier for a consumer to rebut the presumption.

[10] As of 2Q 2010, the VA delinquency rate was 7.79%, compared to 13.3% for FHA and 17% for subprime, comparing favorably to the prime sector's 7.1% rate. Chris Birk, *Redefining Sustainable Homeownership: Lessons*

driving the role of residual income are. However, in the meantime, it is crucial that any ATR requirements in the rules upgrade the role of residual income over that proposed, even if only by talking about its importance and studying over time what makes sense.

One question that arises is whether the analysis should take into account the specific expenses of the borrower at hand or rather set out general standards based on certain factors (as the VA standard does, based on geography and family size). Some categories of recurring expenses may not be of a kind traditionally requested by financial institutions, yet will be a predictable, foreseeable and continuing expense from the household budget.. Because many of these payments are not traditionally documented, capturing them also would be challenging. Thus, more general guidelines are more likely to be successful**.**   The Census Bureau's new Supplemental Poverty Measure, which takes basic expenses into account to get a better measure of disposable income, may be a useful process to tap into in evaluating how reliable residual income guidelines could be updated and refined from the existing VA model.[11]

On a related note, the Bureau also should pay special attention to how income is "grossed-up" for applicants on fixed incomes. The rule or Commentary should require such income to be grossed up based on the actual tax bracket applicable to the income at hand, rather than allowing for a blanket grossing up to 125%, an approach that often results in overestimating income.

The Commentary Should Also Clarify Pleading Standards

Irrespective of what standard is adopted, there is a critical question of what a consumer must plead when asserting a violation of the Dodd-Frank ability to repay standard where a QM may be involved. Because a consumer will not have proof before filing a lawsuit or a defense of what the creditor did regarding underwriting the loan, the rule must clarify that the consumer can simply plead that the loan is unaffordable. The rule should also clarify the subsequent procedure: that the creditor would then plead and establish that it had satisfied the Qualified Mortgage Standard, which would then shift the burden to the homeowner to demonstrate that the loan is not a qualified mortgage, or, if there is a rebuttable presumption, that the loan is otherwise unaffordable.

Learned from the VA, Mortgage News Daily-Community Commentary, (October 22, 2010), available at http://www.mortgagenewsdaily.com/channels/community/177967.aspx The delinquency/foreclosure rate through Q311 is around 9%, compared to FHA's approximately 15%, *see* Mortgage Delinquencies by Loan Type, Calculated Risk (November 18, 2011), *available at* http://www.calculatedriskblog.com/2011/11/mortgage-delinquencies-by-loan-type.html (VA and FHA charts). *See generally* Michael E. Stone, *What is Housing Affordability? The Case for the Residual Income Approach,* 17 Housing Policy Debate 151 (2006).

[11] The supplemental measures for non-cash benefits on the income side, and on the expense side, looks at taxes, transportation costs for work, child care, child support paid, and out-of-pocket medical expenses. It also attempts to adjust for geographic differences. *See*, The Research SUPPLEMENTAL POVERTY MEASURE: 2010, U.S. Census Bureau, P60-241 (November 2011).

Another approach to addressing pleading issues would be to require that creditors provide documentation of income verification (whether or not there is a hard set of standards for underwriting DTI and other factors) to both homeowners prior to closing and assignees prior to purchase as well as the affordability analysis, including both the DTI and residual income analysis. The verification and underwriting should be apparent from the face of the documents. Simply requiring such documentation might have the additional effect of promoting sound underwriting.

APPENDIX A

Litigating Compliance with the Ability to Repay Rule:

Safe Harbor vs. Rebuttable Presumption:

A Case Illustration

This hypothetical loan illustrates how the litigation of a consumer's claim that the loan was not made in compliance with the Ability to Repay rule involving a "qualified mortgage" would proceed. For illustrative purposes, it will use a 5/25 ARM refinancing loan.

The first variation will describe the consumer's litigation burden if the QM is a rebuttable presumption and the second will describe it if the QM is a safe harbor. A final variation will describe how the consumer's rights under a safe harbor would compare to the case she can make today.

Definition of Qualified Mortgage assumed for purposes of this illustration:

For purposes of this illustration, we assume that the definition of a "qualified mortgage" includes both product characteristics, general underwriting rules, and individualized underwriting, without "bright lines" regarding those individualized underwriting standards. We assume that the elements of the definition of a Qualified Mortgage are substantially the same as Alternative # 2 as proposed by the Federal Reserve Board, consisting of 10 prongs, all of which must be met:[12]

1. Regular, amortizing payments: no negative amortization, interest-only, or balloons;

2. Loan term less than or equal to 30 years;

3. Maximum of 3% "points and fees" (as defined by the rule);

4. For an ARM loan, loan payment (including associated interest & insurance costs) must be underwritten to the maximum interest rate that could apply in the first five years, and that will fully amortize the loan;

5. The creditor must consider and verify current and reasonably expected income or assets (other than the collateral);

6. The creditor must consider and verify current employment, if income from that employment is relied upon for repayment;

[12] Proposed §226.43(e)(2), Alternative # 2. For purposes of this illustration, the proposed exceptions will be ignored.

7. The creditor must consider and verify the consumer's obligation on any simultaneous second loan that the creditor knows or has reason to know about;

8. The creditor must consider and verify the consumer's current debt obligations;[13]

9. The creditor must consider and verify consumer's debt-to-income ratio or residual income;[14] and

10. The creditor must consider and verify the consumer's credit history.[15]

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ILLUSTRATIVE HOMEOWNERS:

Mr. and Mrs. Smith purchased their home for $250,000 in Albany, NY in 1995. At present they owe a combined principal balance (first and second mortgages) of $185,883.

As a result of the downturn in the economy, Mr. Smith's company downsized, and he was unable to find re-employment, so he retired last year at age 66, earlier than planned. Mr. Smith now receives Social Security and a small pension. Mrs. Smith, aged 60, had also been working until a few months ago, but developed a serious chronic illness. They incurred $20,000 in medical expenses from her hospitalization, which were not covered by insurance. Her condition will require approximately $550 in recurring medical out-of-pocket ("MOOP"[16]) expenses each month.

Homes in upstate New York have retained their value, so they still have equity in their home. Utility expenses in upstate NY, however, are higher than average.

Their gross income now is $38,000, or approximately $32,300 after-tax income. Net monthly income is $2692, but after adjusting for the recurring monthly MOOP, it is $2142. They are seeking to refinance at a lower rate and to pay the outstanding $20,000 hospital bill.

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[13] Proposed OSC 226.43(c)(2)(vi), incorporated by 226.43(e)(2), would allow creditors to rely on "widely accepted governmental and non-governmental underwriting standards" to both define and verify "debt obligations, e.g. student loans, child support, existing mortgages, credit card debt.

[14] See proposed OSC 226.43(c)(7) (would allow creditors to rely on "widely accepted governmental and non-governmental underwriting standards" to determine an appropriate DTI, and may also consider compensating factors to mitigate high DTI or lower residual income.)

[15] See proposed OSC 226.43(c)(2)(viii) (would allow creditors to rely on "widely accepted governmental and non-governmental underwriting standards" to both define and verify credit history.)

[16] The new Census Supplemental Poverty Measure is collecting data on "MOOP," which includes household share of health insurance premiums, uncovered prescription medicines and doctor co-payments.

The refinancing loan given to Mr and Mrs Smith pays off the $185,883 owing on both mortgages, the hospital bill, and includes 3% points and fees, for a total loan amount of $212,250. They are given a 5/25 teaser rate ARM at an initial discounted teaser rate of 5.5%, with monthly PI payments of $1205.13 and PITI totaling $1605.13. This is a front-end DTI of 51% of gross income. After the recurring MOOP, it leaves them $536.87 residual income for food, utilities, transportation, non-medical insurance, and other basic expenses.

If we assume that the loan resets after five years to a fully indexed rate of 9.5%, , the PITI would be $2,114.61[17] Even assuming modest expected increases in monthly SSA benefits bringing the Smiths' income after 5 years to $40,000 ($34,000 after tax income or $2,833/mo.), that payment would be a 63% front-end DTI. It would leave the Smiths with only $168 per month for food, utilities,[18] transportation, other insurances, etc, after paying $550 in monthly MOOP.

LITIGATION PROCEDURE ILLUSTRATION # 1:

IF THE QM CREATES A REBUTTABLE PRESUMPTION

Step One: Mr and Mrs. Smith are in foreclosure. They defend in a judicial foreclosure state by filing an answer and in a non-judicial foreclosure state by filing a defensive lawsuit to stop the foreclosure. Their defense is based on the creditor's violation of the ATR rule. To raise this defense they must plead that the loan, at the time of consummation, was predictably unaffordable after reset and that the creditor failed to make "a reasonable and good faith determination" when making the loan that there was a "reasonable ability" to repay the loan according to its terms. Their pleading specified the following facts:[19]

> Our combined gross income was $38,000/year at origination and is currently slightly higher at $40,000. We provided our lender with all income information and with information about our recurring debts including our monthly medical expenses of $550.

> Our PITI of $1605.13 at closing for the refinance was barely affordable, leaving us only approximately $537 in residual income, after the recurring medical expenses for chronic

[17] The PI was calculated at 9.5% to amortize the balance of $196,247.63 remaining after the 60th payment over the remaining 25 years.

[18] Energy costs alone in the Albany, NY area now average just under $200/month. *See, e.g.* *http://www.bankrate.com/calculators/mortgages/moving-cost-of-living-calculator.aspx?ec_id=m1081725*

[19] For purposes of these illustrations, the homeowners' pleading could either be an affirmative claim, filed to forestall a non-judicial foreclosure, under 15 U.S.C. § 1640(k), or an affirmative defense to a judicial foreclosure.

conditions. We scraped by in making payments during the first five years of the loan but often had to seek help from friends and family to help us meet monthly expenses.

> When the loan reset and our PITI increased to $2,114.61, the loan became completely unaffordable and we fell into foreclosure.

> Given the loan terms, which allowed our interest rate to increase to a maximum of 10% at reset, our actual front-end DTI % of 63% and total residual income of $718, or only $168 after MOOP, after re-set, was completely predictable at closing and therefore the creditor could not have made a good faith determination at closing that the loan was affordable and that we would have a reasonable ability to repay it after reset. Indeed, the fully-indexed rate at closing was 9.5 % as calculated under TIL (i.e., the index value at consummation[20]), generating precisely the monthly PITI of $2,114.61 that we were charged after reset, leaving almost no funds after taxes and recurring medical expenses for a chronic condition to pay for food, utilities and other basic necessities.

Step Two: The holder of the mortgage files a responsive pleading alleging that it is entitled to a rebuttable presumption that the loan was affordable because the loan is a "qualified mortgage". The creditor will also assert that it was required to underwrite the loan to the first five years and no more and therefore it is entitled to dismiss the homeowners' claim. It should (but may not even) specifically allege compliance with all 10 prongs of the definition, including that it underwrote to the maximum rate within the first 5 years, that it verified all the information in accordance with the regulations, and that it "considered" all the factors required by the rule, all "in accordance with widely accepted governmental or non-governmental underwriting standards." (*See prongs 5-10, listed above)*

If the judge indicates that s/he will not decide this case on a motion to dismiss, the lender would most likely follow-up or accompany this pleading with a motion for summary judgment, with affidavits attached attesting to the compliance with all 10 prongs, including the 7 (# 3-10, above) that are not apparent on the face of the loan documents and knowledge about which is in the creditor's exclusive control. However, creditors may simply move to dismiss and argue they need not prove up all the elements of QM.

Step Three: Homeowners oppose the motion, with one and likely both of the following two responses:

a) They would dispute that the loan is a qualified mortgage and demand strict proof from the mortgage holder. Only prongs 1-3 may be contested from evidence apparent on, or derived from, the face of the loan documents that would be available to the consumer. It is unlikely that

[20] See Reg Z, §226.17(c)(1)-10, which requires that the initial TIL disclosures for teaser ARMs be calculated for the post-teaser period as if the index rate remained at the level it was as of consummation.

the homeowners would have direct evidence regarding prongs 4-10 prior to discovery. If the loan is not a qualified mortgage, the rebuttable presumption would not apply.

b) They would argue that the facts demonstrate that the creditor could not have made a *reasonable, good faith* determination that there was an ability to repay the loan according to its terms, irrespective of whether it was a qualified mortgage. In this example, repaying according to its terms would include the reasonably foreseeable excessive DTI and inadequate residual income after reset, and that they are entitled to develop the evidence to show this. The homeowner's resistance would likely include reference to widely accepted governmental underwriting standards as to front and back end-DTI, and to residual income and a comparison between those standards and their DTI, etc.

Step Four: **If the mortgage holder had filed a motion to dismiss,** the judge would evaluate the sufficiency of the legal claims, although it should not be possible for the judge to conclude a loan is QM on a motion to dismiss, given the factual nature of this determination, many judges will do so; thus, the homeowners' claims of unaffordability would need to be strong enough to overcome the rebuttable presumption that the loan was affordable because it met the QM standard for the first five years.

If the mortgage holder had filed a motion for summary judgment, in addition to the assessment of the legal sufficiency of the claim above, the judge as fact-finder would assess the evidence submitted in connection with the motion. If the judge determined that there was a genuine dispute as to the material fact of whether a) the loan met all 10 prongs of the definition of a Qualified Mortgage, and/or b) whether, irrespective of whether it is a Qualified Mortgage or not, there is evidence that there was not a good faith, reasonable determination at consummation that there was a reasonably likely ability to repay the loan according to its terms, the mortgagee's M/SJ would be denied, and the case would proceed with discovery. In some cases, a homeowner might be able to establish that the loan is not QM (e.g., interest only term) or that the loan was clearly unaffordable at origination and no lender exercising good faith and reason should have originated it. In most cases, the determination of the lender's good faith and reasonable determination will likely have to await trial.

LITIGATION PROCEDURE ILLUSTRATION # 2:

IF THE QM CREATES A <u>SAFE HARBOR</u>

Step One: Mr and Mrs. Smith are in foreclosure. They defend in a judicial foreclosure state by filing an answer and in a non-judicial foreclosure state by filing a defensive lawsuit to stop the foreclosure. Their defense is based on the creditor's violation of the ATR rule. To raise this defense they must plead that the loan was predictably unaffordable after reset and that the creditor failed to make "a reasonable and good faith determination" when making the loan that there was a "reasonable ability" to repay the loan according to its terms. Their pleading specified the same facts as described in Illustration # 1, Step One above.[21]

Step Two: The holder of the mortgage files a responsive pleading alleging that the loan is a "qualified mortgage," most likely a motion to dismiss, or an answer with an accompanying motion for summary judgment. It specifically alleges compliance with all 10 prongs of the definition, including that it underwrote to the maximum rate within the first 5 years, that it verified all the information in accordance with the regulations, and that it "considered" all the factors required by the rule, all "in accordance with widely accepted governmental or non-governmental underwriting standards." (*See prongs 5-10, listed above)* and that based on this analysis the creditor is conclusively presumed to have originated an affordable loan.

If the rule does not explicitly say the lender must establish rather than simply claim QM, most lenders will likely push for rulings on motions to dismiss without providing evidence about compliance with prongs 3-10. Even if the rule requires the lender to establish the QM status of the loan, many courts may accept as proof affidavits asserting that the underwriting criteria #8 - #10 were "considered" in accordance with generally accepted non-governmental standards, in accordance with the regulatory guidance.

Step Three: Unless the homeowners can show on the face that the loan was not, in fact, a qualified mortgage (because of an interest only term or a failure to verify credit), the homeowners are out of luck, even though the homeowners, in the same facts, under a rebuttable presumption might be able to convince a fact-finder that the loan was objectively unaffordable at the time of origination. The homeowner has no access to facts that would support a resistance on the basis that the lender did not "consider" the appropriate factors, in accordance with non-governmental or government standards, which vary widely, and allow up to 55% DTI. [22] In essence the basis for the borrower's initial allegation was similar to *res ipsa locquiter* – given the

[21] For purposes of these illustrations, the homeowners' pleading could either be an affirmative claim, filed to forestall a non-judicial foreclosure, under 15 U.S.C. § 1640(k), or an affirmative defense to a judicial foreclosure.

[22] Even recent guidelines mentioned by FHFA for loan modifications would allow up to 55% DTI.

DTI & residual income available to them at consummation and the predictable jump at reset – no reasonable creditor could have made this determination in good faith.

What the creditor did in the back office are facts completely within the creditor's control. Absent a homeowner having found some "smoking gun", such as a whistle-blower, the homeowner's case will end at this point under a safe harbor for QM loans.

LITIGATION PROCEDURE ILLUSTRATION NUMER #3:

TIL SAFE HARBOR vs. ABILITY TO REPAY LITIGATION TODAY

One of the key principles for regulators implementing Dodd-Frank is that homeowners should not be worse off than they were prior to Dodd-Frank. That should be a touchstone for any regulator in writing these regulations. A safe harbor would violate this principle. It would leave homeowners worse off than currently, by undermining, if not completely preventing, consumers ability to raise unaffordability under state law.

Today, consumers can allege unaffordability under state UDAP or unconscionability principles.[23] However, if TIL regulations create a safe harbor, those state law claims are vulnerable to conflict preemption analysis.

Step One: Mr. and Mrs. Smith plead that the creditor failed to make "a reasonable and good faith determination" when making the loan that there was a "reasonable ability" to repay the loan according to its terms, and that the conduct was unfair and deceptive in violation of their state UDAP law,or that the loan was unconscionable. Their pleading would lay out the facts as specified in Illustration 1, Step One, above:[24]

Step Two: The holder files a responsive pleading alleging that the loan is a Qualified Mortgage, and therefore is, by federal law, conclusively presumed to be in compliance with standards requiring good faith and reasonable determinations of ability to repay. It further alleges that state law to the contrary substantially interferes with the CFPB's regulation allowing lenders to originate QM loans with a conclusive presumption of affordability. A state law requiring a more rigorous analysis of affordability is in conflict with and undermines the Bureau's rule or it is impossible to comply with both..

[23] *See, e.g.,* Williams v. First Gov't Mortgage & Investors Corp, 974 F. Supp. 17 (D.D.C. 1997)(jury finding of unconscionability raised under UDAP based on knowledge of the lender that there was no reasonable probability of payment in full and knowingly taking advantage of a borrower's inability to protect his interest), aff'd in part, 176 F.3d 497 (D.C. Cir. 1997), *remanded after jury verdict, 225 F.3d 738 (D.C. Cir. 2000)(remanding on another claim)*

[24] For purposes of these illustrations, the homeowners' pleading could either be an affirmative claim, filed to forestall a non-judicial foreclosure, under 15 U.S.C. § 1640(k), or an affirmative defense to a judicial foreclosure.

The homeowners would respond that there is no conflict preemption, and that more protective state laws are not inconsistent with the TIL standards.[25] Irrespective of the ultimate outcome, the issue would greatly complicate the matter, and raise the costs of the litigation for both parties.

By contrast, the issue simply does not arise if there is a rebuttable presumption. Homeowners could rebut the presumption that the loan was affordable after reset and could reference state law that looks to affordability over the life of the loan in developing their argument for unconscionablity. Because the rules would explicitly allow that the presumption of affordability could be rebutted, state law would not automatically be displaced.

[25] See TIL §1610(b).

Exhibit D

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Qualified Mortgage:

Proposed Procedure for Implementing the Rebuttable Presumption

(1) QM/non QM Loans. For any loan subject to Dodd-Frank, the borrower's initial burden in litigation is met by stating that at the time the loan was made it was either unaffordable then or foreseeably unaffordable in the future.

(2) The creditor may rebut this allegation in one of two ways:

(a) If the loan is QM, and the creditor proves that the loan meets the QM standard, then the creditor sets out the specific factors and information it used in determining that the borrower had the ability to repay the loan under section 1412 (b) [§129C(b)] and documentation of its verification of that information, or

(b) If the creditor does not prove that the loan is QM, the creditor must prove that it determined that the borrower had the ability to repay the loan in accordance with section 1411 [§129C(a)] by setting out the specific factors and information it used in determining that the borrower had the ability to repay the loan under section 1411 [§129C(a)] and documentation of its verification of that information,

(3) Operation of presumption. If the creditor proves that the loan is a Qualified Mortgage, the creditor shall, upon providing the information in section (2)(a), be entitled to a presumption that it complied with section 1412 (b). The borrower may rebut this presumption by showing the creditor did not make a reasonable determination of the borrower's ability to repay the loan at consummation as provided below. The borrower has the ultimate burden of proving any violation of section (b).

(a) The presumption shall be rebutted where the borrower can show:

(i) that the creditor failed to consider whether the borrower had adequate residual income to meet basic living expenses, and the borrower did not in fact have adequate residual income to meet basic living expenses at the time of consummation; or.

(ii) that the creditor made a residual income determination prior to consummation, but erred in determining that the borrower had adequate residual income to meet basic living expenses based on information that was required to be collected by the creditor pursuant to this Section or that was provided to the creditor prior to consummation of the transaction. Creditor errors include mathematical errors, errors in verification, other processing errors, and failure to consider information collected in the course of the application, such as information provided by the borrower about debts that are not listed on the borrower's credit report would be evidence available to rebut the presumption.

(b) The creditor or its assignee is not entitled to any presumption that it complied with section 1412(b) based on attestations by the borrower that the borrower believes the loan to be affordable or has provided all relevant income and debt information.

(4) Provision of Underwriting Documents to Assignees. The creditor shall provide to any assignees all documents used in underwriting the loan. Notice of the transmission of the documents as well as all documents transmitted shall be retained by the creditor and the assignee for at least one year after the termination of the loan.

(5) There is no presumption of compliance with the ability to repay standard for non-QM loans. The creditor or assignee bears the burden of proof that it complied with the ATR standard.

March 12, 2012

Exhibit E

Richard Cordray, Director

Consumer Financial Protection Bureau

1500 Pennsylvania Avenue, N.W.

Washington, DC 20220

Mar. 12, 2012

Dear Director Cordray:

The undersigned national, state, and regional consumer, fair housing, community reinvestment, and legal services organizations and law professors write in response to the joint comment submitted by CRL, CFA, the Leadership Conference, and the Clearinghouse regarding the definition for Qualified Mortgages under the Dodd-Frank Ability to Repay requirement.

The parties who have submitted the joint comment invested considerable time and effort in developing it and should be commended for doing so. The joint comment makes significant progress on two important issues—underwriting to the maximum payment in the first six years for all ARM loans (including those outside of QM) and affirming the statutory language and legislative history as providing a rebuttable presumption, not a safe harbor.

However, the joint comment does not go far enough. The joint comment leaves the door open to known types of abusive lending and will predictably encourage the emergence of ARMs timed to reset at the end of six years instead of five. Additionally, the burden given the homeowner under the joint comment is so onerous as to approach a safe harbor. Without more protections, the approach advocated in the joint comment undermines access to safe and sustainable credit for all.

CFPB Should Continue to Solicit Input from All Stakeholders as to the Appropriate Definition of a Qualified Mortgage

The stakes for the Qualified Mortgage definition are high. The definition of Qualified Mortgages likely will define the contours of mainstream mortgage lending for generations to come. Concerns about the balance between access to credit and protecting homeowners from unaffordable lending are complex. Moreover, much disastrous lending in the 1990s and early 2000s was done to under-served communities in the name of access to credit. In the wake of the collapse of the housing market, and unprecedented loss of wealth in communities of color, it is clear that not all credit is good credit and some credit can be worse than none.

Please view the joint comment for what it is—the summary of the closed-door negotiations of a few parties. The terms of such a critical matter of national economic policy and basic economic justice must be openly debated in a transparent process. The concepts identified in the joint letter should not be adopted by the CFPB without further development and public discussion in light of the important and complex process of setting QM standards.

The CFPB should more broadly engage the communities affected. There is a range of perspectives on these difficult issues and a full and open debate will best serve the public interest.

The Proposed Qualified Mortgage Definition Would Allow Too Many Unaffordable and Abusive Loans to Be Made

The proposed QM definition proceeds through a waterfall, with increasingly loose and risky standards for Qualified Mortgages. Particularly worrisome is the prospect that lenders could qualify homeowners for mortgages, at any DTI, based on either payment of six months of housing payments only, without reference to other debt payments, or eighteen months of reserves (including retirement accounts or education savings accounts, albeit at a discount) for mortgage-related expenses only. Homeowners who received Qualified Mortgages under these relaxed standards would be the homeowners receiving high DTI loans because, under the joint comment, there would only be an inquiry into reserves or past housing payments if the back-end DTI was greater than 43% and the housing-related DTI was greater than 31%.

We believe that stable housing payments can be an important indicator of ability to repay, but more protections must be built into the QM definition. The six month time frame is too short; the proposed standard would allow a five percent increase in the payments over the pre-existing payments without any inquiry as to actual income over the past six months; and there would be no inquiry into whether the homeowner had been able to service other debt during the same period. From those of us who have worked with homeowners directly, there are many examples of homeowners who scrape by for six or seven months on their mortgage payments, hoping for a refinancing to lower payments at an affordable amount. Evaluating ability to repay on mortgage or rental payments alone is insufficient over a mere six-month time frame. Traditionally, pre-existing housing payments have been used to qualify borrowers only in connection with sustained housing counseling by HUD-approved counseling agencies that evaluated current income and debt service ability and reviewed the history of housing payments and other debt service over a 12 to 24 month timeframe.

The provision that would allow a Qualified Mortgage to be made to a homeowner based solely on eighteen months of reserves (or six months if the total DTI was capped at 50%) is potentially disastrous. This approach invites lenders to engage in predatory behavior with respect particularly to recently disabled homeowners who have received a large lump sum payment of back benefits or a workers' compensation claim. For example, a middle-aged homeowner with an annual income of $70,000 who became permanently disabled would receive approximately $1866/month in Social Security Disability (SSD) benefits. If Social Security delayed approval of that homeowner's SSD application for 10 months, that homeowner could qualify for a mortgage with a monthly payment of

$1000, at a front-end DTI of 54%. Even modest pre-existing medical bills and health insurance costs could reduce the nominally sufficient residual income of $866 to zero. The result is even more stark for a homeowner whose Supplemental Security Income (SSI) application is approved by the Social Security Administration after a year or two. That homeowner could easily have assets, in the form of a lump sum payment, of $18,000, which again would mean she could receive a Qualified Mortgage with a $1000 monthly payment. But the maximum federal SSI payment is only $698, more than $300 less than the threshold payment standard proposed. The standard proposed under the joint comment leaves open the real possibility that homeowners, particularly disabled and impoverished homeowners, could receive Qualified Mortgages whose monthly payment exceeds their monthly income.

The joint comment would even allow 60% of retirement accounts to count towards this measure. Thus, a homeowner with a relatively modest retirement account of $30,000, who had no income due to unemployment or recent disability, could nonetheless qualify for a loan with monthly payments of $1000—a loan the homeowner would have no realistic prospects of paying back. Retirement accounts, in particular, can mean the difference between living in abject poverty and surviving modestly in retirement; they should never be the primary basis for underwriting. With seniors increasingly forced to work into their 80s and 90s now as a result of insufficient savings and unaffordable mortgage payments, the federal government should not endorse the use of retirement accounts as an indicator of affordability. Nor should younger workers who are temporarily employed be encouraged to borrow against those retirement accounts, as this policy would promote. There is no evidence that reserves, by themselves, guarantee long-term affordability of a loan. Allowing reserves to stand alone as a measure of ability to repay for homeowners with high DTI ratios invites abusive lending.

Reserves and stable housing payments should not be used in isolation to determine if a loan is a Qualified Mortgage. While these may be appropriate co-measures of ability to repay, they must be coupled with additional safeguards, including residual income, sustained housing counseling by a HUD-approved housing counseling agency, and, potentially, DTI limits.

Given the Lack of Specificity of the Proposed Rebuttable Presumption, Homeowners Will Lack Redress for Loans Made without Regard for the Ability to Repay

The joint comment provides two examples of how a homeowner might rebut the presumption that a QM meets the ability to repay requirements of the statute. These two examples are that 1) the creditor altered information the consumer provided or that 2) the consumer provided evidence of debt not on the credit report that the creditor did not consider. Neither of these examples provides protection for homeowners with limited residual income. (Debt may be connected to residual income, but homeowners can have low DTIs and low residual income; because the joint comment proposes that homeowners could receive a Qualified Mortgage at any DTI provided they have eighteen months of reserves or have made housing payments for six months, many homeowners likely will have both very high DTIs and very low residual income).

Absent an explicit provision that limited residual income may be used to rebut the presumption that a QM loan is affordable, many courts will find that an analysis of residual income is irrelevant. The presence of residual income as the last step of the waterfall is also likely to influence courts in finding that an analysis of residual income is unnecessary unless the loan otherwise fails to meet the QM definition.

Lenders during the go-go 90's and early 2000's were often willing to gamble on making illegal and abusive loans, knowing that the risk of enforcement was slim. Once we recover from the current credit crunch, occasioned by that predatory behavior, many lenders are likely to return to their old ways. The proposed QM definition and weak protections afforded homeowners under the joint comment would provide lenders with more cover for making abusive loans than they had during the 1990s and early 2000s.

There are additional problems with the discussion of the rebuttable presumption in the joint comment. The joint comment creates significant barriers for a homeowner seeking to demonstrate a violation of the ability to repay requirement by strengthening industry's hand in litigation in numerous ways. For example, the joint comment:

- Provides that a loan that fails one of the QM tests is not presumed to be unaffordable, and, by implication, may be presumed to be affordable, in contravention of the statute;
- Leaves vague whether the lender's analysis of affordability may be confined to the homeowner's income at the time of consummation or whether it must include foreseeable changes in the homeowner's income, a basic tenet of assessing affordability;
- Limits lenders' liability to information the homeowner provided "reasonably prior" to closing;
- Provides that lenders need not accurately determine a borrowers' DTI but grants them an extra-statutory "cushion" for determining a borrower's DTI.

The examples of how the homeowner might rebut the QM presumption are themselves full of wiggle room for lenders: lenders need not consider debt of which a homeowner advised them if "existence of the debt did not materially affect a reasonable determination of the borrower's ability to repay" and lenders may alter or omit borrowers' information if they have a "reasonable basis" to do so. At best these concessions to industry are a full-employment scheme for lawyers; at worst, they are a trap for homeowners and an incentive to lenders to continue abusive lending. Few homeowners ever are in a position to challenge a lender's determination of ability to repay; the cards are stacked in favor of lenders who push the envelope in all of these areas.

Resolution of questions that the joint comment leaves on the table, such as whether the borrower must provide information in writing to the lender in order for the lender to consider it, will also have a large impact on the ability of homeowners to protect themselves from predation. Homeowners seldom fill out the application themselves; they provide information orally to the loan officer and rely on the loan officer's instructions as to what documentation to provide. If borrowers may only rely on written documentation they submitted to demonstrate that the creditor did not make a reasonable determination of their ability to repay, loan officers will be able to control, by and large, whether homeowners can challenge an unaffordable loan. Loan officers offered this power are likely to choose to insulate themselves and their employers from future liability, thus barring the courthouse door to borrowers. Similarly, the CFPB must issue strong rules protecting homeowners from overreaching lenders who seek to eviscerate the ability-to-repay protections through the inclusion of waivers and other language designed to evade the lender's legal responsibility to evaluate the homeowner's ability to repay.

The Failure to Require Assignment of the Ability to Repay Analysis Undermines Market Incentives to Ensure Affordability of Qualified Mortgages

Because securitization will soon drive most mortgage lending again, incentives are necessary to encourage the market to police itself. Recent history demonstrates that buyback provisions and representations and warranties in the purchase agreements provide no meaningful restraint on abusive lending. If assignees can escape liability for the loans they purchase, they will have no incentive to ensure that the loans they purchase are affordable to homeowners.

Key to responsible securitization is knowledge: assignees must not be able to deny knowledge of abusive lending from which they seek to profit. The CFPB must require originators to provide assignees with the full underwriting file and all analysis of the ability to repay. Such a provision would encourage assignees to screen loans they purchase for affordability, would protect homeowners facing foreclosure, and would aid the CFPB itself in compliance exams.

We look forward to further conversations with you on this complex and vital topic.

Sincerely,

Consumer Action

National Association of Consumer Advocates

National Consumer Law Center (on behalf of its low-income clients)

Atlanta Legal Aid Society, Inc.

California Reinvestment Coalition

Connecticut Fair Housing Center

Empire Justice Center

Financial Protection Law Center

Housing and Economic Rights Advocates

Law Foundation of Silicon Valley

Legal Aid Center of Southern Nevada

Legal Assistance Foundation of Metropolitan Chicago

Legal Services of New Jersey

Metropolitan St. Louis Equal Housing Opportunity Council

Michigan Poverty Law Project

Mountain State Justice

Neighborhood Economic Development Advocacy Project

North Carolina Justice Center

Northwest Side Housing Center

Ohio Poverty Law Center

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Ability-to-Repay ("ATR") Analysis and
Qualified-Mortgage ("QM") Determination
DISCUSSION DRAFT
by
Center for Responsible Lending
The Clearing House Association
Consumer Federation of America
Leadership Conference on Civil and Human Rights
For a Meeting With
Consumer Financial Protection Bureau

On

March 7, 2012

This document represents consensus recommendations concerning the ability-to-repay ("**ATR**") and qualified-mortgage ("**QM**") requirements of Dodd-Frank. These recommendations are interrelated and dependent upon each other.

Comment [DW1]: The comments are a consensus recommendation only among the parties submitting the documents and do not represent the views of other organizations.

1.0 Qualified Mortgage

Congress intended QMs to comprise the vast bulk of the mortgage market, and they should. QM loans by statute have safer features associated with responsible lending and lower default rates than loans without those features, such as limited fees, full amortization, and limited terms. Congress gave loans with these features a litigation advantage precisely to incent lenders to make QM loans.

If the QM definition is construed narrowly, it will be more difficult for low-income and minority families to qualify for safer loans, and, to the extent that mortgage credit is available to them at all, many of these borrowers will be left to the part of the market where they will be significantly more vulnerable to equity stripping through high fees and bad practices. A large non-QM market would not by its size alone protect consumers, and the broad availability of loan features that experience has shown to entail greater risks for consumers and investors will add to costs without providing commensurate consumer benefits.

By contrast, a broad definition of QM would combine prudent lending with less litigation, benefiting homeowners, investors and lenders alike. It would also support access to credit, since secondary market standards are very likely to require loans to be QM.

Comment [DW2]: A broad QM definition will only promote prudent lending if the boundaries are drawn tightly enough to discourage lending without regard to ability to repay. This is a balancing act that the CFPB must perform.

2.0 Ability-to-Repay Determination

2.1 General standards

Statutory requirement

The statute states that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(1).

The ability-to-repay analysis should be based on factors that reflect capacity to repay as of the time of consummation, not willingness or propensity to repay.

Comment [DW3]: Yet the definition of QM is likely to determine the outer boundaries of how many loans are underwritten with respect to ability to repay. It should not be assumed that homeowners' ability to repay will be protected by some additional process or that, over time, lenders' underwriting processes will be more solicitous of homeowners' ability to repay than the QM definitions.

- The determination of ability to repay is separate and distinct from the underwriting decision, which properly includes factors other than just ability to repay.
- The regulations and accompanying commentary should clarify that:

  - the statutory ATR analysis concerns the borrower's capacity (the statute uses the term "ability") to repay a loan through current income, assets (other than the home), and funds available, not the propensity to make such payments.

  - other factors unrelated to ATR that influence the credit decision (e.g., credit score, LTV, appraisal) should not be used by creditors in establishing the borrower's ATR or in challenging a creditor's determination of ATR.

  - while the statute refers to a consumer's "credit history," this reference was intended to ensure only that a lender obtained a consumer's credit report (which contains the consumer's credit history) to verify the consumer's debts and associated monthly obligations[1],not that lenders should use the credit history or credit report to otherwise determine the borrower's ability to repay. Otherwise, it would make no sense that QM establishes a rebuttable presumption of ATR when QM does not discuss creditworthiness.

- The CFPB should adopt the portion of proposed commentary Paragraph 43(c)(1)-1, which clarifies that a creditor is required to "determine that a consumer will have a reasonable ability *at the time the loan is consummated* to repay the loan" (emphasis added). The CFPB should further clarify that the lender must determine the consumer's foreseeable reasonable ability to repay the loan. Thus, for example, if a consumer relied on child support payments, the lender should not include those payments in determining ability to repay past the time when the child support payments are scheduled to cease. Lenders should be required to review all information they are provided in making a determination as to the borrower's foreseeable ability to repay. ~~A change in a consumer's circumstances after consummation of the loan is not relevant to determining compliance with the rule, unless such events are documented in the consumer's application or by information provided by the consumer reasonably prior to consummation of the loan. For example, the creditor must consider the potential impact of a consumer's impending retirement and the consumer's ability to repay if the consumer's application contains a notation that the consumer plans to retire six months after the loan is made~~. However, a significant reduction in income due to a job loss that occurs after consummation or a significant obligation arising from a major medical expense arising after the loan is consummated

Comment [DW4]: The original paragraph leaves many issues unresolved and invites litigation. What is reasonably prior? How much does the consumer have to provide? What if the information is obvious to the lender?

[1] The proposal would require, as part of an ability-to-repay determination, a consumer's credit history. Proposed Regulation section 226.43(c)(2)(vi); Proposed Commentary Paragraph 43(c)(2)(viii). This improperly conflates the full underwriting analysis that all lenders must undertake in order to ensure safe and sound underwriting practices—which includes assessing creditworthiness, loan-to-value ratios, and other factors—with the statute's requirement to consider the borrower's capacity to repay. An analysis of a borrower's ability to repay a debt is simply one important part of a lender's full underwriting analysis.

would not be relevant to an ability to repay challenge. *See* Paragraph 43(c)(1)-1.

The regulation and commentary should require creditors to verify and document income, assets, and debts using third-party sources.

- **Income or assets:** The final rule should adopt the proposed regulatory provisions and commentary that require verification of income or assets using third-party documentation that provides reasonably reliable evidence of the consumer's income or assets and that permit creditors to consider expected income if it is reasonable and documented. Proposed Rule section 226.43(c)(4); Proposed Commentary Paragraph 43(c)(2)(i)-1; Proposed Commentary Paragraph 43(c)(2)(i)-3. Dodd Frank requires that income and assets be appropriately documented and verified. However, this requirement can pose barriers to obtaining credit for some borrowers who have non-traditional or alternative income sources, such as boarder income and informal self-employment income, which is more difficult to document and verify. Since CFPB will have to confront and resolve these issues in issuing the final regulations, the parties would like to work with the CFPB to develop standards that specifically address how such non-traditional or alternative income sources can be considered by the creditor in the underwriting process and verified, including working through parties that work closely with borrowers, such as HUD-approved housing counselors.

- **Debts:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-1, which provides that creditors may look to widely accepted governmental and nongovernmental underwriting standards to define debts, and a creditor may, for instance, look to credit reports, as well as statements for student loans, auto loans, credit cards, etc., to determine a consumer's outstanding debts. However, see the discussion below regarding expenses not on a credit report or the consumer's application.

- **Reconciling different information:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-2, which provides that the creditor must consider debts in the credit report that are not listed on the consumer's application. The credit report is deemed a reasonably reliable third-party record under § 226.43(c)(3). "For debts not listed in the credit report, but offered by the borrower through the application process, the creditor need not verify the existence or amount of the obligation through another source. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source."

Ability to repay—when the creditor must consider expenses not listed on the credit report or the borrower's application

- The commentary should clarify that the lender must consider additional information that the borrower provides [~~in writing] a reasonable time before~~ prior to consummation about regular/recurring expenses that would have a material impact on the borrower's ability to repay the loan. However, the borrower would have the burden of proving that she had offered such information ~~[in writing] reasonably~~ prior to the consummation of the loan~~ and that it would have a material impact on her ability to repay the loan~~. **[Note to CFPB: The parties disagree about whether this information must be provided in writing.]**

[There is agreement that the borrower needs access to information that describes how the lender conducted the ability-to-repay determination. The parties will attempt to propose a solution at a later date.]

2.2 Payment used to qualify the borrower—treatment of ARMs

Comment [DW5]: Note certain groups have additional views on types of income and types of documentation to be included.

Comment [DW6]: The CFPB should not do this as a closed-door negotiated rulemaking process, but should more broadly engage the communities affected. There is a range of perspectives on these difficult issues; a full and open debate will best serve the public interest.

Comment [DW7]: Most homeowners only provide documentation as instructed by the loan officer or broker. Limiting this requirement to information provided in writing allows some originators to manipulate this process. Whether information was provided orally will be a question for the fact finder, and obviously a substantial burden for a homeowner in any event.

Comment [DW8]: This vague phrase as originally drafted could be used to justify exclusion of information provided to the creditor. All information provided prior to loan consummation should be considered.

Comment [DW9]: Any exemptions based on a material impact are likely to have the result of creditors pushing the envelope because they will only have to demonstrate material impact for the few who are able to litigate.

Comment [DW10]: This information may not be useful to borrowers outside of disputes about the lender's determination and should be made available at the borrower's request after consummation, not as a default at closing. Moreover, all of the ATR paperwork should travel to the assignee to ensure incentives for compliance.

For all ARMs, the ATR standard should require the following:

- The contract interest rate and payment *cannot*:
  - adjust more frequently than annually;
  - increase by more than 200 basis points in any annual rate adjustment; or
  - adjust by more than 500 basis points over the life of the loan.

- The borrower must be qualified based on the *maximum* rate and payment that could occur in the life of the loan ~~first 6 years of the term of the loan (that is, the rule would not allow the creditor to ignore the first rate and payment adjustment on a 5-1 ARM in the ATR analysis).~~
-

[**2.3** ~~Potential ATR Carve-Out for Certain Streamlined Refinancings: There is agreement that an exception to the ability-to-repay and qualified-mortgage requirements should be established for certain streamlined refinancings. The parties will attempt to propose such an exception at a later date.~~]

3.0 QM Definition

All items below must be met in order for the loan to be a designated as a qualified mortgage:

3.1 Loan Terms

A qualified mortgage cannot have terms that provide for:

- an increase of the principal balance as a result of negative amortization based on regular required payments
- interest-only payments
- balloon payments
- a term greater than 30 years
- points and fees that exceed the greater of $3,000 or 3 percent of the total loan amount so long as the loan is not a HOEPA loan
- the contract interest rate and payment to:
  - adjust more frequently than annually;
  - increase by more than 200 basis points in any annual rate adjustment; or
  - adjust by more than 500 basis points over the life of the loan
- In addition, the borrower must be qualified based on the *maximum* rate and payment in the life of the loan. ~~that could occur in the first 6 years of the term of the loan (that is, the rule would not allow a creditor to ignore the first rate and payment adjustment of a 5-1 ARM in the ATR analysis).~~

3.2 Documentation Requirements

- The following documentation requirements would be required for QM loans:
- Verification of borrower income;
- Verification of employment ("**VOE**") status, if applicable (either written or oral VOE);
- Documentation of current debt obligations (based on credit report and borrower application); and
- Documentation of payments on simultaneous seconds and any other subordinated loans in place at

Comment [DW11]: While the six year maximum timeframe and approach hugely improves upon the faulty statutory fully indexed approach, it still allows creditors to game the system and set up increases at the 6-year mark.

Comment [DW12]: Streamlined refinancings are often a source of predatory lending. In order to prevent predatory loan flipping of this nature, it is essential that these loans be included in QM protections unless other additional protections are included, such as housing counseling.

Comment [DW13]: While some would argue that the limitations on loan terms take care of most of the affordability problems and thus some looseness in QM in favor of access outweighs the risk of predatory lending, the characteristics of loans in the last 10 years were only the latest wave in a longer history of predatory lending, which included fixed rate mortgages without onerous prepayment penalties. Thus, the balancing must take into account the long view on abuse variations.

origination.

3.3 Additional QM Underwriting Requirements

In order to be a qualified mortgage, a loan must meet at least one of the "waterfall" tests described below. However, the fact that a mortgage might qualify under one of these tests does not imply an obligation on the creditor's part to make the loan or to otherwise forego the underwriting process. All references to housing debt, housing obligations, and housing payments below would include principal, interest, taxes, insurance, condominium association fees and other housing-related obligations.

- If the borrower's total debt-to-income ratio ("TDTI") is 43 percent or less (~~with a bona fide error cushion~~), the loan would meet QM requirements. No other tests would be required.

- If the borrower's TDTI is more than 43 percent, the following tests could be applied:
  – *Front-End Ratio*: Is the borrower's housing debt-to-income ratio 31 percent or less of the borrower's gross monthly income and is TDTI 50 percent or less?

  ➢ If yes, the loan meets QM requirements; no further test required. If no, continue.
  – *Previous Housing Payments*. Has the borrower had stable income for the past ~~six~~ twelve months and made timely mortgage or rental payments over ~~a specified period of time (TBD)~~the past twelve months, as well as timely payments on other debt ~~and will her new monthly housing obligations be no more than 5 percent higher than her current housing expenses? ~~ Has the borrower met with a HUD-approved housing counseling agency? [Parties are still discussing the appropriate definition and timeframe for establishing a history of "timely" payments.]

  ➢ If yes, the loan meets QM requirements; no further test required. If no, continue.
  – *Reserves*. Does the borrower meet one of the following tests: 1) at least 6 months of liquid financial reserves available to meet all ~~mortgage-related~~ obligations and a TDTI of 50% or less; or 2) greater than 18 months in liquid financial reserves (i.e., no TDTI cap required)? (~~Only 60 percent of any reserves with a withdrawal penalty would be allowed to count.~~) ~~[Parties agree that some degree of seasoning should be required but do not have a specific recommendation.]~~Have the funds been held for at least 12 months? Does the borrower also have sufficient residual income and has the borrower met with a HUD-~~certified~~approved housing counseling agency~~or~~?

  ➢ If yes, the loan meets QM requirements; no further test required. If no, continue.
  – *Residual Income*. Is the borrower's net residual income above the minimum threshold established by the CFPB and/or other government agency (e.g., U.S. Department of Veterans Affairs ("**VA**")?

  ➢ If yes, the loan meets QM requirements; no further test required. If no, the loan will only be made as a non-QM loan unless one of the prior tests in the waterfall is met.

  The residual-income test could be based on tax-adjustment tables and income guidelines prepared by CFPB, VA guidelines, or industry standards.

~~Even if the loan does not meet any of the QM tests, there is no implication that the loan fails to meet the ability-to-repay test.~~

4.0 Contesting the Presumption

We propose the following process:

Comment [DW14]: There is no reason to provide a bona fide error cushion for lenders in determining DTI. The question will still be asked whether ability to repay was reasonably determined and that is where the cushion already resides.

Comment [DW15]: Omission of residual income at this stage ensures that some lower income homeowners will receive loans that meet the DTI test but are unaffordable based on dollars available. This is a predictable, substantial problem that can be addressed. A generic residual income test, such as that included lower in the waterfall, would easily address this problem and would be based on information already collected for underwriting/QM purposes.

Comment [DW16]: The proposed standard of 6 months of payments even where many homeowners manage to borrow money for such a time. Many defaults happen in or shortly after this time frame. Moreover, there is no basis for increasing the payment by 5%--an amount that could make it unaffordable. The changes proposed here track the standard used in the housing counseling industry.

Comment [DW17]: We recommend that housing counseling be included in this test.

Comment [DW18]: Reliance on retirement or other reserves is not a substitute for ensuring affordability. Moreover, many homeowners can come into large reserves while having extremely limited ability to meet ongoing expenses: workers' compensation claims, payment of back government benefits, or inheritances can all result in a short-term accession to wealth without any long term ability to finance debt. Property and loan flipping cases often included a reliance on reserves where the creditor put the money into the homeowner's account shortly before consummation. Any reserves requirement should include a requirement that the money was in the account for at least one year. Finally, the government should not approve the use of retirement savings for loan payment.

Comment [DW19]: Based on how the waterfall is set up, this part of the test is unlikely to be used. This approach undermines the purpose of including residual income in the test.

Comment [DW20]: This is in total contravention of the statute. The role of a presumption is that if someone doesn't meet the QM test, the loan is presumed to not comply with the statute. Then the rebuttal process starts.

Comment [DW21]: It should be clarified that a homeowner only needs to plead that the loan was unaffordable, since the homeowner will not have access to further information to demonstrate what the creditor did. Particularly pro se borrowers are unlikely to know or understand any of the basic tests of QM that are set out. We have submitted our recommendations on the presumption under separate cover.

- Borrower initially pleads that the loan was foreseeably unaffordable when made.

- ~~presumption of QM when a borrower demonstrates that the loan fails to meet the basic tests of QM—product type, fee levels, etc.~~

- If the loan is a QM, and the borrower does not demonstrate that the loan fails to meet the basic tests of QM, the borrower can still assert that the ability-to-repay requirement was not met by demonstrating that the lender failed to take into account information provided to it that, if properly considered, would have prevented a reasonable and good faith finding of a reasonable ability to repay.

  - For example, the borrower shows that she provided information to the creditor before consummation that she owed debt that was not listed on the borrower's credit report. Failure to consider this debt could be grounds for challenging whether the ability-to-repay requirement was met. ~~The lender could still have met the requirement if the existence of the debt did not materially affect a reasonable determination of the borrower's ability to repay.~~
  - Similarly, if a creditor alters or omits information collected in the course of the application, ~~without reasonable basis,~~ that is relevant to the borrower's ability to repay, the borrower can challenge whether the ability-to-repay standard was met.
  - For example, the borrower shows that her residual income (based on actual expenses and income) at the time of closing was insufficient to meet the maximum possible payment under the loan terms.
    - Absent further information or evidence submitted by the borrower that either contradicts the creditor's records and assertions or documents information that the lender had but did not reasonably consider, the presumption for qualified mortgages should provide a sufficient shield to the lender.

- If the loan is not QM to begin with, the burden of proof that the lender did not appropriately consider the borrower's ability to repay falls on the lender. In this case, the lender will not have the benefit of the presumption of ability to repay when defending borrower claims that the lender failed to consider relevant information provided by the borrower.

- The CFPB should ~~clearly articulate how this process can work~~provide non-exclusive examples of unaffordability that could be used to rebut the presumption .

- Where the homeowner contests that the lender determined the ability to repay, the creditor or its assignee may not rely on a borrower's written attestation that the loan was affordable or all relevant information was provided to demonstrate that the creditor in fact made a good faith determination of the ability to repay.

- Accordingly, revise proposed Alternative 2 Commentary Paragraph 43(e)(1)-1 as follows [*additions in bold and deletions in strikethrough*]:

  In general. Under § 226.43(c)(1), a creditor must make a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations. **A borrower raises a claim or defense of violation of sec 226.43(c)(1) by setting forth specific facts**

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Comment [DW22]: Such a fact-specific determination invites litigation and provides a loophole for creditors—what may be used regularly since violations could be viewed as a cost of doing business.

Comment [DW23]: If, in fact, the creditor had a reasonable basis to alter or omit the information, the creditor will still have made a reasonable determination of the borrower's ability to repay, as required by the statute. Piling on exceptions invites litigation and excuses lenders from compliance. It also makes it less likely the basic QM requirements will be the default ATR process.

Comment [DW24]: Actual residual income is critical to the homeowner's rebuttal that there was not a reasonable determination of ability to repay. It is essential that the CFPB clearly articulate how such rebuttal can occur using borrower expenses and income. While QM and nonQM underwriting rules would explicitly cover the first 5/6 years under the proposed standards, it is logical that longer term affordability is still part of the fact finding that occurs in the context of a particular case. QM provides presumption, not a ceiling on the definition of affordability.

Comment [DW25]: While the lender may formally hold the burden, the outcome will still be more likely to favor the lender unless the CFPB is clearer about what are the indicia of unaffordability.

that, at the time the loan was consummated~~, the creditor did not make a reasonable and good faith determination tha~~t the borrower did not have ~~had~~ a reasonable and forseeable ability to repay the loan.~~ based upon information provided by the borrower reasonably prior to closing.~~ Under § 226.43(e)(1), a creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirement of § 226.43(c)(1) if the terms of the loan comply with § 226.43(e)(2)(i)-(ii) (or, if applicable, § 226.43(f)); the points and fees do not exceed the limit set forth in § 226.43(e)(2)(iii), and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or, if applicable, § 226.43(f)). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must **prove** ~~demonstrate~~ that the loan complies with all of the requirements in § 226.43(c) (or, if applicable, § 226.43(d)). However, even if the loan is a qualified mortgage, the ~~consumer may rebut the presumption of compliance evidence that the loan did not comply with~~ **lender has not necessarily complied with the ability-to-repay requirement** in § 226.43(c)(1). For example, **(1)** evidence of ~~a high debt-to- income ratio with no compensating factors, such as~~ inadequate residual income ~~could be sufficient to rebut the presumption~~, **or (2) evidence that the lender did not ~~reasonably~~ consider information provided to it relevant to the borrower's ability to repay could be used by the borrower to establish that the creditor did not meet the ability-to-repay requirement. When a loan is a qualified mortgage, the consumer has the burden of proving that the creditor did not comply with the repayment ability requirement of § 226.43(c)(1).**

Comment [DW26]: The homeowner will not have information regarding creditor conduct and pleading standards make it unlikely that they could satisfy this test as originally drafted.

Comment [DW27]: Whether or not compensating factors were present is not the ultimate question. For loans outside of QM, the ultimate question is whether the loan was foreseeably unaffordable—which at core is a question of residual income.

Exhibit F

National Consumer Law Center
July 9, 2012

Methodology for Calculating Damages
For Dodd-Frank Ability to Repay Requirement

I. Definition

Calculation of enhanced damages under 15 U.S.C. § 1640(a)(4)), assuming consumer establishes the claim:

- Amount equal to the sum of all finance charges and fees *paid* by the consumer.

- 3 year statute of limitation for affirmative claim. Defense to foreclosure permitted any time afterward, but damages capped at end of third year (*i.e*,. 3 years worth of paid interest, with the applicable three years being the first 3 years).

II. Example

Loan terms:

Loan Amount	$150,000
Upfront fees financed	$ 2,500
Interest rate	7 % (30 Yr., Fixed Rate)
Payments	$997.95 per month

Loan Status at Time of Dispute:

A. <u>Pre-default</u>
> Payments made timely and fully through payment 45 = $44,907.75.
(997.95 x 45 = $44,907.75)
> Principal balance after payment 45 = $143,534.10.
(according to Mortgage-x.com calculator amortization table)
> Interest earned *and paid* after payment 45 = $38,601.76.
(according to mortgage-x.com calculator amortization table)

B. <u>Default</u>
Complete default after payment 45.
Foreclosure filed 6 months later (51 months out).
6 months' earned but unpaid interest = $5,023.70
($143,534.10 x .07/12 x 6 = $5023.70)
Late fees (est.) 6 @ $50 = $300

Calculating 1640(a)(4) Damages:

A. Determine Damages

Interest paid during first 3 years = $31,016.78

(according to Mortgage x.com amortization, total interest after mo. 36)

Prepaid finance charges & fees + $ 2,500

(under *Newton* case, payments made can be attributed to financed origination charges. They are considered accrued as of consummation.)

Total enhanced damages = $33,516.68

Add $4000 1640(a)(2)(A)(i) statutory damages = $ 37,516.68.
(Availability of actual damages unlikely, so no value added.)

B. Offset the Damages Against Amount Consumer Owes the Holder:
(excluding all the other foreclosure fees: inspection fees, collection fees, etc.)

Outstanding principal balance	$143,534.10
Plus 6 months accrued, unpaid interest	$ 5,023.70
Plus late fees (e)	$ 300.00
Value of holder's claim	$148,857.80
Consumer's damages from successful ATR claim offset:	- $37,516.68
Value of holder's lien *after* offset of borrower's successful ATR damages	**= $111,341.12**

III. Attorneys Fees

The CFPB asks about the likely litigation costs, including attorney's fees, incurred by lenders in QM cases. Such matters are hard to estimate, and are entirely within the creditor's control. For example, if a creditor chooses to litigate a case through trial the costs will be much higher than if the creditor settles the case promptly upon notice from the homeowner. The difference in costs is due largely to tactical decisions creditors make, and not to the litigation risk exposure occasioned by the statute. In our experience representing homeowners, creditors' attorneys often engage in a high-stakes strategy of attrition, knowing that borrowers' attorneys are comparatively poorly funded. Creditors choose to spend money on litigation because they believe it will discourage other litigation; that election by creditors' should not influence the CFPB in its weighing of the balance between homeowners and creditors.