

COMMENTS
to the
Department of Housing and Urban Development

Docket No. FR 5707-P-01
RIN 2502-AJ18
78 Fed. Reg. 59890 (Sept. 30, 2013)

Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages

by the
National Consumer Law Center
on behalf of its low income clients

as well as

National Association of Consumer Advocates

Oct. 30, 2013

The **National Consumer Law Center**¹ ("NCLC") submits the following comments on behalf of its low-income clients, as well as the **National Association of Consumer Advocates**.²

I. Overview

These comments support the alignment of FHA lending programs and the Qualified Mortgage definition, including the import of the points and fees cap. However, we oppose the proposed establishment of a safe harbor for most FHA loans, which will incentivize a reemergence of abusive FHA lending. While we support HUD's adoption of a points and fees cap for streamline refinancings and for all Title II lending, the points and fees cap should apply to all FHA lending programs receiving Qualified Mortgage status.

FHA has traditionally played a key role in housing the nation's low-wealth borrowers, who often reside in low-income communities and communities of color. For example, in 2009-2011, over half of all loans made to African American borrowers were FHA loans, with the proportion hovering around 60% for 2009 and 2010.³ The picture for Latino borrowers is similar, with the percentage hovering around 60% in 2009 and 2010 and easing off slightly in 2011 with the proportion almost at 49%.⁴ Getting the Qualified Mortgage rule right is essential not only for promoting lending in those communities but ensuring that the rules do not inadvertently shield unsustainable lending with the government's imprimatur. This would have particularly damaging consequences in low-income communities and communities of color, where good loans have been hard to get and where the foreclosure crisis has decimated neighborhoods.

The government guarantee for FHA lending has, in the past, created a refuge for lenders seeking to recoup losses on unsafe lending. A safe harbor would promote such conduct by emboldening those who would engage in unsustainable practices, both by pushing the envelope within the flexibility provided by FHA guidelines and by making FHA loans that are in fact outside FHA guidelines (but which too often homeowners and enforcement personnel are unable to remedy due to resource constraints). Moreover, applying a safe harbor to certain loans without the points and fees cap, which HUD proposes, would provide opportunities for equity stripping while enabling abusive lenders to benefit from 100% legal insulation from liability (and thus below we recommend

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 Mortgage Lending, Truth in Lending and Foreclosures. These comments are written by NCLC attorneys Alys Cohen and Diane Thompson with research assistance from Marina Levy. NCLC attorneys provide assistance on a daily basis to the attorneys and housing counselors working with distressed homeowners across the country. These comments are based on the information from these advocates as well as our knowledge and expertise in RESPA and TILA specifically and consumer law in general.

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 HUD Annual Reports to Congress 2010-2012, Financial Status: FHA Mutual Mortgage Insurance Fund (Nov. 16, 2012; Nov. 15, 2011; Nov. 15, 2010).

Fiscal Years 2012, 2011, 2010).

⁴ *Id.*

applying the points and fees cap to additional categories of FHA loans). The points and fees cap ensures that homeowners are not subject to inflated costs associated with the initial making of the loan. The cap also pushes more of the cost of the loan into the interest rate, which promotes the making of loans that perform over time. Points and fees are considered “earned” at origination but interest rates only produce profit if the loan is performing.

Additionally, a safe harbor would magnify the weaknesses in existing FHA underwriting guidelines. Some FHA underwriting guidelines do not adequately protect some homeowners against unaffordable loans and those homeowners, often low-income consumers, should have the ability to receive properly underwritten loans and to remedy those that are not. It is unclear that rebuttable presumption does have significant additional costs associated with it; however, even if homeowners would receive marginally lower prices, this does not justify protecting unaffordable loans with a safe harbor. Access and affordability are an important combination; a safe harbor will skew away from affordability.

Instead of a safe harbor, HUD should adopt a rebuttable presumption approach for all FHA QM loans. A rebuttable presumption means that a homeowner can hold the lender to the basic promise of Dodd-Frank’s loan origination rules—that lenders will reasonably assess a person’s ability to afford a loan before that loan is made. Concerns that a rebuttable presumption is associated with substantially heightened costs of compliance due to legal risk are unfounded, as we demonstrate below.

The safe harbor is particularly problematic with regard to the streamline refinancing program. The FHA streamline refinancing program has a limited focus on underwriting and relies on a small number of recent payments as evidence of affordability. Because those previous payments can be borrowed as part of the previous loan (a feature prohibited in the streamline refinancing program itself), the streamline refinancing program includes loans, such as one described below, that are refinancings of already-unaffordable loans, now with a government guarantee. A rebuttable presumption will provide a better opportunity for homeowners who are victims of predatory refinancings to document that the loan was clearly unaffordable at inception. While the application of the points and fees cap to streamline refinancings is prudent, it does not remove the larger problems with affordability created by the limited scope of underwriting.

Whether or not HUD pulls back on the breadth of its safe harbor, additional measures should be adopted alongside the Qualified Mortgage implementation to promote sustainable FHA lending and better FHA compliance. First, HUD’s underwriting and QM requirements should include clear and tested rules on the underwriting requirements, and on how to rebut presumption of compliance with such rules, so that government actors and private citizens can adequately hold lenders accountable for noncompliance. We support adoption of standards beyond a straight debt-to-income ratio, however compensating factors should be drawn narrowly enough to ensure that proof of compliance is clear and that predictably unaffordable loans do not fall within the purview of FHA. Adoption of a residual income test would substantially improve the sustainability of FHA lending, particularly for low-income borrowers.

Second, because markets are dynamic and legal protections must stay flexible to react to developments, any final rule on Dodd-Frank Qualified Mortgage Implementation should make clear that it does not preempt state claims for lending abuses. State enforcement of fair and responsible lending is essential to prevent unintended consequences.

Third, because government enforcement is a key component of securing widespread industry compliance with regulation, HUD should engage in active oversight of FHA lending, including direct endorsement lenders, with aggressive consequences for non-compliance. This oversight should include proactive resolution of consumer complaints, including requirements for lenders and servicers to document answers to HUD in response to consumer complaints.

Fourth, homeowners must not lose their homes if FHA rules have not been followed. This can be accomplished through several mechanisms including: inclusion of a provision in the FHA Model Note Form incorporating FHA lending and servicing regulations and standards; inclusion in the FHA Model Note Form a provision designating the homeowner as a third party beneficiary; and regulatory provisions establishing noncompliance with FHA standards as a defense to a judicial or non-judicial foreclosure.

Fifth, rigorous loss mitigation requirements and compliance with those rules is essential to a sustainable system. HUD should fully review its loss mitigation options and compliance programs to maximize beneficial outcomes for homeowners, communities, investors and the FHA insurance fund.

Sixth, any difference within the FHA QM standards, such as those proposed by HUD between safe harbor and rebuttable presumption loans, should be keyed to a bright line standard, not a rate cutoff that incorporates a floating MIP component. Clear standards without a floating component will simplify lender implementation as well as compliance oversight and accountability. If HUD chooses to stay with a two-tiered system, the cut-off for FHA QM loans should not differ from other loans subject to the Consumer Financial Protection Bureau's rules. The higher threshold proposed by HUD would promote the migration of abusive loans into FHA because the safe harbor would be available in instances where the lender could not avail itself of that protection through other channels.

II. Applying the Qualified Mortgage Rubric, Including the Points and Fees Test, to FHA Loans Will Promote More Sustainable FHA Lending, However the Points and Fees Cap Should Apply to All FHA Loans

The Dodd-Frank Wall Street Reform and Consumer Protection Act⁵ ushered in a new era in substantive mortgage regulation. Its passage was an acknowledgement that disclosure alone cannot restrain market abuses. Congress established a regime for ensuring that homeowners throughout most of the mortgage market can expect to be offered loans that are affordable, based on verified income. These new requirements were passed after many years of loans made without regard to their affordability; where loan terms were suited to investor tastes rather than borrower capacity. FHA's implementation of these requirements should be informed by this important context. FHA's rulemaking should ensure that traditional communities of FHA borrowers—low-wealth borrowers often in low-income communities and communities of color—have access to sustainable loans and are not left without recourse for unsustainable lending sheltered by the FHA program.

The Qualified Mortgage component of the ability to repay requirement provides a presumption of compliance for loans that meet certain characteristics. The role of this designation is to promote safer lending. HUD's proposal to designate FHA loans that comply with its lending programs as

⁵ Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

Qualified Mortgages will promote FHA lending, which plays an important role in underserved communities, by giving creditors the confidence they need that these loans, often made to borrowers with more challenged credit profiles, come with a legal presumption of affordability. This is especially important at a time when the market will be expanding again. The QM designation in FHA loans will provide an important form of leverage that will allow FHA to maintain its intended presence in the marketplace. This is especially helpful in meeting the goals of access and affordability at a moment when data show that private label QM loans exclude most borrowers in communities of color.⁶⁶

At the same time, it is essential that FHA guidelines ensure that the Qualified Mortgage rules promote the sustainability intended by the Dodd-Frank Act. The points and fees maximum on Qualified Mortgages is an essential contribution to that safer lending. By limiting the points and fees on mortgages that receive the presumption of affordability, homeowners are able to shop more based on the interest rate. Moreover, creditors are incentivized to make performing loans because most of the profit comes from interest payments from loan performance, rather than points earned at closing. Shortly before the end of the previous decade, many abusive loans included grossly inflated points and fees that were financed into the loan. These costs earned quick cash for lenders while inflating loan costs (and sometimes interest as well, when they were financed). While the high-cost mortgage rules brought the points and fees on high cost loans down gradually, it is the Qualified Mortgage points and fees cap that will discourage creditors from loading junk fees into mainstream mortgage loans and encourage the origination of sustainable loans. In general, markets have adjusted to provisions like the points and fees cap, adjusting prices by eliminating some junk fees and moving more of the price into the rate where needed. Homeowners have little bargaining power when seeking a mortgage; the points and fees cap helps narrow the options to more sustainable options.

We support HUD's inclusion of the points and fees cap in the FHA QM definition for streamline refinancings and for all Title II loans. It will help ensure that FHA borrowers obtain loans in a more fair and transparent market while discouraging price gouging. The points and fees cap ensures that homeowners are not subject to inflated costs and junk fees associated with the initial making of the loan. We also agree with HUD's observation that loans on the edge of such a cap will be adjusted to comport with the new requirements. A Qualified Mortgage rule for FHA loans without a points and fees cap would provide legal insulation to loans that could pile on junk fees simply because the opportunity presents itself and also create opportunities for adverse selection in light of the CFPB's points and fees cap.

We support the retention of the cap at the CFPB's level of three points and fees. As with conventional QM lending, the FHA QM points and fees cap can be keyed at three points and fees while maintaining access to credit. The points and fees definition, which has been part of mortgage regulation for two decades, seeks to address the creditor's opportunity to "decouple" and proliferate fees for origination. Accordingly, all fees received directly or indirectly by the creditor, even through affiliates, are included in the points and fees test (other than certain carve-outs such as bona-fide discount points). Without inclusion of affiliate fees, creditors would be free to migrate loan origination costs further into affiliate entities in order to inflate up-front mortgage origination profits without running afoul of the points and fees cap.

⁶⁶ Rachel Witkowski, *Blacks and Hispanics Likely to Be Hurt By Qualified Mortgage Rule*, National Mortgage News (Oct. 22, 2013).

Despite its inclusion of points and fees in the QM structure for Title II loans, HUD's proposal declines to adopt a points and fees cap for certain other loan categories, such as Title I home improvement loans and Section 184 and 184A loans in the Native American and Hawaiian communities. Loans without points and fees caps encourage the assessment of junk fees, as described above, and these incentives should not be part of loan programs meant to shore up needs in vulnerable communities.

The Title I loan program in particular has had a long history of abusive lending,⁷ primarily in low-income communities. Those problems declined in recent years in part because many of those loans moved over to the private label subprime market—where homeowners were further subject to abusive loans. Unsustainable loan terms and swollen default rates were long endemic in the Title I loan program. For example, at a hearing on Title I loans in 1998, subcommittee Chairman Lazio observed in his opening remarks:

Recently, investigations by HUD, the HUD Inspector General, GAO, and the news media have uncovered potentially widespread fraud and abuse in the Title I Home Improvement Loan Program. Among the allegations are false advertising, incomplete work, falsifying loan applications, high claims rates, and strong-arm tactics that force homeowners into greater debt. Of great concern to the subcommittee, in addition to the cases of fraud and abuse, is what appears to be HUD's alarming lack of oversight of the program.⁸

A GAO report that same year found, among other things, inadequate oversight of lender compliance with lending standards in FHA Title I programs and payment of claims despite lack of compliance with underwriting requirements.⁹ While certain changes have been made to the program, the history of the program itself and the overall challenges FHA has faced in overseeing compliance with its programs make clear that this program needs the additional safeguard of the points and fees cap.

If HUD finds that a higher cap is needed in targeted programs, a small increase in the cap would be a stronger mechanism for maintaining sustainable loan terms than a complete exemption from the cap. Any increase in the cap (or exemption) should be documented with data supporting this need and demonstrating that access will not be provided at the substantial expense of sustainability.

⁷ See, e.g., Government Accountability Office, *Defaulted Title I Home Improvement Loans—Highly Vulnerable to Fraud, Waste and Abuse*, AFMD-82-14 (Dec. 7, 1981).

⁸ Opening Remarks of Rep. Lazio, *Hearing on Consumer Abuses in Home Improvement Financing*, U.S. House of Representatives, Subcommittee on Housing and Community Opportunity, Committee on Banking and Financial Services (Apr. 30, 1998).

⁹ Government Accountability Office, *Home Improvement: Weaknesses in HUD's Management and Oversight of the Title I Program*, GAO/RCED-98-216 (July 16, 1998).

III. The FHA QM Rule Should Use a Rebuttable Presumption Standard, Not a Safe Harbor, in Order to Account for FHA's Long History as a Haven for Abusive Loans

If HUD were to adopt its proposal as written, almost all FHA lending would be eligible for a safe harbor. The history of abusive FHA lending by lenders points to the need for the greater self-monitoring and opportunity for redress that would result from a rebuttable presumption. Recent developments have made clear the extent of non-compliance with FHA underwriting standards.

The Office of the Inspector General's report from March 2011 reviewing loans with high compare ratios in the direct endorsement program found that 49 percent of the loans reviewed were not properly underwritten. Damage to the FHA insurance fund was projected to be at least \$11 million. Problems with income/employment analysis, qualifying ratios and credit history each were evident in more than one third of the noncompliant loans.¹⁰ The surge of federal False Claims Act cases against FHA lenders confirms these findings, calling attention to the blatant disregard for FHA underwriting guidelines by numerous lenders. For example, the complaint against Wells Fargo describes the bank's conduct as a "regular practice of reckless origination and underwriting" intended to vastly increase the lender's FHA volume.¹¹ While this case is ongoing, the Department of Justice has entered into settlements with Deutsche Bank for \$200 million and with Bank of America for Countrywide's practices for \$1 billion.

Property flipping cases also have highlighted the ways in which the availability of government insurance has been used as a backstop for scammers seeking to cover their losses.¹² Property flipping scams involve speculators who buy dilapidated residential properties at low prices and resell them to unsophisticated first time home buyers at huge markups. The price is often run up through a series of flips to straw buyers.¹³ Because FHA insurance, unlike regular mortgage insurance, covers 100% of a lender's losses, lenders can profit from inflated loans they know will foreclose in short order.¹⁴ The loan officer gets a commission, but HUD (along with the homeowner) is faced with the financial consequences of the bad loan. In these circumstances, loan officers and the lenders they work for may actively help speculators evade HUD requirements and defraud the consumer.¹⁵ Although HUD issued anti-flipping regulations attempting to restrict this practice by limiting the availability of FHA insurance where the property has been sold in the prior six months, the suspension of the rule limiting resales within 90 days leaves FHA loans susceptible to abuse.

Limited federal resources, even in good times, make it difficult to police the breadth of FHA underwriting, especially in the direct endorsement lending program. Moreover, most homeowners

¹⁰ <http://www.hud.gov/offices/oig/reports/files/ig11cf1801.pdf>

¹¹ Complaint, *U.S. v. Wells Fargo Bank*, No. 12 CIV 7527 at 16 (Oct. 9, 2012), available at <http://www.justice.gov/usao/nys/pressreleases/October12/WellsFargoLawsuitPR/Wells%20Fargo%20Bank,%20N.A.%20Complaint.pdf>.

¹² See, e.g., *Vaughn v. Consumer Home Mortg.*, 293 F.Supp. 2d 206 (E.D. N.Y. 2003); *Consumer Prot. Div. v. Morgan*, 874 A.2d 919 (Md. 2005).

¹³ See *United States v. Sloan*, 505 F.3d 685 (7th Cir. 2007) (providing an overview on how straw buyers are used in an FHA flipping scheme).

¹⁴ See *M&T Mortgage Corp. v. White*, 2006 WL 47467 (E.D.N.Y. Jan. 9, 2006) (finding that predatory lending scheme caused in part by HUD's issuance of insurance without due diligence); *Vaughn v. Consumer Home Mortgage*, 293 F. Supp. 2d 206 (E.D.N.Y. 2003) (denying HUD's motion to dismiss declaratory judgment that FHA insurance issued without due diligence).

¹⁵ E.g., *Hoffman v. Stamper*, 867 A.2d 276 (Md. 2005).

facing non-compliant FHA loans will be unable to obtain any legal representation to challenge these practices due to shortages in the availability of legal services and the difficulty in bringing such cases. As the mortgage market re-expands, the allure of increasing volume at the expense of quality will return. A rebuttable presumption will promote greater compliance on the front end of FHA mortgage originations. Moreover, the FHA guarantee itself already provides protection to lenders against loss and serves as a bulwark encouraging FHA loan origination.

While both a safe harbor and a rebuttable presumption require compliance with FHA underwriting guidelines, lenders nevertheless will have fewer incentives to comply with those rules if they have a safe harbor. We describe below other reasons for employing a rebuttable presumption, including the need to ensure that gaps in the underwriting guidelines do not leave homeowners with no recourse for loans clearly unaffordable at inception and the limited litigation risk presented by a rebuttable presumption.

IV. Litigation Risk Related to a Rebuttable Presumption is Not Substantially Different Than it is for a Safe Harbor

Those who support a safe harbor emphasize the additional cost associated with a rebuttable presumption. An examination of the structure of the Truth in Lending Act and the litigation facts associated with claims under the Act makes clear these claims are unfounded.

The Truth in Lending Act's pre-existing general rules on liability already carefully calibrate the interests of the industry and its customers, and are applicable even where there is a rebuttable presumption for ability-to-pay claims.

- The general provision on statutory damages caps those damages at \$4,000 for closed-end mortgages.¹⁶
- Though actual damages are available, in fact they are very rare due to the extremely high evidentiary hurdles courts have imposed.¹⁷
- Class action exposure for statutory damages is limited in amount.¹⁸ (And, of course, any purported class action would also have to meet the standards of commonality and other requirements for a certifiable class action under Rule 23 of the Federal Rules of Civil Procedure.)¹⁹

¹⁶ 15 U.S.C. § 1640(a)(2)(A)(i).

¹⁷ 15 U.S.C. § 1640(a)(1). *See generally* National Consumer Law Center, Truth in Lending §§ 11.5.3-11.5.4 (8th ed. 2012) (on proof requirements for actual damages).

¹⁸ 15 U.S.C. § 1640(a)(2)(B) (lesser of \$1 million or 1% of creditor's net worth, as amended by Dodd-Frank).

¹⁹ Since ability to pay evaluations inherently deal with individual circumstances of borrowers, class actions are extremely unlikely in this context. They would be maintained only if the lender policies in place encourage non-compliance or there is a widespread pattern and practice of non-compliance. For class actions not subject to the general statutory damages cap, courts look to other factors to limit exposure when warranted. 15 U.S.C. § 1640.

- There is no liability for any violation if the lender establishes that the violation was not intentional and resulted from a “bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such errors.”²⁰
- The lender or assignee can avoid liability if it discovers the error on its own and promptly corrects it.²¹
- Assignees have an additional layer of protection in that, in many cases, they are liable for monetary damages for violations only where the violation is apparent on the face of the documents.²²

In adding the ability-to-pay requirements, Congress consciously and carefully weighed what additional liability rules should govern violation of the ability-to-repay requirements. Early versions of the bill would have given a safe harbor to assignees and securitizers for the ability-to-pay provision, and greatly restricted liability for the secondary market in other respects.²³ But the final version, crafted after the collapse crystallized the problems in the market, reflected a different course. In the midst of the foreclosure crisis, the need to make the law’s requirements enforceable by consumers in a meaningful way was abundantly clear.

To that end, Congress crafted additional carefully balanced remedies applicable to the ability-to-pay requirement.

- Additional “enhanced” damages in an amount equal to the sum of all finance charges and fees *paid by the consumer within three years of consummation* are available.²⁴
- There is no liability if the creditor demonstrates that the failure to comply was “not material.”²⁵

In the context of the ability-to-pay provisions, practical realities make the three-year cap on enhanced damages particularly key to limiting litigation risk for the market. As a general rule, the earlier in the process a default occurs, the more likely a court is to find that the ability-to-pay determination at consummation was not reasonable and in good faith. (Early defaults, indeed, were one indicator regulators used in identifying potential predatory lenders for enforcement purposes prior to the market collapse.) Early in the loan the consumer will have made few payments, so the interest component of enhanced damages will be relatively small. By contrast, the longer it takes for the consumer to default, the more difficult the borrower’s burden will be to show that the default was reasonably predictable at consummation and was caused by underwriting rather than a subsequent income or expense shock. And even if the consumer surmounts that burden, the amount of damages is still capped at three years’ worth of paid interest.

²⁰ 15 U.S.C. § 1640(c).

²¹ 15 U.S.C. § 1640(b).

²² 15 U.S.C. § 1641(a), (b), (e). The rescission remedy is available against assignees even if not apparent on the face of the documents, and there is expanded (though capped) liability against assignees on HOEPA loans.

²³ H.R. 1728 (111th Congress).

²⁴ 15 U.S.C. § 1640(a)(4) (describing enhanced damages).

²⁵ 15 U.S.C. § 1640(a)(4).

A look at some numbers further highlights the real limitations of litigation risk associated with ability to repay claims. One reasonable proxy for exposure to a Truth in Lending claim in relation to foreclosure litigation would be rescission claims – one of the most important tools homeowners have to contest bad mortgage practices under the Truth in Lending Act. The incidence of litigation is vanishingly small.

<i>Number of foreclosures initiated in 2012:</i> ²⁶	998,964
<i>Number of cases involving Truth in Lending & Foreclosure 2012:</i> ²⁷	677
<i>Number of such cases also involving TIL rescission:</i> ²⁸	351
<i>2012 rescission cases as percentage of 2012 foreclosures:</i>	.035%

Finally, there are extra-statutory, very real practical limitations on litigation exposure for non-compliance with the ability-to-pay provisions. The number of lawyers available to help individual homeowners in consumer credit cases is only a fraction of what is needed. And while the Truth in Lending Act’s statutory attorneys fees bring consumer representation at least theoretically within reach of the average consumer, as a practical matter many attorneys themselves cannot afford to wait months or even years for the attorneys fees awards to be paid, even assuming they establish the claim successfully. Legal services and public interest attorneys, who have historically formed the core of the consumer credit bar, have always been stretched for resources, and are even more so today. While the statute itself provides the market with protection from excessive litigation risk, economic realities limiting consumer access to representation provide even greater insulation.

The foreclosure crisis has brought the imbalance in access to representation into harsh light, as a number of local and state reports have found.

- 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% without access to that kind of representation.²⁹
- The Brennan Center for Justice report, *Foreclosures: A Crisis in Legal Representation*,³⁰ found that the majority of homeowners in foreclosure went without representation.
 - In Stark County, Ohio, 86% of foreclosure defendants in 2009 were unrepresented.
 - In 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.

Even for that very small percentage of homeowners facing the loss of their homes who are able to find attorneys, they typically pursue only the clearest cases of wrongdoing, for the simple reason that they are often uncompensated if they do not succeed with the claim.

²⁶ OCC Mortgage Metrics Report, First Quarter 2013.

²⁷ Westlaw Next search by National Consumer Law Center, Oct. 25, 2013.

²⁸ *Id.*

²⁹ Nan Heald, Pine Tree Legal Assistance, *Justice for Some: Report on Unmet Legal Needs in Maine*.

³⁰ Melanca Clark and Maggie Barron, Brennan Center for Justice, *Foreclosures: A Crisis in Legal Representation*, pp. 12-17(2009).

The experience of states with anti-predatory lending laws fails to support predictions of excessive litigation. 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.

Similarly, North Carolina’s 1999 anti-predatory lending law included an anti-flipping provision applicable to all home loans originated in the state. The Center for Responsible Lending analyzed the North Carolina subprime market for the five years after the law became effective, 1999-2004, for its impact on litigation. It found zero instances of flipping claims.³¹ The North Carolina 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.

It is unclear what the source is of HUD’s conclusion that there are substantial legal costs associated with “defending” rebuttable presumption loans. Most homeowners will not have counsel to seek redress, the remedy is circumscribed, the amount of proof is substantial and the objective amount of litigation in this area is very small. We urge HUD to look behind claims of substantial compliance costs associated with a rebuttable presumption.

V. A Rebuttable Presumption for More FHA Loans is Needed Because FHA Lending Standards Still Leave Room for Unaffordable Lending

HUD’s proposed rule observes that while a safe harbor limits the ability of homeowners to challenge problem loans, this risk is outweighed by the purported additional savings in loan costs offered by the safe harbor (due to the increased litigation they would face under a rebuttable presumption). The discussion above regarding litigation risk makes clear that the additional cost, if any, would not be justified by any significant litigation risk. Accordingly, it is essential to address the question of whether the ability to bring rebuttable presumption claims for FHA loans that the lender knew or should have known were unaffordable at inception is important to maintaining a safe and affordable market.

One area where FHA guidelines include gaps that allow some borrowers to receive patently unaffordable loans is the streamline refinance program. While the program provides needed access to capital for many homeowners, the guidelines assume that a borrower making payments on the previous loan can actually afford those payments. It does not account for instances where the previous loan’s payments were paid out of proceeds from that loan (and therefore out of equity from the property). While we support the application of the Qualified Mortgage points and fees cap to streamline refinancings, the safe harbor will promote exploitation of underwriting loopholes.

For example, in 2009, a bank made a loan to Ms. H – an elderly woman living on \$1,125 Social Security in Chicago – which she could not afford to pay.³² This 2009 loan, which required monthly

³¹ Center for Responsible Lending, *Flipping Prohibitions in North Carolina Elicit No Substantial Litigation*, (May 7, 1994), available at http://www.responsiblelending.org/north-carolina/nc-mortgage/research-analysis/S-P_research0504.pdf.

payments of principal and interest of \$1010 a month, refinanced a 2008 FHA loan purchased by the bank. The 2008 loan was based on income—purportedly a pension--that Ms. H never actually had. The 2009 refinance was with an FHA Streamline Refinance product, which did not require either an independent verification of income or an assessment of affordability. As a result of the reliance on the payments on the previous loan, the underwriting guidelines for the streamline refinancing allowed this unaffordable loan to be made. These facts are not unique; a safe harbor would insulate lenders from any liability even where the lender knew or should have known that the homeowner could not afford the FHA loan.

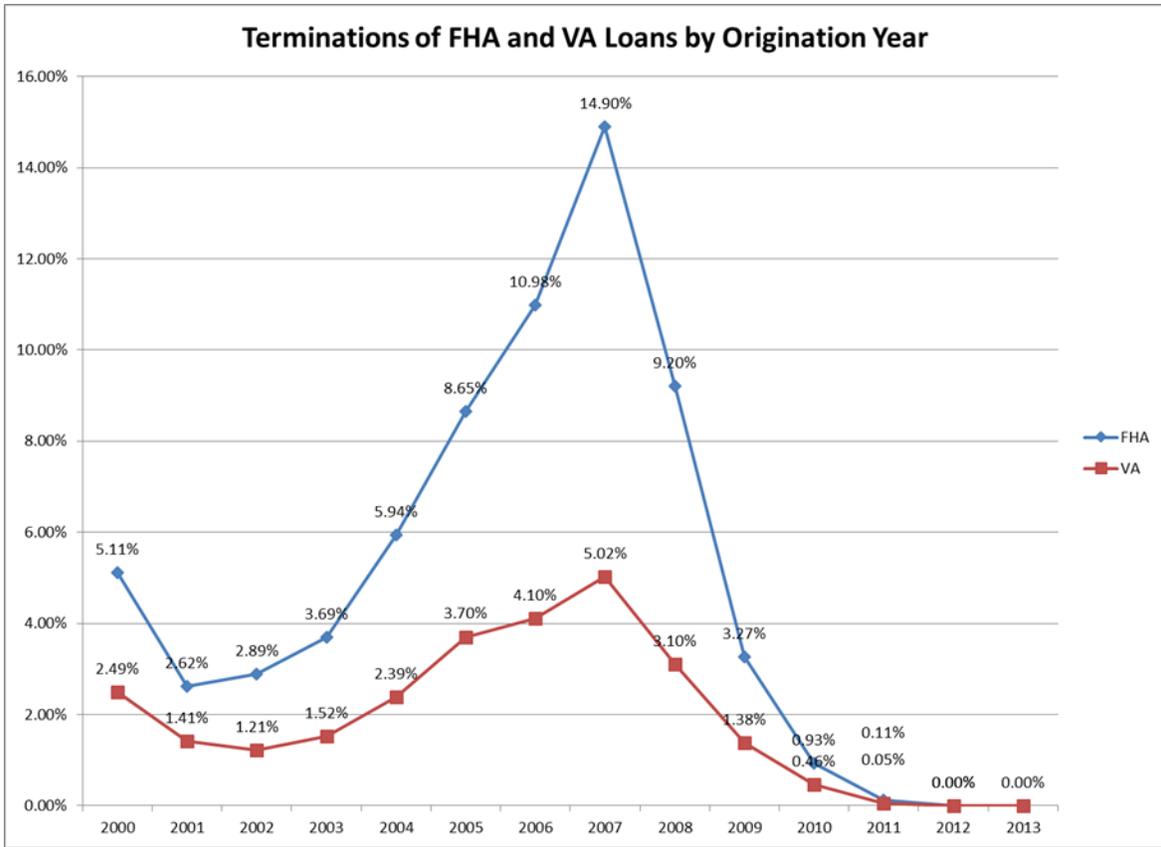
Some of the FHA compensating factors, while providing important access to credit for some borrowers, can also be gamed to make lending available on terms some borrowers will not be able to afford. For example, while for many homeowners a downpayment of 10% may be indicative of a loan that is less likely to result in a default (because this ability to save is often correlated with the means to properly budget for future payments), it is not a foolproof measure of affordability. Additionally, the compensating factor of the potential to earn higher income due to education or professional training does not automatically result in an income high enough to justify an increased payment. A rebuttable presumption for loans associated with compensating factors would leave room for homeowners to pursue the promise of affordable housing through FHA’s lending program when the actual guidelines did not deliver. FHA should also publish further analysis regarding default and foreclosure rates of loans associated with compensating factors, in order to increase understanding of the effects of compensating factors. Our recommendation below to incorporate residual income analysis into FHA underwriting also would diminish the weaknesses in the compensating factors.

A look at FHA loan performance trends underlines the need to have a rebuttable presumption option for FHA loans. FHA loans have consistently had a higher termination rate, across all FICO categories and all years, than VA loans (originations in recent years are too new to provide meaningful data).³³ This difference seems most likely attributable to more rigorous underwriting standards incorporated in VA lending.

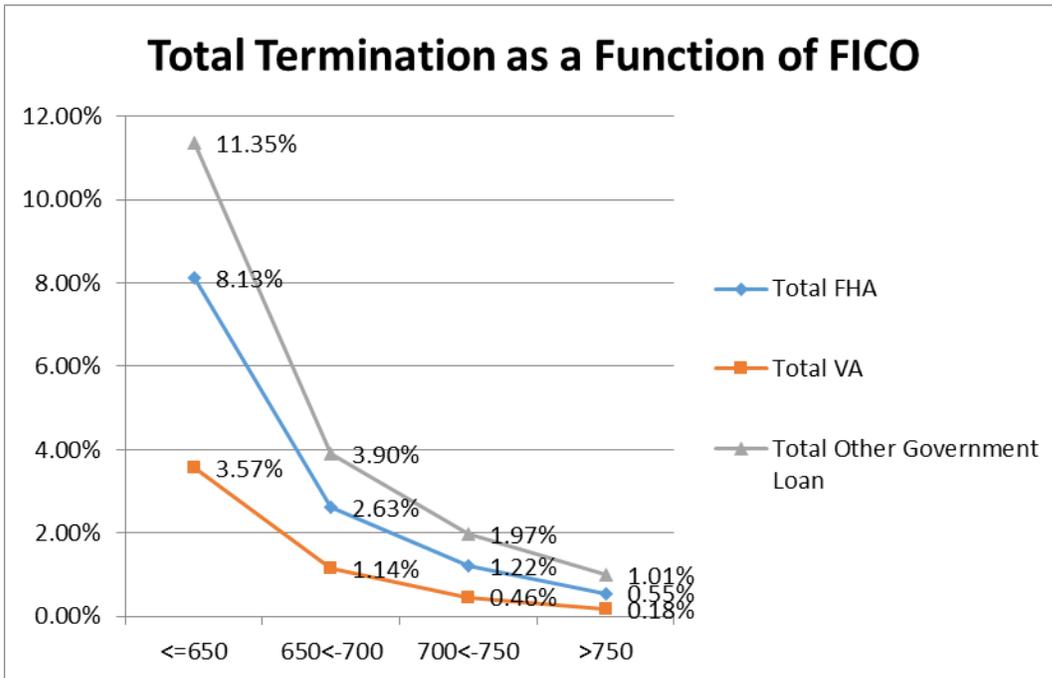
³² The essential facts of this case are that Ms. H owned her home free and clear before 2004. She then entered into five successive mortgages in a period of about 4 years. Each mortgage, except the last, produced a significant amount of cash to Ms. H, which she apparently used to cover the mortgage payments until she was able to refinance. The payments required for each mortgage exceeded her income from Social Security. In the chart below, Ms. H’s Social Security income is compared to the payments required for principal, interest and escrow for each mortgage and presented in a debt-to-income ratio.

<u>Date of Loan</u>	<u>Lender Name</u>	<u>Loan Amount</u>	<u>Monthly Housing Payments</u>	<u>Debt-to-Income Ratio</u>
10/25/04	redacted	\$75,000	\$662.98	72.35%
11/9/06	redacted	\$127,500	\$1,155.68	119.82%
5/17/07	redacted	\$139,500	\$1,038.87	102.32%
6/9/08	redacted	\$155,295	\$1,095.07	102.46%
1/26/09	redacted	\$157,624	\$1,008.85	89.79%

³³ CoreLogic Prime Servicing Data, Urban Institute Calculations.



¹ CoreLogic Prime Servicing Data, Urban Institute Calculations.



¹ CoreLogic Prime Servicing Data, Urban Institute Calculations.

VI. HUD and FHA Should Adopt Additional Measures To Promote Sustainable Lending

Whether or not HUD pulls back on the breadth of its safe harbor (and we strongly encourage HUD to do so), additional measures should be adopted alongside the Qualified Mortgage implementation to promote sustainable FHA lending and better FHA compliance.

First, HUD's underwriting and QM rules should include clear underwriting requirements, including regarding compensating factors, and sufficient guidance on how to rebut presumption of compliance with such rules, so that government actors and private citizens can adequately hold lenders accountable for noncompliance. We support adoption of standards beyond a straight debt-to-income ratio, however compensating factors should be drawn narrowly enough to ensure that proof of compliance is clear and that predictably unaffordable loans do not fall within the purview of FHA. Adoption of a residual income test would substantially improve the sustainability of FHA lending, particularly for low-income borrowers.³⁴

Second, because markets are dynamic and legal protections must stay flexible to react to developments, any final rule should make clear that it does not preempt state claims for lending abuses. State enforcement of fair and responsible lending is essential to prevent unintended consequences.

Third, because government enforcement is a key component of securing widespread industry compliance with regulation, HUD should engage in active oversight of FHA lending, including of direct endorsement lenders, with aggressive consequences for non-compliance. This oversight should include proactive resolution of consumer complaints, including requirements for lenders and servicers to document responses to consumer complaints. Oversight should also include data collection (and transparent reporting) to monitor the effect of FHA lending policies. For example, as suggested above, FHA should collect, examine and publish default and foreclosure rates of loans associated with specific compensating factors, in order to increase understanding of the effects of compensating factors.

Fourth, homeowners must not lose their homes if FHA rules have not been followed. This can be accomplished through several mechanisms including: inclusion of a provision in the FHA Model Note Form that the homeowner is a third party beneficiary; inclusion in the FHA Model Note Form a provision explicitly incorporating FHA lending and servicing standards; and regulatory provisions allowing noncompliance with FHA standards as a defense to a judicial or non-judicial foreclosure.

Fifth, rigorous loss mitigation requirements and compliance with those rules is essential to a sustainable system. HUD should fully review its loss mitigation options and compliance programs to maximize beneficial outcomes for homeowners, communities and the FHA insurance fund. A clear handbook containing all loss mitigation requirements should be issued (to replace the complex network of mortgagee letters setting out FHA loss mitigation policy) and servicers should face sanctions and/or withholding of FHA insurance payments for substantial noncompliance with FHA

³⁴ For a discussion of why residual income can be a better measure of affordability than a straight debt-to-income ratio, see Michael E. Stone, et al., *The Residual Income Method: A New Lens on Housing Affordability and Market Behaviour* (2011), available at http://works.bepress.com/michael_stone/8.

servicing guidelines. FHA also should ensure that any loans sold as part of the distressed asset sale program have first received full processing through FHA's loss mitigation tree.

Finally, any difference within the FHA QM standards, such as those proposed by HUD distinguishing between safe harbor and rebuttable presumption loans, should be keyed to a bright line standard, not a rate cutoff that incorporates a floating MIP component. Clear standards will simplify lender implementation as well as compliance oversight and accountability. If HUD chooses to stay with a two-tiered system, the cut-off for FHA QM loans should not differ from other loans subject to the Consumer Financial Protection Bureau's rules. The higher threshold proposed by HUD would promote the migration of abusive loans into FHA because the safe harbor would be available in instances where the lender could not avail itself of that protection through other channels.

VII. Conclusion

Thank you for the opportunity to comment on HUD's Qualified Mortgage Rule. For further discussion, please contact Alys Cohen, Staff Attorney, at acohen@nclc.org or 202-452-6252.