TWO PERSPECTIVES

BY JANET REILLEY HEWITT

Senator Jeff Merkley Q&A

Playing a key role in shaping new limits on mortgage originator compensation, Sen. Jeff Merkley (D-Oregon) shares his thoughts on the new Dodd-Frank Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains some significant provisions that will dramatically affect the way mortgage originators can be paid in the future. The new law also requires all originators going forward to verify a borrower's ability to repay the loan based on a formal assessment of his or her income and assets, not including the home's value.

These sweeping changes are partly based on an amendment passed in the Senate and included in the Senate's version of the financial regulatory reform legislation. The amendment was sponsored by Senators Jeff Merkley (D-Oregon) and Amy Klobuchar (D-Minnesota). The Senate amendment was also co-sponsored by Senators Chuck Schumer (D-New York), Olympia Snowe (R-Maine), Scott Brown (R-Massachusetts), Mark Begich (D-Alaska), Barbara Boxer (D-California), Chris Dodd (D-Connecticut), Al Franken (D-Minnesota), John Kerry (D-Massachusetts) and Carl Levin (D-Michigan).

The Merkley/Klobuchar amendment contained two primary features—one prohibiting what was referred to as "secret steering payments" in a two-page description of the amendment. The description says the amendment would "ban mortgage lenders and loan originators from receiving payments based on the terms of the loans." The other component of the amendment is the one that will require all loan originators to ensure the borrower's ability to repay his or her loan.

The description of the senators' amendment states, "Documenting ability to repay would end the practice of 'no-doc' or 'liar' loans, which were an important element of the housing bubble." The provision requires lenders to assess the repayment ability based on the maximum interest rate allowed in the first five years of the loan.

Mortgage Banking caught up with Sen. Merkley in

Washington, D.C., in late July after the historic reform legislation had been signed into law by the president. We asked him about the provisions he was instrumental in getting included in the Senate's bill. Sen. Merkley serves on the Senate Banking, Housing and Urban Affairs Committee.

Q: *Thank you, senator, for taking time to do this.*

A: You bet. I'm delighted to chew on mortgage issues.

Q: *What of all the measures in the new law do you think will make the mortgage market less risky for borrowers?*

A: Well, I think there are three significant factors. And those are prepayment penalties, steering payments and liar loans. And let me touch on each of those.

I'll just give you my version of history here. In 2003, we had a new form of subprime, [and many of the subprime mortgages that were getting approved] essentially [had] a two-year teaser rate. [After the two-year period, the rate] then went up to a much higher interest rate.

And several things combined to drive that subprime market. One was the appeal of the teaser rate. A second is that folks assumed that they could refinance after two years. A third was people generally were not familiar with the prepayment penalty that occurred when they attempted to refinance. A fourth was that you have a situation where if a mortgage originator was receiving a big bonus to advocate for that type of mortgage, . . . [there] certainly was a sales incentive tied into that type of loan.

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And . . . that teaser rate became a two-year fuse. And it came into use on securities that incorporated many of these loans, [and] the securities blew up.

So having a steady interest rate in most cases, fully amortizing loans, 30-year fixed-rate mortgages, has so much less risk. And [by eliminating sales incentives to originate higher-risk loans] there's not a temptation for [originators] to sign up to do teaser-rate structures. There's much more stability for the economy as a whole having securities that do not have mortgages with that two-year [teaser rate]. It's also beneficial. So those three changes really addressed [the problems in the mortgage market].

I think having a process where everything is on the table in an honest and straightforward manner is not only a good decision-making process for families on what they can afford, but it's also good for the integrity of the market. . . . [These changes could help to] re-establish a vibrant security market for [mortgages]. . . .

Q: *Could you have accomplished the same thing by giving mortgage brokers and originators a fiduciary duty to the borrower? Talk to me a little about that.*

A: You could fully accomplish much of the same thing, but the feedback I have from mortgage originators and mortgage bankers, basically everyone in this field, was that because the outlines of fiduciary responsibilities are so vague, what constitutes it—that that would be a formula for everybody being in court continuously. We wanted to avoid that.

Q: *And in terms of your original amendment in the Senate-passed version of the legislation, did you get everything in the final conference-approved version that you had in that initial Senate amendment?*

A: Well, there were a lot of things that were adjusted along the way due to different points people brought up, . . . but let me just give you an example: We wanted to make sure that there was an accommodation for people who have seasonal employment, . . . we wanted to make sure that there was an accommodation for small-[balance] mortgages. A third would be we made an accommodation for streamline refinancing of mortgage loans.

And so as issues like that came up, we worked to try to find practical solutions to keep in place a structure that would place mortgages on a sound footing.

Q: *But you're happy that you pretty much accomplished what you set out to do in terms of both the ability to repay and the originator compensation provisions?*

A: Yes. Now, you mentioned the ability to repay. And that wasn't one of the three things I mentioned earlier when I talked about yield-spread premiums.

And just to get into the nuances for a minute before I address the ability-to-repay [requirement], for example, in the prepayment penalties, [there] is a [provision] that allows prepayment penalties on standard fixed-rate mortgages. But they're limited to three years, and they're limited in size.

But on the loans where people would be potentially tied into a teaser rate, then they're not allowed. So it's good protection. But I just wanted you to know it's not a single—you know, there's a little more nuance and detail to it than just a straight up-and-down [prohibition].

And in terms of ability to repay, I think one of the first lines [of defense] on this is the whole full-documentation [requirement]. But the second approach on this—and this really came from the House bill. This wasn't something we originated on the Senate side.

But the House bill was structured so if you did a series of things or [didn't do certain things, you were provided with a] legal safe harbor that protects each originator—in a way it's like a mini-fiduciary responsibility. But you have a safe harbor with details, so you know you're on solid ground.

And it gets a little confusing, because a lot of folks have talked to me thinking that certain practices are banned for certain—or that certain practices are required when, in fact, they're not. They're voluntary. But if you do that, it gives you a little safe harbor.

And those are things—and this is related to the ability-to-pay section—that says that you need to look at the debt-to-income ratio and other firm obligations. It has to be fully amortized [when you determine if the borrower has the ability to pay]. You have to verify the W-2s or tax forms, and so on and so forth.

There is also a provision that a lot of mortgage originators want to understand better. . . . Again, this is in the safe harbor, so this is not mandatory. But it gives you protection [as a qualified mortgage that is presumed to meet the ability-to-repay provision] if you fall [under the provision where the loan's total points and fees are] no greater than 3 percent of the [total loan amount].

But that does not include mortgage insurance, which is outside that framework. It doesn't include third-party fees, like appraisals. So that 3 percent actually is a much higher percent. . . . **MB**

> "Until the security markets revive, we're not [going] to interrupt or do damage to the only kind of functioning securities market that exists. And right now it's the GSEs."
>
> –Sen. Merkley

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