

ABILITY TO REPAY STANDARD

AARMR's Advisory Council thanks the AARMR Board of Directors for the opportunity to share our thoughts on how mortgage regulators should examine for a lender's determination that their borrowers have a reasonable ability to repay a loan. In doing so, we strongly urge AARMR to adopt criteria that are consistent with federal standards so that mortgage lenders regulated at the state level operate on a consistent basis with their federally-regulated counterparts.

Underwriting is the cornerstone of responsible lending. Lenders have every incentive to properly underwrite a borrower's ability to repay a mortgage loan since they bear the risk of loss. In the event that loans fail, lenders can be forced to repurchase them, investors who have put loans back to the lender could decide to no longer do business with that lender and the lenders reputation could suffer. For these reasons, lenders take care in considering and evaluating a number of different factors when determining a consumer's ability and willingness to make their mortgage payments – across market sectors.

Generally speaking, prudent underwriting standards require a lender to have a documented methodology (which has been approved by senior management) which enables its underwriting employees to make a reasonable determination that the borrower can repay the loan. This methodology for real estate secured loans should reflect all relevant factors which have a bearing on the capacity of the borrower to adequately service the debt. A lender should not extend a mortgage loan to a borrower unless a reasonable lender would believe at the time the loan is made that the borrower will be able to make the scheduled payments associated with the loan.

It is important that standards or examination guidelines adopted by AARMR allow the lender appropriate flexibility to make individual evaluations based on the interactions between a multitude of different factors used in underwriting a loan. Without such flexibility, a significant number of borrowers will be excluded from the home loan process. This concern can not be overstated given current market conditions. Examiners should review the lender's approved methodology and its safeguards it has in place to determine the approved methodology is being properly used by its employees, rather than individual loan outcomes.

CONSIDERATIONS IN PERFORMING AN ABILITY TO REPAY ANALYSIS

In creating a methodology to measure an ability to repay analysis, each lender uses a different combination of characteristics, which might include the borrower's credit history,¹ loan-to-value ratio, debt-to-income ratio, payment-to-income ratio,² the borrower's employment status,³ current income,⁴ reasonably expected future income,⁵

¹ Credit history analysis may include evaluation of that lender's internal credit scoring models, commercial credit scores, FICO score, experience with that lender, payment history and/or other factors.

² See separate discussion of debt-to-income / payment-to-income ratio.

³ Analysis of employment status may also include consideration of length of employment and/or type of employment.

occupancy status, property value stability analysis, payment history on existing mortgage, payment history with this lender, other relationships with this lender, residual income, other assets/net worth, other available financial resources,⁶ borrower's explanation of credit history blemishes, the borrower's current obligations, including other secured and unsecured debts, etc.

In creating its methodology, each lender assigns different weights to the characteristics it considers and each lender make different trade-offs between strengths on one characteristic against weaknesses on another. This is carefully done to match the individual lender's appetite for risk, expense load for originations, and cost of funds with a desire to maximize the volume of loans that can be done within the parameters allowed by the lender's methodology at an acceptable level of default. An examination formula that sought to specify a definitive list of such characteristics, weights and trade-offs would essentially amount to picking one lender's formula over all others. This would mean that many potential borrowers who might have received a loan under another lender's formula would be denied credit.

Note also that while it is theoretically possible to set an underwriting methodology to yield a default level approaching zero, no lender does so because it would exclude far too many borrowers that should have been able to receive a loan. The methodologies are set to yield an expected default level based on the lender's internal ability to manage risk. Remember that at the margin a 3% default rate means 97 out of 100 borrowers are making their payments. If the margin is raised, all 100 do not get a loan.

⁴ In evaluating current payment levels based on current income, necessarily a question arises about how a lender should look at future payment amounts. The Federal Guidance says that financial institutions should assess repayment ability by using the "fully-indexed rate, assuming a fully amortizing repayment schedule." The Guidance defines "fully-indexed rate" as "the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate." AFSA members are complying with the federal guidance and we agree that it may be imprudent to determine repayment ability solely using an introductory rate that is significantly below the fully-indexed rate. However, in some instances using a "fully-indexed rate, assuming a fully amortizing repayment schedule" would distort the explanation of the risk associated with the product. For example, using a fully-indexed rate would mean that a borrower would be less likely to qualify for a 10/1 hybrid ARM with a 20-year amortization beginning in year ten than a 2/28 product—even though generally the 10/1 hybrid ARM would be considered a less risky loan.

⁵ AARMR, in conjunction with CSBS, previously asked subprime guidance commenters to address whether the assessment of repayment ability after the introductory period should be made based on the borrower's income at the time of application, or whether financial institutions may take into account the possibility that the borrower's income might rise at some point in the future. As with the question of whether lenders should assume that borrowers will only make minimum payments, our view here is that establishing a rigid rule that requires lenders to assume the worst case scenario would be unnecessarily conservative. Of course, the income of some borrowers will not increase appreciably over time. Lenders are aware of this possibility and endeavor to predict the probability of this realistic, but relatively uncommon occurrence among all borrowers. However, lenders should have the flexibility to use sound underwriting techniques and empirical data to consider the likelihood and implications of this.

⁶ This would exclude the borrower's equity in the principal dwelling that secures or would secure the loan.

DEBT-TO-INCOME / PAYMENT-TO-INCOME RATIO

There is no “magic bullet” to determine a proper debt-to-income ratio for a borrower. Many years ago (prior to now near universal use of sophisticated automated underwriting systems) this approach was used more extensively. The Government Sponsored Entities used to use a fairly simple 28%-32% PITI-LTD/PITI to Income ratio as an automatic qualifier, but there were lots of exceptions for other compensating factors. Today, the use of automated underwriting systems makes LTD/PITI ratios exceeding 50% fairly common because it has been determined that the debt-to-income ratio is not a particularly determinative factor (especially taken by itself) in the analysis of the borrowers ability to repay the loan.

In this area, California regulation recognizes the need for flexibility and case-by-case analyses in order to prevent discrimination. Thus, a financial institution’s underwriting standards should reflect the increasing percentage of income that must be devoted to housing expenses for some consumers. “Overly restrictive or inflexible payment to income ratios may discriminate against low- and moderate-income persons who often must devote a greater percentage of their income to basic necessities such as housing. Any payment to income ratio should be applied with flexibility to allow for a case-by-case determination.” (Cal. Admin. Code title 21, § 7109.3)

Though we again emphasize the need for flexibility, we recognize that any institution’s underwriting analysis should include, among other things, an assessment of a borrower’s total monthly housing-related payments (*e.g.*, principal, interest, taxes, and insurance, or what is commonly known as PITI) and an assessment of other existing long term debt (commonly known as LTD) as a percentage of gross monthly income.⁷

⁷An important note on interest-only loans. Some interest only loans have interest only periods of ten years or longer. Although there are relatively few of these products right now, there might be more in the future. We think that as a general rule it is less important that lenders consider repayment ability after the interest-only period in connection with these types of loans. Lenders are not generally going to be able to predict the borrower's income level ten years or more in the future, so a lender making a repayment determination would generally have to consider the borrower’s current income. This will result in the disqualification of many borrowers who could benefit from these products, and to whom a loan could be made consistent with prudent lending standards. Even though a lender could not predict what the financial situation of the borrower will be in a decade or more, a prudent lender could become comfortable that the risk of the borrower defaulting in ten or more years when the loan begins to amortize is reasonably low. Over ten or more years, many things can happen: 1) There is a reasonable probability that the borrower's income will, in fact, increase; 2) Although property values can decline in value, as a general rule property values will increase over the long term, which means that a lender could reasonably conclude that there will be a net appreciation in the value of the property during the long introductory period (which would allow the borrower to refinance or sell the property if his or her financial situation at the end of the introductory period is such that he or she will not be able to manage the higher monthly payments), notwithstanding periodic fluctuations in value; 3) The borrower might refinance; 4) The borrower might sell the property. While the likelihood that any one of these individual events (or others) will occur is too speculative to be determined with certainty, a lender still might reasonably be able to conclude that the confluence of these factors makes it unlikely that the borrower will actually have to start making the higher monthly payments and be unable to do so. Accordingly, we ask that AARMR examination guidelines allow lenders some flexibility in making assessments about repayment ability in connection with interest only loans with long interest only periods.

INCOME VERIFICATION

We support documented income verification in most cases for simple wage earners. Stated income and reduced documentation loans to borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors should also be documented. Income documentation verification may include:

- Review of a borrower's tax returns, pay stubs / payroll receipts, or records of accounts from a borrower's financial institution, or reasonable third party verification thereof, in determining a borrower's ability to make the scheduled payments associated with the mortgage loan; or
- Review of reasonable alternatives to the borrower's tax returns, payroll receipts or records of accounts from a borrower's financial institution, or reasonable third party verification thereof, in determining a borrower's ability to make the scheduled payment associated with the loan. "Reasonable alternatives" include, but are not limited to, statements from investment advisors, broker-dealers and others in a fiduciary relationship with the borrower; and

Factors that may allow loans to be made without income document verification should include, but not be limited to:

- Refinance of an existing borrower or existing banking client to a lower monthly payment amount.
- Corporate relocation clients when referred by their employers.

CONCLUSION

- In conclusion, prudent underwriting methodology should require a lender to make a reasonable determination that the borrower has the ability at the time the loan is made to repay the loan reflecting all relevant credit factors. We urge AARMR to adopt ability to repay examination standards that focus on establishing that the lender's underwriting methodology has the flexibility to consider a multitude of factors in underwriting a loan. If AARMR adopts criteria that are too rigid, there is a significant risk of cutting off credit to many deserving borrowers. Any rules imposing requirements on underwriting requirements must be part of a holistic approach, be flexible, and reflect the recognition that a one-size-fits-all approach cannot address all consumers' situations and will deprive many deserving consumers of credit they actually can afford. In addition, it is important to realize that mandatory underwriting requirements – whether stated explicitly in guidance

or as interpreted by examiners – will constrain the development of new products and can easily become obsolete as economic circumstances change. We also urge AARMR to seek consistency with federal standards in all cases, so that state- and federally-regulated institutions may operate consistently.