

A Smarter Qualified Mortgage Can Benefit Borrowers, Taxpayers, and the Economy

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Executive Summary

In the [Dodd-Frank Act](#), Congress required lenders to make a reasonable and good faith determination that the borrower has the ability to repay a mortgage loan (ATR) before the loan is made. It also created a category of loans, called Qualified Mortgages, or QM, that are presumed to comply with the ATR requirement given product and borrower credit characteristics that make the loans lower risk. The product protections for a loan to be considered a QM are outlined in the Act, and the credit characteristics are left to the Consumer Financial Protection Bureau (CFPB) to determine.

In setting the borrower credit characteristics, CFPB established a debt-to-income ratio (DTI) limit of 43% for QM loans and also provided three exceptions to permit lenders to obtain QM status while making loans above 43%. First, loans insured by the Federal Housing Administration, Rural Housing Services, and Veterans Administration would be covered instead by rules those agencies develop. Second, community banks that hold loans in portfolio would automatically receive QM status regardless of DTI, since these loans have historically performed well. Finally, since CFPB wanted to permit higher DTI loans with compensating factors but did not want to prescribe detailed underwriting criteria itself, it exempted loans eligible for purchase or guarantee by Fannie Mae or Freddie Mac (the government-sponsored enterprises, or GSEs) from the DTI limitation for seven years or until the GSEs cease to be in conservatorship.

In the absence of the GSE provision, called the GSE Patch, almost 19% of the loans guaranteed by the GSEs over the last five years—3.3 million loans—would not have been QM. Letting the Patch expire on schedule in January 2021 and subjecting these loans to a flat 43% DTI limit would thus have a dramatic impact on mortgage lending in the country.

[This paper explores how the QM rule should be revised once the QM patch expires.](#)

The central purpose of the QM provision is to push the mortgage market towards safer loans and, as stated in the statute, “ensure that responsible, affordable mortgage credit remains available to consumers,” which is good for borrowers, taxpayers, and the economy. A report recently issued by CFPB on the effects of the rule to date makes it clear that QM has succeeded in meeting this objective thus far, but that it no longer would if the Patch is allowed to expire without further action. Were the Patch to expire, many borrowers who today qualify for a QM loan would find themselves ineligible due to the 43% DTI limit, forcing them out of the mortgage market altogether or into more expensive and riskier products. As a result, there would be a steep decrease in lending at all income levels. This would cause significant disruption in the housing market and throughout the broader economy, and many creditworthy lower-income and low-wealth borrowers would no longer be able to access the most sustainable types of loans.

This social and economic disruption can be avoided. A number of recent studies, including data presented in CFPB’s report, demonstrate that DTI *on its own* is only minimally predictive of risk for prime- and near prime-priced loans (which this paper calls “near-prime loans”).¹ These findings are robust and include evaluations of loans that went through the financial crisis. The studies show that *DTI alone is so weakly predictive for near-prime loans that for a thousand borrowers between 45% and 50% DTI, just two additional borrowers default compared to loans between 40% and 45% DTI, not nearly enough to warrant denying QM protections to the remaining borrowers.* The same minimal increase in defaults would apply if CFPB established higher limits. And when the lender requires off-setting, compensating factors on higher DTI loans, risk does not rise at all.

As a result, DTI should not be used on its own to deny QM product protections to near-prime borrowers. If CFPB applied a hard 43% limit, it would be using a single, weakly predictive and poorly measured variable to impose significant litigation risk on lenders. CFPB would be telling private capital providers, in essence, that the government will not permit them to put their own capital at risk on near-prime loans with higher DTIs—given that guaranteeing non-QM loans is for many a prohibitive legal risk—even though the data show that many of these loans pose little credit risk. It is not clear what problem CFPB would be solving, as there is no indication that lenders need the government to tell them what level DTIs need to be when making near-prime loans to their customers.

There is thus little basis for allowing the Patch to expire without further action. Instead, CFPB should choose an approach that allows lenders to rely on holistic underwriting for near-prime loans with the QM product protections. This will ensure that QM serves its goals of protecting mortgage borrowers while making access to affordable credit widely available—rather than relying on a single, often mismeasured, variable. This paper presents two such alternatives:

- **Allow lenders to use compensating factors for near-prime loans.** The first proposal is for CFPB to keep its 43% DTI QM limit and replace the exception for GSE loans with an exception for near-prime loans. Thus, fully documented near-prime loans that meet the QM product protections, just like GSE loans under the Patch and community bank portfolio loans, are QM without an explicit DTI limit. But higher-rate loans, which suggest higher delinquency risk and greater borrower dangers, are subject to the 43% limit.
- **Validated model approach.** The second alternative is the same as the first, but near-prime loans over 43% DTI cannot be considered QM unless the lender uses a validated underwriting model with statistically-predictive compensating factors, including DTI or residual income, to distinguish which higher DTI loans to make.

Under both proposals, the safe harbor would continue to apply to QM loans below 150 basis points over the average prime offer rate (APOR) and the rebuttable presumption at or above this limit. As proposed here with the 43% DTI limit for higher-rate loans, there is significant regulatory precedent to providing greater restrictions on mortgage loans with higher pricing over the APOR benchmark due to substantially greater risks to borrowers of these loans. Through the DTI limit, the proposals encourage lenders to provide the safest types of mortgage loans—near-prime, amortizing loans with low fees and the most favorable interest rates—to creditworthy borrowers.

DTI (or residual income, if it becomes more predictive than DTI in the future) remains an important component of good underwriting; it just should not be the only one taken into account for near-prime loans. Under these two approaches, CFPB would set the QM requirements, not the Federal Housing Finance Agency (FHFA). FHFA could still set whatever DTI limits it deems appropriate on the GSEs based on its assessment of risk, borrower leverage, or the appropriate size of the government footprint. And lenders and mortgage risk-takers will set whatever DTI limits they choose for business reasons, constrained by the fact that loans with near-prime interest rates can only permit low defaults given their limited interest rate earnings.

The question is whether CFPB will allow private lenders to use their sophisticated multi-variate automated underwriting models that include DTI as a factor along with their own risk tolerances to decide which near-prime customers they can serve, or whether CFPB will restrict them to a single, weakly predictive variable, no matter the actual strength of the loans they are considering. While each of the two approaches presented

in this paper has different advantages and disadvantages, both would be vastly more effective at meeting the central objectives of QM than simply letting the Patch expire. In any case, CFPB will need to temporarily extend the Patch while it develops an alternative to allowing the Patch to expire. If CFPB chooses the validated model approach, it would take time to put it into effect. In that case, CFPB should implement the simpler first proposal in the interim.

The Origin of the Qualified Mortgage

In the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), Congress required lenders to make a reasonable and good faith determination, based on verified and documented information, that the borrower has the ability to repay a mortgage loan (ATR) before the loan is made. Congress established the ATR standard to correct widely documented failures by mortgage lenders before the crisis to underwrite and process mortgages properly. Lenders that violate this requirement are subject to damages under the Truth in Lending Act. Congress also created a category of loans, called Qualified Mortgages or QM, that are presumed to comply with the ATR requirement, given a combination of product and borrower credit characteristics that make the loans lower risk.

The Act explicitly defines the product characteristics necessary to be considered QM. To qualify for QM status, a loan cannot:

- Be interest-only or negatively amortizing;
- Have fees that add up to more than 3% of the size of the loan;
- Have a balloon payment; or
- Have terms of greater than 30 years.

If the loan is an adjustable-rate mortgage (ARM), it must be evaluated at the maximum possible rate for the first five years to protect against deceptive teaser rates. In combination with the Act's requirement that lenders verify borrower income, employment, and assets, these product protections address many of the lending weaknesses that led to high defaults during the crisis.

Rather than similarly defining the required borrower credit characteristics, the Act assigns the CFPB to set any such requirements through rule-making. Effective January 2013, CFPB did just that.

In determining QM's borrower credit characteristics, CFPB focused on the ratio between a borrower's total monthly debt obligations, including mortgage payments, and their income. This is the debt-to-income ratio, or DTI, which is a commonly-considered indicator of the risk that the borrower will be unable to continue making his or her mortgage payments. CFPB established a DTI benchmark of 43% DTI, which it called the General QM test. A loan with a 43% or lower DTI that meets the product requirements is automatically QM.

CFPB also provided three exceptions to the general test to permit lenders to obtain QM status while making loans with DTIs above 43%. First, loans insured by the Federal Housing Administration (FHA), Rural Housing Services (RHS), and Veterans Administration (VA) would be covered instead by rules those agencies develop, which permit higher DTI loans. Second, community banks that hold loans in portfolio would automatically receive QM status regardless of DTI, since these loans have historically performed well.² Finally, CFPB wanted to permit higher DTI loans with compensating factors but did not want to prescribe detailed underwriting criteria itself. CFPB therefore exempted loans eligible for purchase or guarantee by Fannie Mae or Freddie Mac from the DTI limitation for seven years (until January 2021) or until the GSEs cease to be in conservatorship, whichever comes sooner. The GSE category is called the GSE Patch.

For loans subject to the 43% DTI limit or the GSE Patch, CFPB distinguished the strength of the presumption of compliance with ATR based on the costs of the loan. For a QM loan with an annual percentage rate (APR) exceeding APOR by 1.5 percentage points or more, the presumption of compliance with ATR is rebuttable. That is, the borrower has the opportunity to show that the lender failed to make a reasonable determination of his or her repayment ability before making the loan. For QM loans below this rate, the presumption is a conclusive safe harbor. This means that the lender that made the loan automatically wins a lawsuit initiated by a borrower, provided that the lender can demonstrate it, in fact, made a loan according to the QM requirements. CFPB made this distinction on the strength of the presumption for two reasons: (1) loans with both the safest terms and favorable interest rates are easier to repay; and (2) a lower rate typically indicates that the lender has determined that the borrower's credit risk is low, meaning his or her ability to repay is high.

The Coming Qualified Mortgage Problem

If CFPB lets the Patch expire on schedule in January 2021, the 43% DTI limit will apply to all loans other than those insured by FHA, RHS, or VA or that use the small originator portfolio exemption. This would mean that almost 19% of the loans guaranteed by the GSEs over the last five years—3.3 million loans—would have fallen outside of QM.³

Such a decrease in the number of loans that fall within the QM definition would have a significant impact on the market, because investors in credit risk have been reluctant to purchase non-QM loans for which borrowers have a right to sue their lender (and loan purchaser) if they default. In the absence of a demand to buy non-QM loans, few are currently being made.

Assuming that we would see a similar decrease in loans made with greater than 43% DTI that today are guaranteed by the GSEs, the expiration of the Patch would have a major impact on the availability and price of credit. Given this pending challenge, it is worth considering alternatives to a flat 43% limit.



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Goals of the Qualified Mortgage

The central purpose of QM is to push the mortgage market towards safer loans.⁴ This provides several benefits: it helps borrowers obtain sustainable loans, treats lenders fairly, and ensures that the economy avoids the disruption of widespread foreclosures.

The QM statutory product protections, such as limited upfront fees, full amortization, and up to 30-year terms, help borrowers sustain homeownership by making QM loans safer, on average, than loans that lack these features. Further, ARMs must be underwritten at their maximum rate for the first five years, which precludes the abusive 2/28 adjustable rate subprime loans common during the boom if such loans have a DTI limit. These product requirements provide borrowers with a consistent mortgage payment that avoids

the payment shocks prevalent in subprime and Alt-A lending during the run-up to the mortgage crisis. And because of reduced lender litigation risk, interest rates that borrowers receive are lower, which in itself improves borrower outcomes.

By incenting lenders to provide borrowers with these safer products, QM broadens access to the fundamental American opportunity to build wealth through sustainable homeownership.⁵ It fulfills Congress's purpose in establishing the qualified mortgage to "ensure that responsible, affordable mortgage credit remains available to consumers . . ."⁶ An overly restrictive QM definition would instead exclude exactly those families that QM was designed to protect. This could recreate the dual market of safe products for some and risky and more expensive loans for others that prevailed during the subprime boom, including loans with high equity-stripping fees, interest-only and negative amortization features, balloon payments, and 2/28 adjustable interest rates. Those families hurt the most by the housing crisis—lower-income people and people of color—should not be excluded from the QM market.

That said, loans that do not meet QM standards should still be available, because these riskier products do make sense for some borrowers. For example, interest-only loans are appropriate for borrowers who can expect a hefty increase to their income on a pre-determined schedule, e.g., medical residents who will become doctors. These types of borrowers can handle the payment shock that occurs when the mortgage begins amortizing over a shorter remaining term. Lenders should, however, have a much higher degree of accountability when offering non-QM loans to encourage them to carefully assess a borrower's ability to succeed with riskier terms. As a result, non-QM loans should remain niche products for niche segments of the market, with lenders taking full responsibility for underwriting them.



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The Impact of the Qualified Mortgage Rule so Far

To date, CFPB's rule has succeeded in incenting the market to make safer loans, with the vast majority of loans made since its implementation appropriately falling within one of the QM categories.

This result has protected borrowers from unsustainable loans. CFPB recently issued its *Ability-to-Repay and Qualified Mortgage Rule Assessment Report* (the Report), a thorough and well-researched review of the impact of its 2013 ATR and QM rules.⁷ CFPB uses the early default rate for mortgages as a reasonable proxy for whether borrowers have demonstrated an ability to repay the loan, which is similar to other researchers' methodologies.⁸ Through the combination of these product and CFPB's borrower credit characteristics requirements and exemptions, the Report finds that, in admittedly strong economic times, borrowers who took out QM loans since the rule became effective have largely been able to repay them.⁹

What would the costs have been if there were no GSE Patch?

When CFPB issued its rule, there was significant uncertainty about what an appropriate cutoff should be or what market reaction might occur. Permitting the GSEs to exceed the 43% limit in the presence of compensating factors through the GSE Patch while limiting DTIs in the jumbo market (the high loan balance segment that is not eligible for the Patch) permits robust analysis of higher DTI lending and the market impact of a particular cutoff. What would have happened if CFPB had never instituted the Patch and the 43% DTI limit applied instead to the entire market? CFPB's Report and other recent data help answer that question.

The first conclusion from data presented in the Report and elsewhere is that applying the 43% DTI limit across the board would have caused many creditworthy borrowers to have been denied access to loans at all or to have paid higher prices for riskier products. This would have created substantial market disruption, and this conclusion is demonstrated by looking at the jumbo market. The strict 43% DTI limit applies to these loans, with no ability for lenders to weigh the presence of compensating factors in evaluating the strength of the loan as a whole.



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Many commentators speculated before CFPB issued its rule that lenders would still make strong loans that did not meet QM requirements, even given the greater litigation risk. In general, they have not. *The Report finds there to be "sharp reductions in access to credit" in precisely the non-QM market:* "The Rule eliminated between 63 and 70 percent of non-GSE eligible [jumbo], High DTI loans for home purchase over the period of 2014 to 2016 . . ." The CFPB Report further determines that these loan rejections were based on lender fears of litigation for non-QM loans, rather than a belief that the borrowers lacked the ability to repay the loans.¹⁰

One would expect a similar market reaction among loans eligible for the Patch in the conventional market if much of the existing market were moved to the non-QM segment. Just as with jumbo loans, a substantial portion of these loans would simply not be made. To the extent lenders offered them, these loans would have higher prices to compensate for the increased litigation risk and, without the QM product protections, have riskier terms.

If the loans were available, the pricing differences would likely be significant. The CFPB Report finds that the interest rates on non-QM loans are 1.19% higher than on QM safe harbor loans with otherwise identical characteristics. This makes the interest costs \$9,500 more on a \$200,000 non-QM loan over a four-year period, while other research finds the interest rate difference to be 0.30% to 0.40% higher.¹¹ In addition, some of these loans would likely shift from the GSEs to FHA. The result would be reduced borrower choice and significantly increased taxpayer risk, given that FHA insures 100% of loan losses, while the GSEs generally require private mortgage insurance for high loan-to-value loans and sell off significant credit risk on most of the loans they guarantee to private investors through their credit risk transfer programs.¹²

Removing anywhere near the 3.3 million loans that the GSEs guaranteed over the previous five years through the Patch from the mortgage system would create significant economic disruption in a recovering

housing market and throughout the broader economy.

The second conclusion from published data is that, with a hard 43% cutoff, lower-wealth families, including families of color, with a strong ability to repay would have been more likely than others to be excluded from the QM market. They therefore would have been unable to obtain loans at all or been forced into more expensive and riskier types of loans.¹³ This is because borrowers with high

DTIs are disproportionately low-income, low-wealth, and borrowers of color. At a given monthly mortgage payment, it is very likely that families with lower incomes will have higher DTIs. Additionally, at a given house price, families with lower wealth who can only afford to make smaller down payments will have higher DTI ratios than borrowers at the same income level who, through savings or family support, can afford larger down payments.

This prediction of exclusion is borne out by the numbers: as estimated by the Urban Institute, African American and Latino families are *1.5 times* more likely to have DTIs over 45% than White families.¹⁴ In a subsequent paper, using GSE loan-level data, Laurie Goodman determines that African American borrowers are 29% more likely, and Latino borrowers 38% more likely, to have an over 43% DTI loan than all borrowers. In addition, Goodman determines that the income of borrowers of all races and ethnicities with DTIs over 43% is 10% to 15% lower than the income of borrowers with DTIs less than or equal to 43% DTI.¹⁵

The fact that low-to-moderate income borrowers and families of color with a strong ability to repay would be excluded from QM product protections by a hard 43% cutoff is further demonstrated by a paper published by the Joint Center for Housing Studies of Harvard University. This paper looks at the impact of DTI limits on “target” loans that indicate borrowers with less wealth who live in poorer areas, which disproportionately include African American and Latino families.¹⁶ The authors identify target loans meeting an acceptable risk threshold, defined as a delinquency rate of 5% or less for prime loans. They calculate the percentage of these target loans meeting the acceptable-risk threshold for government and prime (GSE) loans that would have been excluded by a 43% DTI cutoff. The results are striking. According to the paper, “Over 95 percent of the *acceptable risk* prime and government target borrowers have DTIs above the [43 percent] QM threshold.”¹⁷

In addition, CoreLogic research presented by Peter Carroll demonstrates that borrowers aged below 33 (younger millennials) and 65 or above (mostly retirees) have the highest shares of Patch-eligible loans over 43% DTI.¹⁸ The widely noted growth in student loan debt has substantially increased DTIs for millennials.

One final point about excluding borrowers based on DTI should be noted. Rent levels, particularly those at the lower end of the market, are inexorably rising faster than incomes.¹⁹ As a result, many tenants are severely cost-burdened today. *A quarter of all renters in the United States pay over half of their incomes just for rent*, including more than 30% of African American renters and 28% of Latino renters.²⁰ A rule imposed by the federal government that denies—based solely on DTI—near-prime home purchase loans to families that pay a high proportion of their income on rent does not necessarily lead them to lower housing payment burdens. Instead the rule would deny them a mortgage loan to buy the house of their choice, as well as the opportunity to build wealth through homeownership.²¹



Removing anywhere near the 3.3 million loans that the GSEs guaranteed over the previous five years through the Patch from the mortgage system would create significant economic disruption in a recovering housing market and throughout the broader economy.

Would these costs have been warranted based on the reduction in risk caused by excluding near-prime loans through the DTI cutoff?

No, because a flat DTI cutoff for near-prime loans does not distinguish sustainable from unsustainable loans, and so excludes too many borrowers that have a strong ability to repay.

The QM product protections, in combination with lender requirements to fully document income and assets, are the most important determinants of safe lending for near-prime QM loans. In fact, the CFPB Report concludes that a large proportion of mortgages that defaulted during the crisis had product features that would have made them ineligible for QM status. According to the Report, “50 to 60 percent of early foreclosed loans from the 2005 to 2007 originations that preceded the crisis had features that the Rule generally subsequently restricted or eliminated in some manner.”²²

DTI is an important factor for underwriting loans. Lenders need to consider it, along with a host of other factors, before deciding whether to make a loan. But on its own, statistical analysis demonstrates that DTI is only minimally predictive of risk for near-prime loans. While many credit risk modelers believe that a properly measured DTI variable would help predict defaults, they note that in practice DTI “is a notoriously poor and highly volatile measure.”²³ Whatever one makes of the



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prospects of improving DTI data—and there is reason to be pessimistic given the ever-changing sources of income in today’s economy—CFPB must establish a QM rule based on the DTI measurement we have available today, and there is no grounds for confidence in that metric to play the role asked of it with a flat limit for near-prime loans. In fact, the CFPB Report finds lower delinquency rates for GSE loans over 45% DTI than with DTIs of 44% or 45%, given the much greater importance of compensating factors than DTI in determining defaults.²⁴

When CFPB controls for other factors for which it has data and isolates the impact of DTI changes on recent GSE loan performance, its data show that the increase in the rate of early delinquency in moving from 45% to 50% DTI is just 6.3%. Using a different data set for recent conventional mortgages, CFPB’s data show an 8.6% increase in delinquency in moving from 45% to 50% DTI, and using a data set of recent FHA mortgages, it finds a 6.5% increase.²⁵ CFPB’s data show approximately the same result—a 5.6% increase—when looking at conventional loans originated during the latter part of the financial crisis.²⁶

The Urban Institute reaches similar conclusions comparing the increased risk of default of Fannie Mae loans in the 40% to 45% DTI bucket to the risk in the 45% to 50% DTI bucket, controlling for all factors for which the relevant data were available. Their analysis shows that the difference in risk between the two DTI buckets is just 7.7%.²⁷ The Urban Institute’s data further demonstrate that the increase in risk for higher DTIs is also small. For each of three additional five-point increases in DTI over 50%, the limit of its published data, the increase in risk is generally consistent with going from a 45% to a 50% limit. These conclusions are based on analyzing 1.9 million Fannie Mae-guaranteed loans originated from 1999 to 2016 that had DTIs over 50%, although relatively few were made since 2010.²⁸

It is important to put this approximately 8% increase in risk for each five-point DTI bucket in perspective. Since loans in the 45% to 50% DTI bucket are only around 8% more likely to go into default than loans in

the 40% to 45% bucket, the increase in risk for loans with a 3% risk of default in the lower bucket would be just 0.24% in the higher one.²⁹ *DTI is so weakly predictive for near-prime loans that for a thousand borrowers between 45% and 50% DTI, just two additional borrowers default, not nearly enough to warrant denying QM protections to the remaining borrowers.*³⁰ The same minimal increase in defaults would apply if CFPB established higher limits.³¹ And when the lender requires off-setting, compensating factors on higher DTI loans, risk does not rise at all.

The fact that 50% is not a marker that indicates substantially increased risk for prime loans is also demonstrated by the Joint Center for Housing Studies paper. The paper identifies prime loans made to lower-wealth borrowers in low-income areas that had a delinquency rate of less than 5%. Surprisingly, the median DTI for these acceptable risk loans is 51.5%. This means that *over half of these well-performing prime loans would be excluded even if the DTI limit were raised to 50%.*³²

The conclusion of the limited predictiveness of DTI data on its own for near-prime loans is robust and has been corroborated by other researchers.³³ CFPB's cited data include recent GSE, conventional, and FHA loans, as well as conventional loans from the latter part of the crisis, while the Urban Institute and Joint Center analyses consider loans originated in 1999 through 2016 and 2009, respectively.

The reason that DTI alone is so weakly predictive of risk for near-prime loans is that factors other than DTI are simply far more important in determining whether a borrower has the ability to repay a loan. As the Urban Institute paper concludes, "To put this [small increase in risk due to DTI levels] in perspective, a 10 percentage point increase in LTV ratio or a 60-point decrease in FICO score typically will lead to a doubling or 100 percent increase."³⁴ These two factors alone swallow the impact of DTIs. As the Federal Reserve Board similarly concluded, "data show that the debt-to-income ratio generally does not have significant predictive power of loan performance once the effects of credit history, loan type, and loan-to-value ratio are considered."³⁵

The CFPB, Urban Institute, and Joint Center analyses make clear that there is no sharp increase in defaults for near-prime loans above a 43% or even 50% DTI cutoff and that such limits do not indicate the maximum level at which sustainable lending can occur. A rule based solely on a variable with such a small relative impact on default rates for near-prime mortgages would therefore not warrant the significant market disruption that would result. Nor would it warrant the exclusion of creditworthy borrowers at all income levels, particularly lower-income and low-wealth borrowers as well as borrowers of color, from QM product protections—and potentially from the ability to receive a loan at all.

Because research shows that DTI is weakly predictive for near-prime loans, however, does not mean that it is unimportant. A beneficial outcome of CFPB's DTI rule has been a significantly greater focus on documentation and consistency in reporting DTIs, and this discipline has improved the mortgage market. Lenders need to take account of the predictive impact that DTI does have. But if CFPB had not created the opportunity for lenders to weigh compensating factors through the Patch, it would have instead used this single variable that has a small impact to impose significant litigation risk on lenders. CFPB would have told private capital providers, in essence, that the government will not permit them to put their own capital at risk on near-prime loans with higher DTIs—given that guaranteeing non-QM loans is for many a prohibitive legal risk—even though the data show that many of these loans pose little credit risk. It is not clear what problem CFPB would have been solving for with such a move, as there is no indication that lenders need the government to tell them what level DTIs need to be when making near-prime loans to their customers.

What QM Approaches Should CFPB Consider?

The major takeaway from examining the impact of the existing rule is clear: in its upcoming rulemaking defining QM after the Patch expires, CFPB should choose an approach for near-prime loans that relies on holistic underwriting by lenders—including considering the impact of DTI or residual income—using compensating factors rather than relying solely on DTI. This would ensure that QM serves its goals of protecting mortgage borrowers while making access to affordable credit widely available. It would ensure that creditworthy borrowers, including lower-income and low-wealth families and families of color, can obtain the least risky and most affordable mortgage products, providing them the greatest chance for sustainable homeownership.



CFPB should choose an approach for near-prime loans that relies on holistic underwriting by lenders, using compensating factors rather than relying solely on DTI.

The question, then, is what that definition should be.

Since DTI is only a weakly predictive variable on its own for near-prime loans, many loans have an ability to repay if other factors compensate for a higher DTI. Following this logic, one option would be for CFPB to define what specific loan characteristics would serve as acceptable compensating factors to permit a high DTI loan to be considered QM. A joint proposal from the Center for Responsible Lending, The Clearing House Association, the Consumer Federation of America, and the Leadership Conference on Civil and Human Rights in 2012 requested that CFPB do just that.³⁶ While this approach makes a good deal of sense conceptually, it may not be practical, however. It would require the CFPB itself to determine underwriting criteria for high DTI loans, which CFPB may view as the province of lenders, not a government agency.

Another option for CFPB would be to make the Patch permanent.³⁷ There is a perception that the Patch favors the GSEs over other market participants, since other lender underwriting systems do not get the benefit of exceeding 43% DTI. It is worth noting that QM loans must be eligible for sale to the GSEs, not actually purchased by them. And the GSEs now sell off the interest rate risk of the mortgages they guarantee to mortgage-backed securities investors and significant credit risk on most of the mortgages to private credit risk transfer investors, so private capital still has significant involvement in GSE loans.³⁸ An additional issue with extending the Patch, however, would be continued reliance on FHFA, through its regulated entities, to set DTI and LTV limits for the entire QM market.

This paper proposes two other approaches to defining QM that would rely on holistic underwriting by lenders for near-prime loans to push the market to safer loans and preserve access to affordable credit:

- **Allow lenders to use compensating factors for near-prime loans.** The first proposal is for CFPB to keep its 43% DTI QM limit and replace the exception for GSE loans with an exception for near-prime loans. Thus, fully documented near-prime loans that meet the QM product protections, just like GSE loans under the Patch and community bank portfolio loans, are QM without an explicit DTI limit. But higher-rate loans, which suggest higher delinquency risk and greater borrower dangers, are subject to the 43% limit.
- **Validated model approach.** The second alternative is the same as the first, but near-prime loans over 43% DTI cannot be considered QM unless the lender uses a validated underwriting model with statistically-predictive compensating factors, including DTI or residual income, to distinguish which higher DTI loans to make.

In any case, CFPB will need to temporarily extend the Patch as it fully considers the implications of letting it expire or of selecting an alternative. There simply is not enough time for CFPB to do its job well on such an important issue without an interim extension. Further, if CFPB chooses the validated model approach, it would take time to put it into effect. In that case, CFPB should implement the simpler first proposal in the interim.

DTI (or residual income, if it becomes more predictive than DTI in the future) remains an important component of good underwriting; it just should not be the only one taken into account for near-prime loans. Under these two approaches, CFPB would set the QM limits, not FHFA. FHFA could still set whatever DTI limits it deems appropriate on the GSEs based on its assessment of risk, borrower leverage, or the appropriate size of the government footprint. And lenders and mortgage risk-takers will set whatever limits they choose for business reasons, constrained by the fact that loans with near-prime interest rates can only permit low defaults given their limited interest rate earnings.



Under these two approaches, CFPB would set the QM limits, not FHFA. FHFA could still set whatever DTI limits it likes, and lenders and mortgage risk-takers will set whatever limits they choose for business reasons, constrained by the fact that loans with near-prime interest rates can only permit low defaults given their limited interest rate earnings.

The question is whether CFPB will allow private lenders to use their sophisticated multi-variate automated underwriting models that include DTI as a factor along with their own risk tolerances to decide which near-prime customers they can serve, or whether CFPB will restrict them to a single weakly predictive variable no matter the actual strength of the loans they are considering.

It is important to note that in each of these two approaches, a lender must still fully document income and assets under the ability to repay statute and must meet all the important QM product requirements. Whatever CFPB decides regarding QM, it will separately need to address the widely acknowledged limitations of relying on Appendix Q for lenders to document and verify borrower income and assets, particularly for self-employed borrowers. In some fashion, CFPB will need to permit lenders to use sensible underwriting rules, rather than only the inadequate and outdated requirements of Appendix Q.³⁹

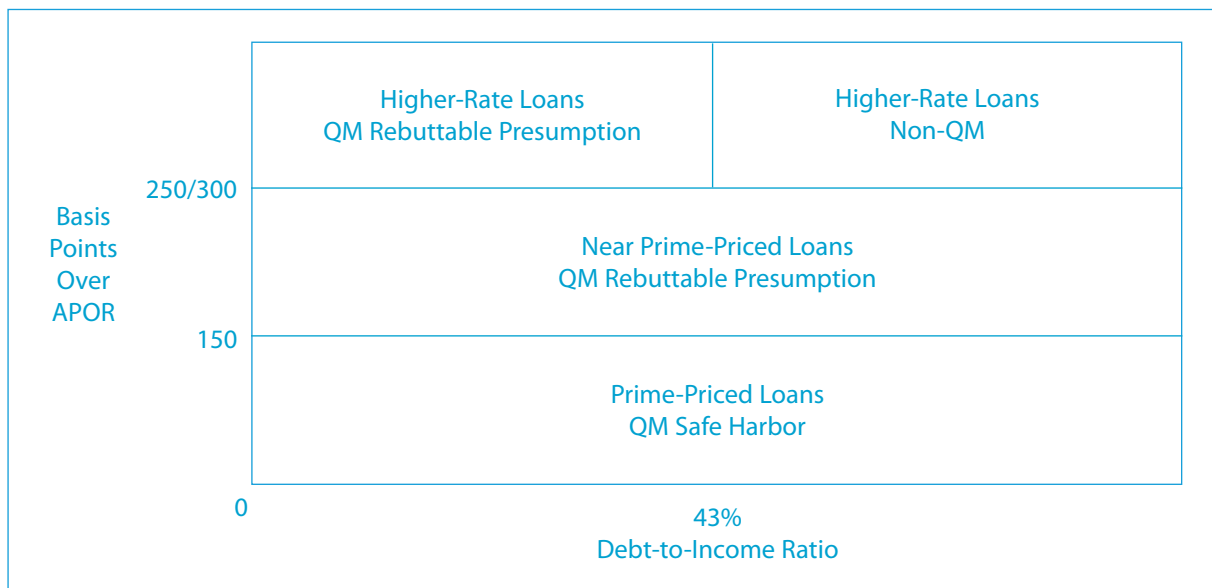
Allow lenders to use compensating factors for near-prime loans

The first option replaces the Patch with what this paper terms prime- and near prime-priced mortgages (together, “near-prime loans”) that meet the QM product restrictions.⁴⁰ *Prime-priced loans* are those originated at less than 150 basis points over APOR. *Near prime-priced loans* are those between 150 basis points over APOR and up to a number selected in the range of 250 to 300 basis points over APOR. What the paper terms *higher-rate loans*—those at 250/300 basis points over APOR or more—continue to be limited to 43% DTI. The safe harbor threshold would not change under this proposal. QM loans below 150 basis points would continue to receive a safe harbor, and loans above this threshold would continue to have a rebuttable presumption.

Under this proposal, lenders must still consider DTI or another ability to repay measure such as residual income as a component in its underwriting guidelines and must calculate and verify income according to the standards set by CFPB. Additionally, under the statutory ability to repay provision, lenders must consider seven specific criteria, including DTI or residual income.⁴¹

In order to determine whether a loan is considered QM under this approach, two questions must be answered: One, has the lender applied the product protections in order to help the borrower successfully repay the loan? Two, is the loan priced at less than 250/300 basis points over APOR? If the answer to both questions is “yes,” then the loan is QM and has no explicit DTI limit, just like loans under the GSE Patch and the community bank portfolio exemptions today. If the answer to the first question is “yes” and to the second is “no,” then the loan is QM so long as its DTI ratio does not exceed 43%; if the DTI is over 43%, it is not QM. And if the answer to the first question is “no,” then the loan is not QM and it therefore does not have a DTI limit, regardless of its price.⁴² See Figure 1 below.

Figure 1



Note: all loans in Figure are subject to the QM product protections.

This approach encourages lenders to use compensating factors to provide the safest types of mortgage loans: near-prime, amortizing loans with low fees and the most favorable interest rates. Prime loans that met QM product and documentation standards did not cause the financial crisis and generally have performed well.⁴³ This is therefore the category of loans that lenders should be incented to provide. Near-prime loans should not be denied to borrowers based solely on a government-mandated DTI ratio because, as discussed, DTI on its own is insufficient to evaluate ability to repay for near-prime loans.

To make matters more difficult in using DTI as a QM bright-line for near-prime loans, DTI is increasingly challenging for lenders to measure, because sources of income have changed in recent years, particularly for affordable loans. Many industry observers believe that the biggest impediment to lenders properly evaluating the credit risk—determining which income of the borrower to count—is exacerbated by a DTI limit for QM. Many lenders are very conservative in calculating income for DTI purposes, because there are substantial penalties for non-compliance. The income that lenders are hesitant to count affects borrowers with low to moderate income and families of color more than others. Examples include: gig economy income that is earned with irregular hours; funds contributed by extended family members living in the house who are not on the mortgage; income of a partner not on the loan because of the possibility that his or her credit score could adversely affect the price of the loan or be disqualifying; or confirmation that a borrower has additional income or can handle the mortgage payment because they regularly made rent payments higher than the mortgage payment. In addition, low- and even moderate-income families have significant monthly income variability.⁴⁴ If there were no QM DTI limit for near-prime loans, remedies for income later determined to be inadmissible would be much reduced given that QM status would not be revoked, and near-prime credit would be more available to creditworthy borrowers at all income levels. As mentioned, however, the lender would still need to document even this harder-to-measure income in accordance with CFPB's standards.

In addition, near-prime loans at high DTIs, including those over 50%, can still perform well and represent a high proportion of loans to low-wealth borrowers who have a strong ability to repay, supporting the approach of only applying a DTI limit to higher-rate loans. As discussed earlier, data presented in an Urban Institute paper does not find significantly increased risk for prime loans at higher DTIs, based on analyzing 1.9 million Fannie Mae loans with DTIs over 50%.⁴⁵ In addition, as discussed, the Joint Center for Housing Studies of Harvard University paper demonstrates that a set of prime loans made to creditworthy lower-wealth borrowers in low-income areas that had a delinquency rate of less than 5% had a median DTI of 51.5%.⁴⁶ In other words, over half of these well-performing target loans would be excluded even if the DTI limit were raised to 50%. Given their low default rates, it is difficult to justify this broad exclusion.

The reasons for not imposing a DTI limit for near-prime mortgages do not, however, apply to higher-rate loans. First, while lenders should be incented to provide near-prime QM loans—the safest type of mortgage—to creditworthy borrowers, higher-rate loans should not receive the same incentive.

Higher-rate loans are significantly higher risk for borrowers. Interest rates can get quite high—over 10.5% in today's still historically-low interest rate environment.⁴⁷ Even though upfront fees are limited to 3%, there is potential for significant borrower harm through excessive interest rates. There is also the possibili-



While lenders should be incented to provide near-prime QM loans—the safest type of mortgage—to creditworthy borrowers, higher-rate loans should not receive the same incentive.

ty of a successful lender business model of continuing to provide such loans even with very high defaults funded by high interest rate earnings, while this same possibility does not exist for near-prime loans. Further, the abusive 2/28 hybrid subprime ARMs that were prevalent before the crisis had very high interest rates when teaser rates expired. QM requires all ARMs to be underwritten at the maximum possible rate for five years, but without a DTI limit, the 2/28 loans could still be considered QM even with extremely high DTIs.

Thus, establishing a DTI threshold for higher-rate mortgage loans as a protection for borrowers is critical. The DTI limit creates an important friction to providing loans that pose greater risk to borrowers. As discussed earlier, this is due to the fact that a lender making a loan subject to a QM DTI limit will be very careful in providing that loan; if sources of income are later disqualified, the lender may lose QM status and significantly increase its litigation risk.

There is significant precedent for regulatory agencies and Congress to provide greater restrictions on mortgage loans with higher pricing over the APOR benchmark due to substantially greater risks to borrowers, and the restrictions provide lenders an incentive to make loans with lower risk to borrowers. Specifically, the Federal Reserve Board in 2008 established a number of restrictions just for higher-priced mortgage loans, defined as those priced at or above 150 basis points over APOR. In addition, CFPB provides a rebuttable presumption rather than a safe harbor using this same threshold. As a means of protecting borrowers, Congress in Dodd-Frank also established restrictions based on specific spreads over APOR in a number of instances, such as limits on prepayment penalties, requirements to establish escrows for taxes and insurance, and exclusions for bona fide discount points.⁴⁸



There is significant precedent for regulatory agencies and Congress to provide greater restrictions on mortgage loans with higher pricing over the APOR benchmark due to substantially greater risks to borrowers, and the restrictions provide lenders an incentive to make loans with lower risk to borrowers.

Second, for higher-rate loans, the lender has already determined through its pricing that the loan is higher risk, demonstrating concerns about the borrower's ability to repay. While market prices reflect a number of factors, ability to repay is a very important component. The market in fact generally does a good job of determining which QM loans need the protection of a DTI ratio. The Federal Reserve Board recognizes that loan pricing is highly predictive of ability to repay in its 2008 rulemaking:

The APR corresponds closely to credit risk, that is, the risk of default as well as the closely related risks of serious delinquency and foreclosure. Loans with higher APRs generally have higher credit risks, whatever the source of the risk might be—weaker borrower credit histories, higher borrower debt-to-income ratios, higher loan-to-value ratios, less complete income or asset documentation, less traditional loan terms or payment schedules, or combinations of these or other risk factors. . . . Therefore, the Board believes it appropriate to use a loan's APR to identify loans having a high enough credit risk to warrant the protections of [the Rule].⁴⁹

Subsequent research has confirmed this finding. Karan Kaul and Laurie Goodman of the Urban Institute point out that if a lender offers a borrower a low-priced loan, it has determined, after assessing the full range of credit characteristics including but not limited to DTI, that the borrower has a strong ability to repay the

loan. The converse is also true.⁵⁰ They examine loan performance and pricing from 1995 to 2018 for GSE, portfolio, government, and private label security loans, finding that:

Mortgage rates reflect credit risk more holistically than DTI ratios. For every channel, the 90-day delinquency (D90) rate is lowest for loans with a rate spread of up to 50 bps and highest for loans with spreads over 200 bps. More importantly, there is a gradual increase in default rate from the lowest-priced loans (spread up to 50 bps) to the highest-priced loans (spread above 200 bps).⁵¹

A 250 to 300 basis points over APOR threshold is chosen for the 43% DTI limit, rather than the 150 basis points limit for delineating the rebuttable presumption, because the combination of GSE loan-level price adjustments and mortgage insurance premium costs push a significant number of lower-wealth borrowers above the 150 basis point threshold today.⁵² The combination of these costs for a 97% LTV loan with a 639 FICO, for instance, adds 210 basis points over APOR.⁵³ This amount would increase if there were additional risk factors on the loan, such as if the property were two units, a condominium, or a real estate-secured manufactured home, or if the loan were an ARM or had subordinate financing. This loan is still a safe one to make, however, and as such the regulation shouldn't discourage lenders from making it. To protect against abuses over the 150 basis point level, as today, the rebuttable presumption would continue to be available to borrowers of these loans, and lenders currently making GSE loans subject to the rebuttable presumption would continue to do so.

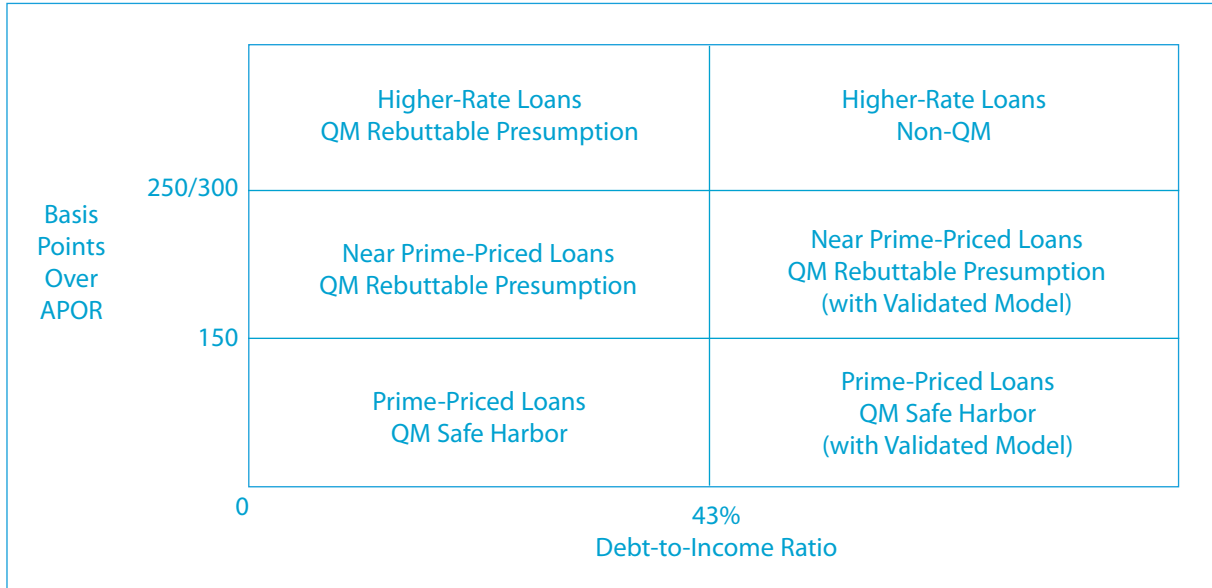
There are several benefits to the approach. Simplicity is a virtue in regulation, and this approach is simple, relying on the clear metrics of APR and DTI to define QM. Lenders benefit through obtaining the litigation protection of QM status. Creditworthy borrowers of higher DTI near-prime loans benefit, because the CFPB Report and other data do not establish that there is an empirically-based limit for sustainable lending for such loans. So if lenders determine these borrowers to be acceptable risks given their compensating factors, the borrowers can obtain the safest, lowest-cost loans available, as opposed to being denied access to credit altogether or shunted into loans with higher costs and riskier features. The approach avoids market disruption, since it permits lenders to use compensating factors that ensure a low risk of default. All market participants are subject to the same standard, both big and small, private and GSE, and it encourages innovation in underwriting.

Lenders who make higher-rate loans would be incented to take care in doing so through use of the DTI limit for those loans. Lenders, of course, could still make higher-rate loans above the DTI limit as non-QM loans, but would not receive the presumption that they complied with the ATR requirements while doing so.

Validated model approach

The second approach is the same as the first, except that it relies on automated underwriting systems (AUS). Those AUS must use statistically-predictive compensating factors to select the near-prime loans (priced at less than 250/300 basis points over APOR) meeting the product protections over 43% DTI that are low-enough risk to count as QM. The model (or a manual process associated with an AUS) must assess the borrower's ability to repay the loan and include DTI or another ATR measure such as residual income as a component.⁵⁴ Higher-rate loans would still be limited to the General QM 43% limit. See Figure 2 below.

Figure 2



Note: all loans in Figure are subject to the QM product protections.

The GSEs' models would be eligible to be considered validated, as would the models of other lenders. Near-prime loans where the model approved the borrower's ability to repay (meaning expected defaults are below the lender's risk tolerance) but excluded the borrower based on external eligibility criteria unrelated to ability to repay (such as jumbo status or the number of units that must be pre-sold in a condominium complex) are still eligible for QM under the proposal.⁵⁵ For example, for a GSE AUS today, such a loan would receive an "Approve/Ineligible" recommendation, and the GSE AUS would have determined that the borrower has the ability to repay the loan, since the eligibility factor is irrelevant to that underwriting determination.

What constitutes a validated model is well understood in the industry. Under the proposal, CFPB defines the standards and components of such a model. CFPB in fact has already issued such a regulation through its definition of an "empirically derived, demonstrably and statistically sound, credit scoring system" under the Equal Credit Opportunity Act (ECOA) in order for lenders to use age as a predictive factor in evaluating creditworthiness. CFPB could slightly modify this regulation to provide a similar definition for a validated underwriting model or adapt FHFA's pending rulemaking on validated credit score models.⁵⁶ Importantly, any validated model, separate from the QM requirements, must continue to meet fair lending standards under ECOA and the Fair Housing Act. While it is advantageous that AUS consider multiple factors in evaluating borrower ability to repay, rather than being limited to a single variable like DTI, it is as important that robust fair lending testing, analysis, and enforcement continue to occur for AUS as when underwriting was all done manually.⁵⁷

CFPB could give the lender or potential loan purchaser either of two options for demonstrating that its underwriting model is validated in order to originate near-prime QM loans over 43%. As is the case with the ECOA rule on credit scoring systems today, it could require the lender to take responsibility for ensuring that its underwriting model is validated according to the CFPB definition. This responsibility would be subject to supervision by the lender's federal supervisory agency.⁵⁸

CFPB should also go one step further and permit lenders to obtain pre-approval that its model is validated. CFPB could adopt the process established by the Office of the Comptroller of the Currency in 2013 for using independent contractors in enforcement actions.⁵⁹ In this case, a lender would have certainty up front that its underwriting model is validated and its loan would receive QM status, as long as the loan meets the QM product requirements. If the rate were below 150 basis points over APOR, the safe harbor would apply. The finding that the model was properly validated should remain in place for a certain period of time, for example, three to five years.

The validated model approach provides several benefits. First, it provides that lenders apply necessary compensating factors that ensure a low risk of default by deploying the most effective means of identifying those higher DTI loans that pose low risk: AUS.⁶⁰ When designed and deployed properly, an AUS considers a large number of variables tested over different economic cycles in evaluating the credit risk of a loan. As a result, an AUS will always be better at assessing risk for near-prime loans than any single credit characteristic, such as DTI, particularly one that is weakly predictive of risk and subject to measurement error. Requiring a validated model that includes DTI or another ATR measure such as residual income imposes discipline on lenders to ensure that they properly weigh this measure as a component in evaluating the borrower's ability to repay higher DTI loans.

Second, the approach minimizes market disruption. The Enterprises would invest the resources to ensure that their AUS is validated, continuing to render near-prime loans eligible for sale to the Enterprises as QM loans, subject of course to any DTI or other limits imposed by FHFA. In making the definition available to private market underwriting systems as well, the approach removes the market uncertainty of what happens to QM if the conservatorships end. It also removes any concern that relying exclusively on GSEs' AUS creates an unfair advantage vis-à-vis other secondary market participants.

Third, the approach does not disadvantage smaller lenders, even if they lack the resources to develop their own validated models. If the smaller lender is a depository institution, it can already hold the loan on portfolio regardless of the DTI and still have it considered QM. If the smaller lender is a non-depository, or a depository that wants to sell its loans, it will need to sell its loans to another entity and meet that entity's underwriting requirements. The purchaser, if it wants to buy near-prime loans over 43% DTI as QM, needs to use a validated model in deciding which loans to buy, and the small lender-seller can rely on that model. Further, third parties will likely develop validated models that they could license to smaller lenders.

Fourth, this approach permits lenders to innovate on underwriting standards with near-prime loans that meet the QM product standards, including through residual income analysis. Machine learning and artificial intelligence can be applied to borrower bank accounts to better understand consumer spending patterns and cash flows and accurately predict the ability to repay a loan. Given the weakness of DTI as a predictive variable, this encouragement of experimentation would be timely.

Lastly, the approach assigns appropriate roles to CFPB and to lenders. Lenders determine their underwriting standards, eligibility requirements, and risk tolerances for near-prime loans over 43% DTI, not CFPB. CFPB sets the validation standards and can ensure that a lender's model is appropriately validated.⁶¹

Conclusion

Letting the Patch expire without further action would expose most of the market to something close to a hard ceiling of 43% DTI. CFPB's Report and other analysis make clear that this would reduce lending dramatically at all income levels, with significant economic consequences, and disproportionately harm lower-income families and borrowers of color. The analyses also make clear that there is no empirical justification for such a disruptive move, because the DTI variable on its own is only minimally predictive of risk on near-prime loans.

This paper presents two alternatives to simply letting the Patch expire that allow lenders to apply compensating factors to determine the risk level of loans and an incentive to ensure that they make these safer loans when possible. The first proposal is for CFPB to keep its 43% DTI QM limit and to replace the exception for GSE loans with an exception for near-prime loans that meet the QM product protections. Higher-rate loans, which suggest higher delinquency risk and greater borrower dangers, are subject to the 43% limit. The second alternative is the same as the first, but near-prime loans over 43% DTI cannot be considered QM unless the lender uses a validated underwriting model with statistically-predictive compensating factors to distinguish which higher DTI loans to make. While these two approaches have different advantages and disadvantages, each would be vastly more effective at meeting the central objectives of QM than letting the Patch expire without further action.

Endnotes

1 This paper refers to "prime-priced loans" as those with APRs less than 150 basis points over the average prime offer rate (APOR), "near prime-priced loans" as those priced at 150 up to 250/300 basis points over APOR, and "higher-rate loans" as those priced at 250/300 basis points over APOR or more.

2 See 12 C.F.R. Section 1026.43(e)(5). CFPB expanded its definition of "small creditor" in an amendment to the ATR rule. 80 Federal Register 59943, October 2, 2015. To receive QM status under the Small Creditor Portfolio QM exemption, the loan must be held in the originating lender's portfolio for at least three years (subject to several exceptions); the loan must be held by a small creditor, defined as a lender who originated 2,000 or fewer mortgages in the previous year (excluding portfolio loans) and has less than \$2 billion in assets; and the loan must satisfy the QM product-level requirements. In addition, through recent amendments to the Dodd-Frank Act, a second provision provides lenders with less than \$10 billion in assets QM safe harbor status if the loan is placed on portfolio permanently. See Title I, Section 101, available at <https://www.congress.gov/bill/115th-congress/senate-bill/2155/text#toc-id8A028BC2C0144A-63B9E53F8D23F3659F>.

3 Laurie Goodman, *New Data Confirm the Urgency of Addressing the Expiration of the GSE Patch*, Housing Finance Policy Center, Urban Institute (March 25, 2019), available at <https://www.urban.org/urban-wire/new-data-confirm-urgency-addressing-expiration-gse-patch>.

4 See the Federal Reserve Board's observation in a qualified mortgage rulemaking that "Congress seems to have intended to provide incentives to creditors to make qualified mortgages, since they have less risky terms and features." 76 Fed. Reg. 27390, 27454 (May 1, 2011).

5 See Christopher Herbert, Daniel McCue, and Rocío Sanchez-Moyano, *Update on Homeownership Wealth Trajectories Through the Housing Boom and Bust*, Working Paper: Joint Center on Housing Studies of Harvard University (February 2016) at p. 6 (stating that "[e]ven after the precipitous decline in home prices and the wave of foreclosures that began in 2007, homeownership continues to be associated with significant gains in household wealth at the median for families of all races/ethnicities and income levels. Households who are able to sustain homeownership over prolonged periods stand to gain much. Meanwhile, renters experienced little wealth accumulation over this period. And though homeownership is certainly not without risk, the typical renter household who transitioned into and then exited homeownership by 2013 was no worse off financially than the typical household who remained a renter over the whole period."), available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/2013_wealth_update_mccue_02-18-16.pdf.

6 15 USC Section 1639c(b)(3)(B)(i).

7 Published January 2019, available at https://files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf.

8 *Ibid.* at pp. 83-84. CFPB defines the "early delinquency rate" as whether a borrower was ever 60 or more days past due within the first two years after origination. It defines the "early foreclosure rate" as whether a borrower was ever in foreclosure within the first two years after origination. According to CFPB, "[f]or purposes of this assessment, the Bureau assumes that the average "early delinquency rate" and "early foreclosure rate" across a wide pool of Qualified Mortgages (QM) are probative of whether QM loans reasonably assure repayment ability, and that the dependence of these rates on the defining characteristics of QM loans is probative of how those characteristics may influence repayment ability."

9 *Ibid.* at pp. 112-115.

10 *Ibid.* at 11, 117; see also pp. 10-11, 156. Finding based on application data surveyed among nine large lenders.

11 *Ibid.* at p. 198. The CFPB analysis compares loan-level detail of QM and non-QM loans found in the same 2015 to 2018 private label securities. 1.19% higher interest rate times a \$200,000 loan balance equals \$2,380 in greater interest costs per year, which, multiplied by 4 years, equals \$9,520 in higher costs. See also Aurel Hizmo and Shane Sherlund, *The Effects of the Ability-to-Repay/Qualified Mortgage Rule on Mortgage Lending*, FEDS Notes. Washington: Board of Governors of the Federal Reserve System (November 16, 2018), available at <https://doi.org/10.17016/2380-7172.2296>.

12 See Federal Housing Finance Agency, *Credit Risk Transfer Progress Report (Fourth Quarter 2018)* at pp. 2-3, available at <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Updates-Progress-on-Fannie-Mae-and-Freddie-Mac-Credit-Risk-Transfer-Programs-32019.aspx>.

13 Given the history of discrimination in the mortgage market, it is especially important that this rule does not inflict unnecessary harm on borrowers of color by denying them access to sustainable mortgages. See *A Review of the State of*

and *Barriers to Minority Homeownership*, U.S. House Committee on Financial Services Subcommittee on Housing, Community Development and Insurance, 116th Cong. (May 8, 2019) (Testimony of Nikitra Bailey), available at <https://financialservices.house.gov/uploadedfiles/hhrg-116-ba04-wstate-baileyn-20190508.pdf>.

14 Edward Golding, Laurie Goodman, and Jun Zhu, *Fannie Mae Raises the DTI Limit: A Win for Expanding Access to Credit*, Housing Finance Policy Center, Urban Institute (July 2017) at p. 1, available at https://www.urban.org/sites/default/files/publication/91936/fannie_mae_raises_dti_limit_0.pdf.

15 See endnote 3; results clarified in email from Laurie Goodman to author (June 26, 2019).

16 Target loans are defined as home purchase loans to borrowers with FICO scores below 720, with greater than 90% LTVs, and located in low-income census tracts. Marsha J. Courchane, Charles River Associates; Leonard C. Kiefer, Freddie Mac; and Peter M. Zorn, Freddie Mac, *Underwriting Standards, Loan Products and Performance: What Have We Learned?* Joint Center for Housing Studies of Harvard University (October 2013) at p. 4, available at <https://www.jchs.harvard.edu/sites/default/files/hbtl-11.pdf>.

17 *Ibid.* at p. 25. The paper considers prime, government, and subprime mortgages originated from 1999 to 2009. The paper calculates the probability that a loan will become 90 days or more delinquent in the first three years after origination. It sets the acceptable risk threshold at a 10% delinquency rate for government loans. The paper does not have DTI information for subprime loans. See pp. 3, 25.

18 *QM Patch Data Overview* presentation at p. 5 (June 20, 2019).

19 According to the Joint Center for Housing Studies of Harvard University, “[a]djusting for inflation, the median rent payment rose 61% between 1960 and 2016 while the median renter income grew only 5%.” *The State of the Nation’s Housing 2018* at p. 5, available at http://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_State_of_the_Nations_Housing_2018.pdf.

20 Joint Center for Housing Studies of Harvard University, *America’s Rental Housing 2019* at Table A-2, p. 40 (finding 10.8 million severely cost-burdened renters out of 43.3 million total), available at https://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_State_of_the_Nations_Housing_2019.pdf and *Renter Cost Burdens By Race and Ethnicity*, available at: http://www.jchs.harvard.edu/ARH_2017_cost_burdens_by_race.

21 See endnote 5.

22 CFPB Report at p. 86.

23 Quoting Mark Zandi, Chief Economist, Moody’s Analytics, who holds such a view; email to author (April 27, 2019).

24 CFPB Report at p. 114.

25 *Ibid.* at p. 104, Figure 31. Loans were GSE purchase loans originated from 2012 to 2016. 0.67% delinquency rate at 50% DTI minus 0.63% at 45% DTI equals 0.04%, and 0.04% divided by 0.63% equals 6.3%. See p. 103, Figure 30, for data on conventional purchase loans originated from 2012 to 2015. 0.76% delinquency rate at 50% DTI minus 0.70% at 45% DTI equals 0.06%, and 0.06% divided by 0.7% equals 8.6%. See also p. 105, Figure 32, for data on FHA purchase loans originated from 2012 to 2016. 6.6% delinquency rate at 50% DTI minus 6.2% at 45% DTI equals 0.4%, and 0.4% divided by 6.2% equals 6.5%. In all cases, percentages obtained by visually estimating points on the “fit” line in the Adjusted for Controls figure.

26 *Ibid.* at p. 102, Figure 29. Loans were conventional purchase loans originated from 2006 to 2008. 13.2% delinquency rate at 50% DTI minus 12.5% at 45% DTI equals 0.7%, and 0.7% divided by 12.5% equals 5.6%. These elevated delinquency rates are a consequence of both the financial crisis and the fact that the GSEs guaranteed loans that lacked the QM product protections; see endnotes 22 and 43.

27 Endnote 14, Table 6 on p. 7, indicates that for Fannie Mae loan-level credit data, the hazard ratio for the >40–45 bucket is 1.68, and it is 1.81 for the >45–50 bucket. $1.81/1.68 = 1.077$, so the loans in the higher bucket are 7.7% riskier. Data based on ever-90 day plus delinquency rates. Calculations by Laurie Goodman.

28 The hazard ratio for the >45–50 bucket is 1.81 and is 1.93 for the >50–55 bucket. $1.93/1.81 = 1.066$, so the loans in the higher bucket are 6.6% riskier. The hazard ratio for the >50–55 bucket is 1.93, and it is 1.94 for the >55–60 bucket. $1.94/1.93 = 1.005$, so the loans in the higher bucket are 0.5% riskier. The hazard ratio for the >55–60 bucket is 1.94, and it is 2.08 for the >60–65 bucket. $2.08/1.94 = 1.072$, so the loans in the higher bucket are 7.2% riskier. See also Table 1 on p. 2. Calculations by Laurie Goodman.

29 The 3% default rate is representative. According to Urban Institute’s Housing Finance Policy Center, the ever 180 days delinquency rate on loans guaranteed by Fannie Mae and originated between 1999 and 2004, with LTVs of greater than

90% and FICO scores between 700 and 750, was 3% (the default rate for 80% to 90% LTV was 2.9%). See *Housing Finance at a Glance, A Monthly Chartbook* (February 2019) at p. 35, available at https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-february-2019/view/full_report. A 3% risk of default times an 8% increase in risk due to the higher DTI equals an incremental increase in default risk of 0.24%.

30 0.24% increased risk of default times 1,000 loans equals an additional 2.4 loans that default in the higher bucket. In order to determine the total number of defaults in the >45% to 50% DTI bucket of loans, the 3% risk of default at the lower DTI level continues in the higher bucket and is added to the incremental defaults due to the higher DTIs. Thus, holding all else constant, the defaults would be 3% times 1,000 loans, which equals 30, plus the incremental defaults of two, for a total of 32 loans that default in the higher bucket. Of the initial loans in the higher bucket, 1,000 loans minus these 32 loans that default equals 968 loans that do not default.

31 Based on a 3% default rate for the >40% to 45% DTI bucket, 1,000 loans initially between >45% and 50% DTI and the incremental default rates presented in endnote 28, if CFPB established a 55% rather than 50% limit, then the increase in risk would be 0.21%, 2.1 additional borrowers would default, and 966 borrowers would be successful. If CFPB established a 60% rather than 55% limit, then the increase in risk would be 0.02%, 0.2 additional borrowers would default, and 965 borrowers would be successful. If CFPB established a 65% rather than 60% limit, then the increase in risk would be 0.25%, 2.4 additional borrowers would default, and 963 borrowers would be successful. Calculations by author and available upon request.

32 Endnote 16 at 25 (finding that “acceptable-risk prime targeted borrowers have a DTI distribution with an interquartile range from around 47% to 56%. For the government market the interquartile range goes from 47 to 53.” The midpoint DTI ratio for prime loans between the 25th percentile of loans, 47%, and the 75th percentile of loans, 56%, is 51.5%, which constitutes the median level).

33 See Diana Farrell, Kanav Bhagat, Peter Ganong, and Pascal Noel, JPMorgan Chase & Co. Institute, *Mortgage Modifications after the Great Recession: New Evidence and Implications for Policy* (December 2017) at pp. 20–21 (finding that “[t]he fact that default was correlated with income loss regardless of mortgage PTI [payment-to-income ratio] provides evidence that affordability measures were not a good predictor of default. Both high and low mortgage PTI borrowers experienced a similar income drop just prior to default, suggesting that even among those borrowers whose mortgages would be categorized as unaffordable by conventional standards, it was a drop in income rather than a high level of payment burden that triggered default.” Endnote omitted.), available at <https://www.jpmorganchase.com/content/dam/jpmorganchase/en/legacy/corporate/institute/document/institute-mortgage-debt-reduction.pdf>; see also Diana Farrell, Kanav Bhagat, and Chen Zhao, JPMorgan Chase & Co. Institute, *Falling Behind: Bank Data on the Role of Income and Savings in Mortgage Default* (October 2018) at pp. 4, 14, 5 (finding that “[d]efault followed a negative income shock for borrowers above and below 43% total DTI at origination threshold, suggesting that it was a drop in income rather than payment burden at origination that triggered default.” “While total DTI measured at origination may have some predictive power for default, the considerable heterogeneity in housing costs and incomes makes it difficult to find a single level of total DTI that indicates affordability across all households and regions.” “[O]ur data do not support a distinction between ‘affordable’ and ‘unaffordable’ mortgages based on a 43% total DTI cutoff.”), available at <https://www.jpmorganchase.com/corporate/institute/document/insight-income-shocks-mortgage-default.pdf>; Anthony DeFusco, Stephanie Johnson, and John Mondragon, *Regulating Household Leverage* (May 7, 2019) at p. 7 (finding that, had the 43% total DTI QM limit been in effect for the entire market, it would have resulted in a minimal reduction in five-year default rates on mortgages originated between 2005 and 2008. According to the authors, “we estimate that the policy would have reduced the five-year default rate by only about 0.2 percentage points for loans originated in 2007 and 2008, with smaller effects for loans originated in 2005 and 2006. Given that the 2007 cohort of loans experienced default rates as high as 24% after five years, we view these performance improvements as relatively small.”), available at <https://ssrn.com/abstract=3046564>.

34 Endnote 14 at p. 7.

35 76 Fed. Reg. 27390, 27454 (May 1, 2011) (endnote omitted).

36 See Appendix to Comments to the CFPB on Qualified Mortgage by Center for Responsible Lending, Consumer Federation of America and The Leadership Conference on Civil and Human Rights (July 9, 2012), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/QM-Comment-Letter_Final_0709.pdf.

37 If CFPB extended the Patch, it would need to address the uncertainty of what to do if the GSEs exit conservatorship, since the Patch would automatically expire under CFPB’s current rule. A solution would be to extend QM status to loans eligible for purchase or guarantee by any FHFA regulated entity, which would include the GSEs in or out of conservatorship, any other guarantors permitted by Congress in the future, and the Federal Home Loan Banks, which have their own

mortgage purchase programs for community banks. FHFA has the mandate of ensuring the safety and soundness of its regulated entities, which would require ensuring that its regulated entities' underwriting does not threaten this status. In addition, CFPB could extend the Patch to include loans eligible for insurance or guarantee by other government programs (FHA, RHS or VA) to lessen its dependence on the GSEs and extend it to other governmentally-sanctioned underwriting models.

38 See endnote 12.

39 Senators Mike Rounds (R-SD) and Mark Warner (D-VA) introduced the Self-Employed Mortgage Access Act, S. 540, to address this issue by permitting lenders to use GSE or other government guides to determine income or debts, available at <https://www.warner.senate.gov/public/index.cfm/2018/8/warner-rounds-introduce-legislation-to-expand-mortgage-access-for-self-employed-workers>. Others suggest simply eliminating Appendix Q and relying on CFPB's ability to repay guidance for QM purposes, where it states that the "creditor is permitted to use its own definitions and other technical underwriting criteria. A creditor may, but is not required to, look to guidance issued by entities such as the Federal Housing Administration, the U.S. Department of Veterans Affairs, the U.S. Department of Agriculture, or Fannie Mae or Freddie Mac while operating under the conservatorship of the Federal Housing Finance Agency. For example, a creditor may refer to such guidance to classify particular inflows, obligations, or property as 'income,' 'debt,' or 'assets.'" See CFPB, Comment 43(c)(2), 1., available at <https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/Interp-43/#43-c-2-Interp>.

40 Edward DeMarco, president of the Housing Policy Council (HPC), suggests removing the DTI limit, Appendix Q, and GSE Patch from the QM rule, "while retaining the mandate that lenders assess and document a borrower's ability to repay the mortgage." See *Three Ways to Draw Private Capital Back into Mortgages*, American Banker (June 14, 2019), available at <https://www.americanbanker.com/opinion/three-ways-to-draw-private-capital-back-into-mortgages>; see also HPC Comment, RFI Regarding Ability-to-Repay/Qualified Mortgage Rule (July 31, 2017), available at <https://www.regulations.gov/comment?D=CFPB-2017-0014-0001>. Karan Kaul and Laurie Goodman of the Urban Institute propose that there be no DTI limit for prime mortgages; see *Updated: What, If Anything, Should Replace the QM GSE Patch?* (October 2018), available at https://www.urban.org/sites/default/files/publication/99268/2018_10_30_qualified_mortgage_rule_update_finalized_2.pdf. Brad Blackwell and Beth Mlynarczyk also provided significant assistance in developing this approach.

It is permissible under the Act for CFPB not to impose a DTI limit for certain loans, as it chose not to do for GSE loans under the Patch. The Act simply requires lender compliance with "any . . . regulations established by [CFPB] relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt . . ." 15 USC Section 1639c(b)(2)(A)(vi). The Act thus does not require CFPB to use DTI or residual income to define QM at all.

41 "A determination under this subsection of a consumer's ability to repay a residential mortgage loan shall include consideration of the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan." 15 U.S.C. Section 1639c(a)(3).

42 This approach is more protective than the Federal Reserve Board's 2011 QM alternative that would have provided no DTI limit for *all* loans that met the QM product protections. See 76 Fed. Reg. 27390, 27453-54 (May 11, 2011). This alternative also provided a safe harbor to all QM loans.

43 See Mark Zandi, Gus Harris, Ruby Shi, and Xinyan Hu, Moody's Analytics, *Who Bears the Risk in Risk Transfers* (August 2017) at Table 1, p. 2 (from 2006 to 2014, GSE loans realized losses of 3.1% of their outstanding balance at the start of the crash, year-end 2007, while private-label securities faced losses of 24.2% and depository institution portfolio loans had losses of 6.3%), available at <https://www.economy.com/mark-zandi/documents/2017-08-02-who-bears-the-risk.pdf>. It was the GSEs' late entrance into purchasing Alt-A no documentation loans and also buying subprime mortgage-backed securities that caused their significant credit losses during the crisis. For example, in 2008, Alt-A loans comprised 45.6% of Fannie Mae's single-family guarantee credit losses, while making up just 10.1% of its book of business. See Fannie Mae, *2008 Credit Supplement* (February 26, 2009) at p. 5, available at http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2008/2008_10K_credit_summary.pdf.

44 See Anthony Hannagan and Jonathan Morduch, *Income Gains and Month-to-Month Income Volatility: Household Evidence from the US Financial Diaries* (March 16, 2015), available at <https://www.usfinancialdiaries.org/paper-1>; see also Diana Farrell and Fiona Greig, JPMorgan Chase & Co. Institute, *Paychecks, Paydays, and the Online Platform Economy: Big Data on Income Volatility* (February 2016) at p. 9 (finding that "[o]n average, individuals experienced a 40% change in total income on a month-to-month basis." Endnote omitted.), available at <https://www.jpmmorganchase.com/corporate/institute/document/jpmc-institute-volatility-2-report.pdf>.

45 See endnote 28.

46 See endnote 32.

47 While there is no upper interest rate limit on higher-priced mortgage loans, there is an effective limit imposed by HOEPA of 6.5% over APOR, since that is the point at which HOEPA's full assignee liability begins. For May 16, 2019, APOR was 4.07% with 0.5% points and fees. See Freddie Mac, Current Mortgage Rates Data Since 1971, Primary Mortgage Market Survey, U.S. 30 YR FRM, available at <http://www.freddie.mac.com/pmms/>. Using this interest rate and these points and fees in an APR calculator for a 30-year fixed rate 80% LTV loan (using Mortgage Professor's calculator, available at https://www.mtgprofessor.com/mpcalculators/APR_FRM/APR_FRM.asp), which is the methodology CFPB directs (see Numerical Example at <https://ffiec.cfpb.gov/tools/rate-spread/methodology>), translates to an APOR of 4.11 APR. Adding the 4.11% APR plus 6.5% for the HOEPA limit equals 10.61% APR.

48 Federal Reserve Board, see Truth in Lending, 73 Fed. Reg. 44522, 44531-33, 44539-40 (July 30, 2008); CFPB, see 12 CFR Section 1026.43(b)(4) and (e)(1); Dodd-Frank, see 15 USC Section 1639c(a)(6)(D)(ii) (nonstandard and balloon loan calculation process); 15 USC Section 1639c(b)(2)(C)(ii) and 15 USC 1602(ee) (discount points); 15 USC Section 1639c(c)(1)(B)(ii) (prepayment penalties); 15 USC 1602(bb)(1)(A)(i) and 15 USC Section 1639 (HOEPA loans); and 15 USC Section 1639d(b)(3) (escrows); 15 USC Section 1639h(f)(2) (appraisals).

49 Truth in Lending, 73 Fed. Reg. 44522, 44533 (July 30, 2008).

50 Endnote 40 at pp. 6–10.

51 Ibid. at p. 8 and see Table 4, p. 9 (emphasis added), analyzing ever-90 day plus delinquency rates.

52 In 2017, for example, 2.4% of the loans purchased or guaranteed by the GSEs (over 80,000 loans) were higher-priced mortgage loans, a disproportionate number of which were to low-income borrowers. See Federal Housing Finance Agency, *Annual Housing Report 2018* at pp. 25, 36–43, available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Annual_Housing_Report2018.pdf. This percentage is likely higher today.

FHFA's pending capital rule for the GSEs and potential revisions to Private Mortgage Insurer Eligibility Requirements will significantly affect the APR of prime loans and could affect what trigger should be selected between 250 and 300 basis points over APOR. In FHFA's revision of the capital rule, the agency should improve the system's current incentives for pooling of risk, which will result in less differential pricing and avoid perpetuating discrimination in the housing finance market, as well as make it more likely that creditworthy families of modest means can afford a mortgage. See Comment by Center for Responsible Lending, joined by NAACP, The Leadership Conference on Civil and Human Rights, National Coalition for Asian Pacific American Community Development, National Fair Housing Alliance, National Community Reinvestment Coalition, and National Urban League, to FHFA on Enterprise Capital Requirements (November 16, 2018), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl_fhfa_capitalrequirements-no-v2018.pdf.

53 See Fannie Mae, Loan-Level Price Adjustment (LLPA) Matrix, available at <https://www.fanniemae.com/content/pricing/llpa-matrix.pdf>. On p. 2, Table 1, the LLPA for 620-639 FICO, 95.01-97% LTV is 3.5%. APOR is based on a survey of the rates of fixed-rate conventional purchase loans at 80% LTV; see endnote 47. Since a majority of Fannie Mae acquisitions are over 740 FICO (see Fannie Mae 2018 Form 10-K at p. 77, available at <http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2018/q42018.pdf>), APOR includes the LLPA for \geq 740 FICO, 75.01-85% LTV loan, which is 0.5%. The incremental LLPA for the subject loan is thus 3.5 minus 0.5%, or 3%, divided by a multiple of 4 to convert the upfront cost to ongoing yield, which equals 75 basis points. Using the private mortgage insurance company Genworth's current rate card for 35% coverage, monthly borrower-paid MI fixed premium, the MI cost of the subject loan is 1.86%. See https://new-content.mortgageinsurance.genworth.com/documents/rate-cards/national/monthly_premium_mi/12869100.NationalMonthly.FIXED.1118.pdf. Because MI is cancelled below 78% LTV, the APR impact is 73% of the total premium amount, or 135 basis points (using APR calculator from endnote 47, assuming \$200,000 current house value, \$194,000 loan, 4.86 interest rate (4.11 APOR plus 75 basis point LLPA yield), 360 month term, 1.86% MI premium, and subtracting the final APR of 6.21 from the 4.86% interest rate equals 135 basis points). The 75 basis point LLPA yield plus 135 basis points of MI yield equals a total of 210 basis points over APOR. If APOR rises 200 basis points to 6.11%, using this number in the mortgage calculator with the same information, the amount over APOR rises to 216 basis points. Fannie Mae's HomeReady and Freddie Mac's Home Possible programs for low-income borrowers have lower LLPAs and require 25% MI coverage.

54 As a practical matter, lenders would use their same validated model to determine the eligibility of loans above and below 43% DTI. Also, the DTI limit should be a certain percentage of pre-tax income and permit the equivalent after-tax calculation, in case lenders move to cash-flow underwriting that uses take-home income and expenses information.

55 FFB could exclude jumbo loans from the universe of loans eligible for the near-prime exception, as it does with the GSE Patch exception, if it prefers to maintain a non-QM market for these loans.

56 See 12 CFR 1002.2(p). The following redline changes to the rule would make it applicable for a validated underwriting model, although further changes may be warranted:

(p) Empirically derived ~~and other credit scoring~~ underwriting systems -

(1) An credit scoring underwriting system is a system that evaluates an applicant's creditworthiness mechanically, based on key attributes of the applicant and aspects of the transaction, and that determines, ~~alone or in conjunction with an evaluation of additional information about the applicant,~~ whether an applicant is deemed creditworthy. To qualify as an empirically derived, demonstrably and statistically sound, credit scoring underwriting system, the system must be:

(i) Based on data that are derived from an empirical comparison of sample groups or the population of creditworthy and non-creditworthy applicants who applied for credit within a reasonable preceding period of time;

(ii) Developed for the purpose of evaluating the creditworthiness of applicants with respect to the legitimate business interests of the creditor utilizing the system (including, but not limited to, minimizing bad debt losses and operating expenses in accordance with the creditor's business judgment);

(iii) Developed and validated using accepted statistical principles and methodology; and

(iv) Periodically revalidated by the use of appropriate statistical principles and methodology and adjusted as necessary to maintain predictive ability.

(2) A creditor may use an empirically derived, demonstrably and statistically sound, credit scoring underwriting system obtained from another person or may obtain credit experience from which to develop such a system. Any such system must satisfy the criteria set forth in paragraph (p)(1)(i) through (iv) of this section; if the creditor is unable during the development process to validate the system based on its own credit experience in accordance with paragraph (p)(1) of this section, the system must be validated when sufficient credit experience becomes available. A system that fails this validity test is no longer an empirically derived, demonstrably and statistically sound, credit scoring underwriting system for that creditor.

In sum, the model must (i) be based on data from recent loans, (ii) be established for a legitimate business purposes such as minimizing losses, (iii) use accepted statistical principles and methodology, and (iv) be periodically reassessed. Sophisticated underwriting models will generally meet these requirements. CFPB could consider adding more specificity to these four factors. For example, it could indicate on (i) whether a "reasonable preceding period of time" must include a period of economic stress, on (ii) that originating loans that meet QM requirements is a "legitimate business interest," and on (iv) an appropriate timeframe for periodically revalidating the model.

Another option would be to take FHFA's proposed rule to implement Congress's recent requirement that the Enterprises use validated credit score models as a base. Congress defined what constitutes a validated model under Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (Pub. L. No. 115-174, section 310). FHFA proposed a rule to implement Section 310 at [https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Credit%20Scores%20Proposed%20Rule%20\(12-11-2018\)_Web.pdf](https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/Credit%20Scores%20Proposed%20Rule%20(12-11-2018)_Web.pdf); see Section 1254.7 Credit Score Assessment.

57 See, for example, the National Fair Housing Alliance settlement with Facebook concerning alleged discriminatory practices that enabled landlords and real estate brokers to exclude people of color, families with children, women, people with disabilities, and other protected groups from receiving housing advertisements, available at <https://national-fairhousing.org/2019/03/18/national-fair-housing-alliance-settles-lawsuit-with-facebook-transforms-facebooks-ad-platform-impacting-millions-of-users/>.

58 All mortgage originators have a federal supervisor, either a safety and soundness regulator or CFPB. Each depository institution (state- or federally-chartered) has a federal safety and soundness regulator. In addition, CFPB has supervisory authority for depository institutions greater than \$10 billion in assets as well as for all non-depository mortgage lenders, regardless of size. See CFPB, Institutions subject to CFPB supervisory authority, available at <https://www.consumerfinance.gov/policy-compliance/guidance/supervision-examinations/institutions/>.

59 See OCC Bulletin 2013-33, Use and Review of Independent Consultants in Enforcement Actions (November 12, 2013), available at <https://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-33.html>. Under the bulletin, a lender proposes to use a particular contractor, subject to the prior review and non-objection of the agency based on the contractor's qualifications, its independence from the lender for conflict of interest purposes, and the proposed scope of consultants in general, which, in the proposal at hand, would limit their task to applying well-understood standards to particular underwriting models.

60 See, for example Marsha J. Courchane, Charles River Associates; Leonard C. Kiefer, Freddie Mac; and Peter M. Zorn, Freddie Mac; *A Tale of Two Tensions: Balancing Access to Credit and Credit Risk in Mortgage Underwriting*, Real Estate Economics, Vol. 43, Issue 4, pp. 993–1034, 2015 (Winter 2015) at p. 2 (“Using recent mortgage market data, we explore whether modern automated underwriting systems (AUS) can be used to extend credit to borrowers responsibly, with a particular focus on target populations that include minorities and those with low- and moderate incomes. We find that modern AUS do offer a potentially valuable tool for balancing the tensions of extending credit at acceptable risks. . . .”), available at <https://ssrn.com/abstract=2679168>.

61 With its current 43% DTI threshold, CFPB similarly relies on lenders to set their own underwriting standards, eligibility requirements, and risk tolerances. This 43% threshold does not establish an acceptable default rate or ability to repay since the DTI variable is only weakly predictive of default. Depending on the strength of the remaining underwriting criteria in a particular mortgage, a QM loan with a 42% DTI loan could be consistent with an extremely high default rate, while another loan with a 49% DTI that meets the requirements of GSE underwriting could be consistent with a low default rate.



Center for Responsible Lending

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The Center for Responsible Lending (CRL) is working to ensure a fair, inclusive financial marketplace that creates opportunities for all responsible borrowers, regardless of their income, because too many hard-working people are deceived by dishonest and harmful lending practices.

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