LouisianaBankers
ASSOCIATION

DATE: August 13, 2014

TO: Assistant Director Dan Smith and Deputy Assistant Director Elizabeth Ellis of the CFPB Office of Financial Institutions

FROM: Joe Gendron, LBA Director of Government Relations

RE: Follow-up from CFPB Briefing to LBA on July 23 in Washington, D.C.

I am writing to follow up on the briefing you provided to the Louisiana Bankers Association (LBA) on July 23 at the Mayflower Hotel in Washington D.C. First off, LBA would like to thank you for attending the briefing, and for listening to the concerns expressed by our bankers in attendance. We understand that CFPB had numerous rulemaking deadlines to meet in accordance with the Dodd-Frank Act, and that a number of rulemakings were issued in a short amount of time. We also appreciate your acknowledgment that CFPB will be revisiting some of these rulemakings, especially the definition of a “rural or underserved” area for the purposes of the small creditor and balloon loan Qualified Mortgage (QM) categories, as well as for the CFPB’s escrow rule.

During our meeting a number of issues related to the CFPB mortgage rules were discussed. LBA provides the following additional feedback on those topics:

Balloon Loan Characteristics

One aspect of our briefing that caused concern to our bankers in attendance was the confusion about the balloon loan product itself. Bankers and LBA staff walked away with the impression that CFPB staff believes that a customer of a balloon loan pays very little principal during the term of the loan. This is just not the case, and an issue that we want to help clarify with this paper.

Take the example of a $250,000 residential mortgage with an Annual Percentage Rate (APR) of 4.503% (interest rate of 4.5%): If a consumer were to get a 30-year fixed-rate loan, the amount of principal paid by the beginning of the 61st month would be $22,498.47, leaving a balance on the loan of $227,501.53. Similarly, if the consumer were to get a 5-year balloon loan with the same interest rate and 30-year amortization period, the amount of principal paid (and the resulting balance) by the beginning of the 61st month would be the same as that of the fixed-rate loan.

Compare the above with a 5-year balloon loan by a community bank with a 20-year amortization period, which is a pretty standard loan-term and amortization period for a balloon loan made by a community bank. At the beginning of the 61st month, the consumer with this balloon loan would have paid off $44,037.43 in principal and have a balance of $205,962.57. As you can see, the consumer will pay considerably more principal with the typical 5-year balloon product. Even if the interest rate were

considerably higher on the balloon loan than on the 30-year fixed-rate loan, the customer could still end up paying more principal with the balloon product. Also remember that often (if not most) times the consumer of a balloon loan does not qualify for a fixed-rate loan on the secondary market, so their only option may be a balloon loan or other loan product held in portfolio by a community bank.

Another aspect of the balloon loan product offered by community banks that needs clarification is the renewal. When the term of a balloon loan expires, our bankers tell us that they always renew the loan if the customer can continue to make payments. One banker on the trip told us that in 40 years of banking, he has always renewed a balloon loan that has become due for a customer that is current on payments. This is the sentiment expressed by all community bankers we have heard from. It just does not make sense for a bank not to renew the loan. Further, the renewal of a balloon loan held by a community bank in portfolio is a simple and inexpensive process for the customer. It is not the same process as the refinance of a conventional mortgage sold into the secondary market.

What do I mean by this? Community banks in Louisiana typically secure balloon loans with collateral mortgages or multiple indebtedness mortgages that secure the current loan, as well as future renewals. Further, it is our understanding that most (if not all) states have some form of mortgage device that secures future renewals. Therefore, when the balloon loan is renewed (after say 5 years) it is not necessary to execute and record a new mortgage agreement. Instead, the customer signs a new promissory note or executes a modification agreement that extends the maturity date of the existing note. The renewal process requires a minimal amount of new paperwork with either very minimal or no fees attached. We are told that historically a new appraisal has not been required if new funds are not advanced. Also, the renewal of the balloon loan does not result in the amortization period starting anew. Therefore, a balloon loan with a 5-year term and a 20-year amortization schedule that is renewed results in the loan essentially continuing on to year 6 of the amortization schedule. Another way to look at it is the 20-year amortization period becomes a 15-year amortization period when the loan is renewed. If the loan is renewed in another 5 years, the amortization period reduces to 10 years. This continues until the loan is paid in full after 20 years. Therefore, the customer continues to pay larger and larger amounts to principal every month.

This is very different from the refinance of fixed-rate loan sold into the secondary market that is secured by a conventional mortgage. In that case, the conventional mortgage is extinguished when the loan is refinanced. Therefore, the refinance requires the execution of a new conventional mortgage agreement, a new appraisal, new title work, a full round of new disclosures as required by law, and a substantial number of fees in order to close the loan. A refinance of a conventional mortgage loan also results in the amortization schedule starting anew from year one. In other words, the customer will start over paying substantially more in interest than principal during the first few years of the new loan.

If nothing else is gleaned from this memorandum, we hope to emphasize the vast difference between a loan secured by a conventional mortgage that must be refinanced with a new mortgage agreement, and a community bank balloon loan that can be easily and inexpensively renewed for the customer because it is secured by an existing collateral mortgage, multiple indebtedness mortgage, or a similar type of mortgage that secures future renewals.

Suggestions for QM Treatment of Balloon Loans

LBA believes that banks should continue to be able to make balloon loans held in portfolio without facing the increased potential liability that comes with making non-QM loans. Therefore, LBA strongly supports giving Safe Harbor QM protection to all loans that are held in portfolio by a bank. Banks that retain 100% percent of the credit risk have every incentive to make good loans that their customers have the ability-to-repay. Further, by using loan, asset or other arbitrary thresholds to determine balloon QM eligibility, you are giving a competitive advantage to some community banks to the detriment of other community banks. The result is an un-level playing field amongst community banks, and potentially fewer options for community bank customers.

If the above suggestion is not followed by CFPB, LBA encourages CFPB to make three necessary changes to the current rule as discussed further below:

(1) Raise the current loan and asset threshold for being a "small creditor". Currently, the CFPB defines a "small creditor" as an institution that has less than $2 billion in assets, and that originates 500 or fewer first-lien, closed-end, residential mortgage loans per year (together with affiliates). LBA and Louisiana bankers believe this definition is extremely limiting and keeps many community banks from qualifying as "small creditors". By excluding so many banks from the definition of a "small creditor", it creates a situation where many of these banks either may not make residential portfolio loans, or may curtail the number of residential loans they are making. This is a losing proposition for consumers who will have reduced mortgage credit opportunities. Many of these consumers may not have other options for financing a home.

LBA respectfully suggests that the asset-size threshold and loan threshold be significantly increased by CFPB in order to promote credit opportunities for consumers.

(2) Broaden the definition of a "rural or underserved" area for purposes of the CFPB mortgage rules. As discussed in our meeting, only about 1/3 of Louisiana parishes qualify as "rural or underserved" areas. This is surprising because Louisiana is an extremely rural and low-income state. LBA recommends significantly broadening the definition, and using a definition that does not exclude entire parishes or counties from being considered "rural or underserved". Many parishes and counties have both rural and populous areas, and we believe the definition should reflect this reality. We believe a good alternative to the current definition is the definition of "rural" that is contained in S. 798 by Sens. Brown and Vitter. It is our understanding that this definition is modeled after a definition of "rural" used by the USDA.

S. 798 defines a "rural" area as an area other than: (i) a city or town that has a population of greater than 50,000 inhabitants; and (ii) any urbanized area contiguous and adjacent to a city or town described in clause (i).

(3) One request made by Louisiana bankers during our meeting on July 23 was to grandfather portfolio loans that were originated before January 10, 2014, but subsequently renewed after January 10, 2014, from the CFPB Ability-to-Repay/QM requirements. This would allow bankers to continue to serve their customers who may be negatively impacted by the new rules. Similarly, in light of CFPB's action last

year creating a two-year temporary balloon loan QM category for all small creditors (regardless of whether they predominantly serve "rural or underserved" areas), it seems necessary to also grandfather balloon loans made between January 10, 2014 and January 10, 2016. The rationale being that some banks that are making QM balloon loans now under the temporary balloon loan QM category will not be able to obtain QM status on those loans when renewed after January 2016. This is presuming that some definition of "rural or underserved" continues to be used by CFPB.

Without some type of grandfathering provision, bankers may be reluctant to renew loans that will not qualify for QM status. Again, the end result is the customer is harmed, and these customers may not have other mortgage credit options.

120-Day Foreclosure Rule Feedback

As discussed at the meeting on July 23, much confusion remains concerning the 120-day period required before foreclosure proceedings can begin under the CFPB's mortgage rules. Questions include how many payments the consumer must be behind on day 120 after initially defaulting on the loan in order for the creditor to begin foreclosure? For instance, does the borrower only need to be one payment behind (30 days delinquent), or do they need to be five payments behind (120 days delinquent)? Interpretative guidance is absolutely necessary to answer many of these questions, and we encourage CFPB to provide such guidance as soon as possible to prevent further confusion, reduced credit opportunities for consumers, and unnecessary litigation.

Risk Management

LBA wants to reiterate feedback given during the meeting regarding the importance of balloon loans and other types of portfolio loans for community banks to be able to mitigate their interest rate risk. For loans that are not sellable in the secondary market, banks take on both 100% percent of the credit risk and 100% of the interest rate risk. If rates rise suddenly and significantly, banks can face considerable safety and soundness threats if they do not have the tools to minimize their interest rate risk. The use of balloon loans is one way for banks to effectively manage their long-term, interest rate exposure. Yet again, if banks cannot safely make balloon loans or other portfolio loans (both from a potential customer liability and interest rate risk perspective), the likely result is reduced mortgage credit options for consumers.

It is also noteworthy that balloon loan products can be more flexible and advantageous to consumers in dealing with interest rate changes. For instance, in an environment where interest rates are falling, consumers obtain the benefit of a reduced interest rate when the balloon loan is renewed. In a rising interest rate environment, the balloon loan still may be more advantageous than an adjustable rate mortgage (ARM) because the balloon loan interest rate will only adjust upward after each loan term (generally between 3-7 years), while most ARM loan interest rates adjust every year after the initial term of the ARM expires. In these situations, the more frequent interest rate adjustments with the ARM loan will result in more interest expense to the consumer.

Thanks for your consideration of our feedback. Please let me know if you have any questions or need additional information by emailing me at Gendron@lba.org or calling me direct at (225) 214-4837.

CC:

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