Testimony of Michael D. Calhoun

President, Center for Responsible Lending

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Examining the State of Small Depository Institutions

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Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Committee. Thank you for the opportunity to testify on the need to maintain strong and reasonable consumer financial protections in the wake of the financial crisis.

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

CRL recognizes the importance of small lenders and credit unions, and the financial services they provide. We also appreciate the different business model they use to provide these services and support regulatory oversight that appropriately recognizes and accommodates these differences. Community banks, credit unions, and other smaller financial institutions often have smaller transactions and closer ties to borrowers and the communities they serve. This allows for more tailored lending and underwriting that result in more successful lending. Smaller financial institutions also participate much less in capital market transactions than their larger bank counterparts. CRL agrees that in the context of regulatory reform, it is important to continue to recognize the work of small lending institutions and how important it is for these institutions to be able to continue to successfully conduct their business in the community. Fortunately, the Consumer Financial Protection Bureau (CFPB) and other financial regulators also acknowledge these differences and have worked to tailor their rules accordingly. However, when adopting separate rules or exceptions to rules, it is essential to carefully craft them to ensure that consumer protections are not compromised.

1. The CFPB and Other Regulators Have Recognized That It Is Essential To Have A Flexible Approach That Supports Small Depository Institutions.

The regulators of small depository institutions have adopted a flexible approach to regulation and oversight. The CFPB has taken a lead in adopting regulations that are balanced for financial institutions and has made accommodations for smaller lenders. The CFPB's most visible and important rules have addressed past flaws in mortgage lending, which proved to be the underlying cause of the financial crisis that led to the great recession. The new mortgage rules strike the right balance of protecting consumers without constraining lenders from extending credit broadly. The rules—required by The Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") [1] — address a key cause of the mortgage meltdown and ensuing recession: the practice of many lenders to make high-risk, often deceptively packaged home loans, without assessing if borrowers could repay them. Because of these reforms, lenders now must assess a mortgage borrower's ability to repay a loan.

[1] Pub.L. 111–203.

Families who, in the past, were too often steered into unfair, harmful financial products will benefit from the safer mortgage standards defined in the CFPB's Qualified Mortgage ("QM") rule. While protecting borrowers, the CFPB's rule also provides lenders with significant legal protection when they originate qualified mortgages. The rule rightfully provides certain exemptions for small and community lenders.

We note that the housing crisis was not merely caused by a drop in housing values. Reckless and poorly regulated mortgage lending undermined the housing market and sparked the crisis. As noted above, the CFPB then promulgated the QM rule and the Ability-to-Repay standard, which established reasonable and clear conditions under which the market can move toward safer lending. The new rules, which went into effect on January 10, 2014, established four pathways to QM status. With a some exceptions for certain agencies and small lenders, loans will meet QM criteria if: 1) they are fully amortizing (i.e. no interest-only or negatively amortizing loans; 2) the points and fees do not exceed 3% of total loan amount, 3) the terms do not exceed 30 years, and 4) the rate is fixed or, for adjustable-rate loans, has been underwritten to the maximum rate permitted during the first five years.

The CFPB also established an Ability-to-Repay provision that requires lenders to determine whether a borrower can afford a mortgage. Lenders are deemed to have complied with the Ability-to-Repay provision if they originate loans that meet the QM definition. This provision will prevent features such as no documentation loans that allowed for reckless lending and resulted in a myriad of defaults and foreclosures. Reforms such as these will allow the housing market to recover, more borrowers to achieve successful homeownership, and it will significantly reduce the likelihood of the nation experiencing a similar housing crisis in the future.

When a loan gains QM status, it carries with it a legal presumption of complying with the Ability-to-Repay requirements. The rule creates two different kinds of legal presumptions: a 'safe harbor' and a 'rebuttable presumption.' Under a 'safe harbor,' a borrower is unable to challenge whether the lender met its Ability-to-Repay obligations. If the loan is a prime QM loan, under a 'rebuttable presumption,' the borrower has the ability to raise a legal challenge but must overcome the legal presumption that the lender complied with this Ability-to-Repay obligation.

The CFPB adopted numerous special provisions for small depository institutions to ensure that they can participate and compete in the financial services market. For example, the CFPB created the small creditors definition when it promulgated the QM rule, a special designation that was not required by the Dodd-Frank Act. The CFPB created this designation using its regulatory authority with the goal of preserving access to credit for those who rely on the services of small creditors. Under this definition, lenders need to meet two criteria to count as a small creditor: first, the institutions must have assets of less than $2 billion and second, originate no more than 500 first-lien mortgages per year. Mortgages originated by an eligible small creditor can obtain QM status if the loan meets the points and fees threshold, is fully amortizing, does not include interest-only payments, and has a term of no more than 30 years. In addition, the lender is also "required to consider the consumer's debt-to-income ratio or residual income and to verify the underlying information." [2] However, these lenders do not need to meet the 43% debt-to-income ratio threshold or use the debt-to-income ratio standards in Appendix Q. These bright line rules provide appropriate guidance for small lenders, while still offering appropriate flexibility.

In addition, the CFPB created a QM definition for small lenders specific to balloon loans. This designation is required by Dodd-Frank for small lenders operating predominantly in rural or under-served areas. The Bureau used its regulatory authority to establish a two-year transition period that allows all small creditors – regardless of whether they operate in rural or underserved areas – to obtain QM status for balloon loans that are held in portfolio. After the transition period, the balloon loan exception only applies to those lenders who operate in rural or underserved areas under a definition that CFPB will continue to study. The mortgage rules also establish a minimum period of time for which escrows must be held for higher-priced mortgages. The CFPB also created an exemption to the escrow requirement for small creditors operating predominately in rural and underserved areas.

Small creditors receive accommodations regarding the legal safeguards of QM loans. The rule establishes a two-tiered system regarding legal protections for lenders. For the vast majority of loans, lenders will have a 'safe harbor' against potential legal challenges from borrowers. Somewhat higher costing loans will have a 'rebuttable presumption.' The threshold between the two depends on the loan's annual percentage rate (APR) relative to the average prime offer rate (APOR). A loan's APR is a figure that represents the overall cost of the loan, including both the

[2] CONSUMER FINANCIAL PROTECTION BUREAU, ABILITY TO REPAY AND QUALIFIED MORTGAGE STANDARDS UNDER THE TRUTH IN LENDING ACT (REGULATION Z), 78 Fed. Reg. 34430, 35487 (June 12, 2013) (rule was issued by the CFPB on May 29, 2013 and printed in the Federal Register on June 12, 2013).

interest rate as well as some specified fees. The APOR is a calculation that reflects the APR for a prime mortgage, and these figures are released on a weekly basis.

For the general QM definition using a 43% debt-to-income ratio threshold or the definition based on eligibility for purchase or insurance by Fannie Mae, Freddie Mac, and government agencies, the dividing line between a 'safe harbor' and a 'rebuttable presumption' is 1.5% above APOR for a first-lien mortgage and 3.5% above APOR for a subordinate lien mortgage. For loans below the thresholds, a lender receives a 'safe harbor.' For loans above the thresholds, they receive a 'rebuttable presumption.' Regarding small lenders, the CFPB adjusted the first-lien threshold for a safe harbor upward to match the second-lien threshold, resulting in a 3.5% threshold for both first and second-lien mortgages to receive the safe harbor.[3] For instance, for a 30 year first-lien mortgage (with today's APOR rate of 4.16%),[4] larger lenders originating QM loans receive safe harbor protection at an interest rate of 5.66%, whereas small lenders receive safe harbor protection for a higher interest rate of 7.66%. The effect of this CFPB created exception is a significant additional flexibility for smaller lenders.

The CFPB continues to review appropriate considerations for small lending institutions. The CFPB has requested comment on whether to increase the 500 first-lien mortgage cap under QM's small-creditor definition.[5] CRL expressed support to a reasonable increase of the 500 loan cap, limiting any potential increase to rural banks or for loans held in portfolio. We also

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[3] CONSUMER FINANCIAL PROTECTION BUREAU, ABILITY-TO-REPAY AND QUALIFIED MORTGAGE RULE: SMALL ENTITY COMPLIANCE GUIDE 28 (2014), *available at* http://files.consumerfinance.gov/f/201401_cfpb_atr-qm_small-entity-compliance-guide.pdf.
[4] *Available at* https://www.ffiec.gov/ratespread.
[5] 79 Fed. Reg. 25,730, 25746 (May 6, 2014).

encouraged the CFPB to examine data and feedback to determine if the 500 loan cap is creating problems for small-servicers to conduct business and reach underserved markets.

2. **Reasonable Flexibility with Oversight is Essential but Exceptions and Exemptions Must Be Carefully Drawn to Protect Consumers and to Mandate Responsible Lending.**

As outlined above, the CFPB has rightfully taken careful consideration to formulate rules that protect consumers and allow for broad access to credit. However, we have serious concerns about some proposed legislation that would loosen consumer protections.

The Portfolio Lending and Mortgage Access Act (H.R. 2673), introduced in the House of Representatives, would inappropriately exempt all mortgage loans held in portfolio.[6] These mortgages still carry significant risk to consumers, financial institutions, and the overall economy. In the financial crisis, many of the toxic loans, such as negative amortization loans underwritten to initial teaser rates were held in bank portfolios. These loans had initial payments that covered only a small amount of the accruing interest. As a result, the balance of the loans dramatically increased each year. Lenders made these loans based upon only this initial, artificially low payment, even though the loans required borrowers to make dramatically higher payments after a few years. Further increasing the risk of these loans, many lenders did not even document the income of the borrowers, instead making no documentation ("no-doc") loans.

[6] Note that this legislation does not set a loan size limitation, nor does it establish a loan-holding period.

Hundreds of billions of dollars of these loans were made, and many were kept on bank portfolios. These loans soon crashed, helping to trigger the financial crisis, and devastating banks such as Washington Mutual and Wachovia.

Portfolio loans also pose risks for consumers and tax-payers. For refinance loans, borrowers put their hard earned equity at stake. This equity covers the risk of the lender in the event of foreclosure, but borrowers lose all of their home wealth. Many portfolio lenders in the housing expansion period engaged in these asset-based loans, with disastrous results for consumers. It is important to remember that in the subprime mortgage market, which was a trigger for the crisis, only 10% of loans were first time homeowner loans; the bulk of these were refinance loans, largely based on the homeowners' equity.[7] Therefore, it is imperative to preserve Ability-to-Repay standards for these loans.

The Ability-to-Repay standard and the QM rule are also important safeguards for the mortgage market. When the housing market expanded, sustainable mortgages, such as thirty year fixed rate mortgages with full documentation were squeezed out by toxic products that appeared to be more affordable for consumers, but in fact had hidden costs and a high risk of foreclosure. Lenders who did not offer these toxic products saw their market shares plummet. They often felt they had to offer similar products in order to maintain market share and stay in business. The result was a race to the bottom. If exceptions to these critical lending standards are not very carefully drawn, we risk a repeat of this disastrous period of lending. I urge both bodies of

[7] CENTER FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A DRAIN ON NET HOMEOWNERSHIP, CRL ISSUE PAPER NO. 14 , TBL 1 (2007) , *available at http://www.responsiblelending.org/mortgage-lending/research-analysis/Net-Drain-in-Home-Ownership.pdf*

Congress to reject the Portfolio Lending and Mortgage Access Act and any similar legislation that weakens responsible and safe lending standards set forth by regulators such as the CFPB.

Conclusion

A healthy national economy depends on both healthy community financial institutions and consumer protections. We applaud the work of credit unions and small lenders who provide services to communities greatly in need of opportunity. We also applaud the role small creditors have played in creating successful homeownership for many who would not otherwise have the opportunity.

The reckless and predatory lending that occurred without appropriate safeguards resulted in one of the worst financial disasters of American history. In order to avoid the repetition of past mistakes that proved to be devastating for American families, regulators like the CFPB must protect the American people and ensure access to a broad, sustainable mortgage market. We understand the need for appropriate flexibility for small depositories, but it must be balanced against the need for consumer safeguards, and not extend exemptions tailored for small banks and credit unions to larger financial institutions. I look forward to continuing to work with these community institutions, their associations, the regulators, and this Committee to ensure that these institutions can thrive while consumers are protected. Thank you for the opportunity to testify today, and I look forward to answering your questions.