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September 16, 2019

Kathleen L. Kraninger
Director
Consumer Financial Protection Bureau
1700 G Street, N.W.
Washington, D.C. 20552

Re: Response to ANPR on Qualified Mortgage Definition under the Truth in Lending Act (Regulation Z) Docket No. CFPB-2019-0039; RIN 3170-AA98

Dear Director Kraninger:

I appreciate the opportunity to comment on the Consumer Financial Protection Bureau's (CFPB) advanced notice of proposed rulemaking (ANPR) on the Qualified Mortgage Definition under the Truth in Lending Act (TILA) (Regulation Z).

The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace. Cato's Center for Monetary and Financial Alternatives, at which I am a policy analyst, is dedicated to building a better tomorrow through monetary and financial alternatives—exploring policy reforms that capture the power of markets to provide for people's welfare and developing ideas for a robust, resilient, innovative, and inclusive monetary and financial system worthy of a free and prosperous society.

I thank you and the CFPB for your leadership in the discussion of how consumer protection rules can encourage an inclusive, competitive, innovative, and stable mortgage market.

Summary

The CFPB's announcement that it will allow the temporary category of Qualified Mortgage (QM) loans (the QM "patch") to expire on the earlier of January 20, 2021 or the end of the government-sponsored enterprises' (GSEs) conservatorship is a positive step toward a more stable and competitive market for housing finance. The CFPB is right to end the "patch," and it should make changes to the 2013 Ability-To-Repay/Qualified Mortgage (ATR/QM) Rule that provide greater certainty to lenders about their future liability and simplify the process of verifying borrowers' ability to repay.

The stated purpose of amendments to the Truth in Lending Act (TILA), contained in the Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), was "to assure that consumers . . . receive mortgages that reasonably reflect their ability to repay."[1] Yet since its enactment, the "patch" has encouraged issuance of higher-risk mortgages on which borrowers are more likely to default within two years of their origination.

[1] Wall Street Reform and Consumer Protection Act of 2010, Section 1402(a)(2).

The "patch" has also preserved the GSEs' privileged position by granting them a competitive advantage with regulatory sanction. There is also some evidence that the "patch," contrary to proponents' claims, has not improved housing affordability but rather pushed up housing prices, particularly for lower-priced homes that first-time buyers and low-income households typically seek.

The purpose of the Dodd-Frank amendments to TILA, which the 2013 ATR/QM Rule implemented, was to ensure that mortgage borrowers can repay their loans. The existence of the QM "patch" does not promote that goal, but rather seems to provide a loophole for mortgage originations that have higher early delinquency rates than other loans. Moreover, the Bureau clearly stated in the 2013 Rule that, as a temporary QM category, the "patch" would "sunset when [the GSEs'] conservatorship ends."[2]

Opponents of the "patch's" programmed expiration claim that this "sunset" will make it harder for vulnerable households to get a mortgage. Yet, while credit availability and housing affordability are important policy objectives, they are not the focus of either TILA or the 2013 Rule. Other measures, such as the liberalization of local zoning laws and the use of alternative data in underwriting, can more effectively promote affordability and access to credit.[3] In any case, one should note that the "patch's" impact on housing demand in the context of supply constraints offers grounds to doubt that it has in fact improved affordability.

To better promote TILA's statutory objectives, the CFPB should let the "patch" expire and treat all mortgage loans that do not meet the general definition of a QM as non-QM loans. Letting the "patch" expire does not mean that non-QM loans such as those currently originated under the "patch" will not be viable in future. Rather, they will be subject to the standard ATR requirements. The growth of non-QM loans as a share of originations can spur a deeper market for private-label mortgage-backed securities (MBS), an essential step toward a more competitive guarantor market. That is a stated objective of the Trump Administration because it is likely to reduce systemic risk in the secondary mortgage markets that Fannie Mae and Freddie Mac presently dominate. But all of these beneficial developments cannot take place so long as regulation grants special treatment to the GSEs in the form of the "patch."

To provide greater certainty to originators, the CFPB should allow any mortgage loan to earn QM status after a seasoning period, meaning a period from origination over which the loan has not gone delinquent. In accordance with the CFPB's definition of "early delinquency," this seasoning period might last anywhere between 12 and 24 months. Finally, the Bureau should encourage competition in underwriting and the use of a growing array of customer data by allowing lenders to verify income using a "reasonable method" based on historical performance.

Background

The Dodd-Frank amendments to TILA prescribe that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination . . . that . . . the

[2] 78 FR 6533.

[3] See generally Vanessa Brown Calder, "Zoning, Land-Use Planning, and Housing Affordability," Policy Analysis No. 823 (October 2017), Cato Institute, https://www.cato.org/publications/policy-analysis/zoning-land-use-planning-housing-affordability.

consumer has a reasonable ability to repay the loan."[4] At the same time, the Act creates a safe harbor from liability for violation of the Act's ATR requirements. Loans that qualify for this safe harbor are qualified mortgages (QMs). The purpose of the QM is thus to create a category of low-risk loans that are automatically compliant with Dodd-Frank's ATR requirements.

In 2013, the CFPB issued a Rule that defined a general category of QM loans. These are loans compliant with the Rule's prohibitions on certain loan features, its underwriting requirements, its limitations on points and fees, and a 43 percent limit on the borrower's debt-to-income (DTI) ratio. The DTI ratio is the ratio of monthly debt repayments to the borrower's gross income, measured according to guidelines set by the CFPB in Appendix Q to Part 1026 of Regulation Z, the implementing regulation for TILA.[5]

As part of the 2013 Rule, the CFPB also defined a temporary category of QM loans. Unlike the general category, loans in the temporary category (known as the QM "patch") are exempt from the maximum DTI ratio if they are eligible for purchase by one of the GSEs (Fannie Mae or Freddie Mac). The CFPB has announced it will let the "patch" expire as planned on the earlier of January 10, 2021, or the GSEs' exit from conservatorship.[6]

The ANPR reiterated the CFPB's concern that the existence of the "patch" has "define[d] the limit of credit availability,"[7] turning the GSEs into underwriting standard-setters for loans above the DTI limit set for QMs by the 2013 Rule.[8] The CFPB also expressed concerns about "presuming indefinitely that loans eligible to be purchased or guaranteed by the GSEs" meet its ATR standards, and that the "patch" has prevented the market for private-label MBS from rebounding.[9]

Why the CFPB Should Let the QM "Patch" Expire

The stated purpose of Dodd-Frank's ATR/QM amendments to TILA is "to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive."[10] Since the CFPB issued the 2013 Rule implementing those amendments, supporters of the GSE "patch" have often claimed that it makes mortgages more easily accessible and should therefore remain in place.

However, while access to credit at competitive prices that reflect the borrower's repayment risk is important for financial inclusion and the soundness of the financial system, those are not the primary concerns of the 2013 Rule. Instead, that Rule aims at minimizing loan delinquencies by giving QM status only to loans that are unlikely to become delinquent soon after the loan's

[4] Dodd-Frank, Section 1411(a)(2).
[5] 12 C.F.R. Part 1026, Appendix Q, "Standards for Determining Monthly Debt and Income," https://www.law.cornell.edu/cfr/text/12/appendix-Q_to_part_1026.
[6] ANPR, 7.
[7] ANPR, 19, citing 78 FR 6408, 6528.
[8] The U.S. Treasury recently echoed this concern in its housing reform plan. See U.S. Department of the Treasury, "Housing Reform Plan," September 2019, 11, https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.
[9] Ibid.
[10] 15 U.S. Code § 1639b.

origination.[11] The Rule provides, on the other hand, that creditors should remain liable for non-QM loans as an inducement to engage in sound underwriting practices.

There are problems with the 2013 Rule and Appendix Q. In particular, the 2013 Rule potentially places liability on creditors for loan defaults long after origination. Furthermore, income verification under Appendix Q is burdensome and uncertain. But the "patch" is an inadequate remedy to these faults. That creditors are afraid to originate non-QM loans because of the lack of clarity in Appendix Q and legal uncertainty about their future liability is not a good argument for preserving the "patch." The CFPB should therefore allow the "patch" to expire while making changes to the 2013 Rule that provide greater clarity and certainty. The following section expands on the reasons why the "patch" should expire. A subsequent section proposes other changes to the Rule that will facilitate access to credit and the provision of non-QM loans, while maintaining consumer protection.

The "Patch" Harms Competition by Giving the GSEs Regulatory Privileges

Dodd-Frank tasks the CFPB with ensuring that consumer financial markets are "fair, transparent, and competitive."[12] Competitive markets are important for consumer welfare because economic theory and empirical evidence show that more competition lowers the cost, raises the quality, and increases the quantity and scope of products and services available to consumers. In the area of banking, the promotion of competition since the 1970s has reduced interest-rate spreads, increased loan options, and ushered in larger fee-free networks for consumers, among other benefits.[13]

The QM "patch," however, counters the CFPB's mission to promote competition. Specifically, the "patch" is harmful because it discourages lenders from competing in the way they underwrite mortgages outside the CFPB's QM category; it entrenches the privileged position of the two existing government-sponsored guarantors, Fannie Mae and Freddie Mac; and it forces greater uniformity on mortgage loans by making it more attractive for lenders to originate QM than non-QM loans. Allowing the "patch" to expire can lead to a more diverse and more competitive mortgage market, without endangering financial stability.

The purpose of the QM was to reduce uncertainty for market participants by creating a category of low-risk loans which were automatically compliant with the 2013 Rule's ATR requirements.[14] But the CFPB expected a deep market for non-QM loans to emerge following the 2013 Rule, a development that has not materialized.[15] The 2013 Rule created the "patch" as a

[11] See, for example, 78 FR 6462, outlining factors that would demonstrate "a creditor's ability-to-repay determination was reasonable and good-faith." See also CFPB, "Ability-to-Repay and Qualified Mortgage Rule Assessment Report," January 2019, 84, https://files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf: ". . . 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."
[12] 12 U.S. Code § 5511.
[13] Katherine Ho and Joy Ishii, "Location and Competition in Retail Banking," International Journal of Industrial Organization 29, no. 5 (September 2011): 537-46; Astrid A. Dick, "Nationwide Branching and Its Impact on Market Structure, Quality, and Bank Performance," Journal of Business 79, no. 2 (March 2006): 591.
[14] 84 FR 37156.
[15] 78 FR 6534.

temporary category precisely because it was deemed necessary to support the mortgage market during the recovery from the financial crisis. Whatever the merits of this view at the time, it clearly no longer reflects economic circumstances, given strong growth, low unemployment, and a stock of outstanding mortgages whose market value recently surpassed its pre-crisis peak.[16]

As the mortgage market has recovered, however, the market share of the GSEs has not declined but increased. Fannie Mae and Freddie Mac now account for a larger proportion of conventional single-family mortgage loans than before the financial crisis, larger even than before the 2013 ATR/QM Rule came into force.[17] As the GSEs' footprint has grown, so has the share of higher-risk mortgages in the mortgage pool: according to the Federal Housing Finance Agency (FHFA), mortgage loans above the 43 percent DTI limit account for three times the share of unpaid principal balances purchased by GSEs that they did in 2014.[18]

The GSEs' large and, in some cases, growing footprint is concerning for several reasons. First, it suggests that the 2013 Rule, and the "patch" it created, have encouraged lenders to structure their mortgage originations in accordance with the GSEs' underwriting standards.[19] This would contradict the CFPB's goal of promoting a deep market for non-QM loans and private-label MBSs. Given the government backstop of GSE-acquired loans, the growth in the GSEs' market share and in the share of risky loans in their portfolios also raises the likelihood that taxpayers will be liable for defaults.

Second, the GSEs' outsized role complicates their exit from conservatorship, the emergence of a more competitive secondary market for mortgages, and, ultimately, the advent of additional guarantors that will compete with Fannie Mae and Freddie Mac. This, in turn, makes it harder to reduce the extent of government support of the U.S. mortgage market. Yet decreasing the GSEs' footprint, promoting competition, and tapering down the government's supporting role in housing finance are all key objectives of the Trump Administration.[20] The GSEs' enormous portfolio made a taxpayer bailout inevitable during the financial crisis, after years of poor underwriting caused loan delinquencies and foreclosures to grow rapidly over 2007 and 2008.[21] The Congressional Budget Office (CBO) estimates the cost of the GSE bailout at $291 billion.[22] Only reducing the role of Fannie Mae and Freddie Mac in housing finance can meaningfully reduce the likelihood of future bailouts.

Letting the "patch" expire will eliminate an unnecessary privilege granted to two government-favored institutions, which cannot prevail in a more competitive market. It will also help reduce taxpayer exposure to mortgage defaults and create incentives for lenders to ensure that

16 Harriet Torry, "U.S. Mortgage Debt Hits Record, Eclipsing 2008 Peak," *Wall Street Journal*, August 13, 2019, https://www.wsj.com/articles/u-s-mortgage-debt-hits-record-eclipsing-2008-peak-11565708431.

17 CFPB, "ATR/QM Rule Assessment Report," 192.

18 U.S. Treasury, "Housing Reform Plan," 33.

19 Ibid., 11: ". . . the GSEs' underwriting criteria . . . have become the industry standard even for non-GSE mortgage loans."

20 Ibid., 34 ff.

21 Christopher J. Mayer, Karen M. Pence, and Shane M. Sherlund, "The Rise in Mortgage Defaults," Staff Working Paper 2008-59, Federal Reserve Board (November 2008), 2-3, https://www.federalreserve.gov/pubs/feds/2008/200859/200859pap.pdf.

22 Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2009, 17, https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/08-25-budgetupdate_1.pdf.

mortgages with higher DTI ratios have low early delinquencies. (This incentive is already in place for non-QM loans, but not for "patch" loans.)[23] Finally, allowing the "patch" to expire will support alternative securitization of mortgages outside the GSEs.

The Positive Impact of the "Patch" on Housing Affordability is Questionable

Supporters of the "patch" argue that it promotes housing affordability. Specifically, they argue that non-standard and underserved borrowers—such as young buyers, retirees, and minorities—are overrepresented in the pool of mortgages originated under the "patch."[24] Yet there are reasons to question that the "patch" makes housing more affordable for the less well-off, and that underserved borrowers in fact always benefit from easy access to mortgage lending.

Evidence shows that house price growth among lower-priced homes has outpaced that of higher-priced ones by as many as 30 percentage points since 2012. Much of that excess growth took place after the GSE "patch" went into effect in 2014.[25] Even if the "patch" increased access to higher-DTI mortgages, which lower-income and non-standard borrowers are more likely to apply for, the above-average price growth for these homes has offset the "patch's" impact on access to mortgage loans. Indeed, by inducing higher home prices and therefore bigger mortgages, the "patch" may have caused borrowers to take out more high-DTI loans than they would have without it. In other words, the "patch" may have created a market for itself.

It is a mistake to conflate housing affordability with homeownership. Promoting housing affordability entails changing policy to make the cost of both owned and rental housing lower for consumers, particularly those of lesser means. Promoting greater homeownership may or may not address this issue. Particularly in the context of supply-side restrictions on building, easier credit can mainly translate into higher prices, with little positive impact on affordability and homeownership rates.[26] It is also worth questioning the extent to which homeownership is in fact advanced by costly, low down-payment mortgages on which borrowers are likely to default.

Finally, the financial crisis demonstrated that housing credit for housing credit's sake is a misguided policy objective. Many underserved borrowers may in fact suffer greater financial distress as a result of getting a mortgage, if they soon find themselves unable to make regular payments and falling into delinquency and even default. Bad repayment performance, by adversely affecting a borrower's credit score, also has a negative impact on her future access to financial services. The goal should not be to extend more credit to underserved groups, but to ensure that they have access to competitively priced financial services and a good standard of living, whether they own or rent. Importantly, this should happen without endangering taxpayers and overall financial stability.

[23] CFPB, "ATR/QM Rule Assessment Report," 83.
[24] Archana Pradhan, "Expiration of the CFPB's Qualified Mortgage 'GSE Patch' – Part 2" *CoreLogic Blog*, July 19, 2019, https://www.corelogic.com/blog/2019/07/expiration-of-the-cfpbs-qualified-mortgage-gse-patch-part-2.aspx, and Pradhan, "Expiration of the CFPB's Qualified Mortgage 'GSE Patch' – Part 3," *CoreLogic Blog*, July 26, 2019, https://www.corelogic.com/blog/2019/07/expiration-of-the-cfpbs-qualified-mortgage-gse-patch-part-3.aspx.
[25] Edward J. Pinto, Tobias Peter, and Neil Filosa, "The QM Patch: The Seen, the Unseen, and the Foreseeable," *AEI Blog*, August 22, 2019, http://www.aei.org/publication/the-qm-patch-the-seen-unseen-and-foreseeable/.
[26] Serafin Grundl and You Suk Kim, "The Marginal Effect of Government Mortgage Guarantees on Homeownership," Federal Reserve Board Staff Working Paper 2019-027 (February 2019), 31-32, https://www.federalreserve.gov/econres/feds/files/2019027pap.pdf.

The DTI Ratio is a Good Predictor of Loan Delinquency

Some analysts argue, using recent loan performance data, that the DTI ratio is not a useful predictor of loan default.[27] However, using longer-term data that capture the full credit cycle, it quickly becomes apparent that DTI ratios are often strongly predictive of default, particularly in distressed circumstances.

For example, long-term loan performance data from the years before the financial crisis suggest that loan delinquencies increased with the DTI ratio, particularly as house prices rose and underwriting standards generally declined from the early 2000s.[28] The CFPB's own research prior to releasing the 2013 Rule shows the same relationship between DTI ratios and loan delinquencies.[29] Subsequent CFPB research confirms the strong positive correlation between DTI ratios and mortgage default.[30] DTI ratios are not the sole factor determining a mortgage loan's likelihood of default. Other common measures, such as the borrower's credit score, the loan amount as a share of the market value of the home, and the borrower's cash flow all show some predictive power.[31] Furthermore, there may be complex interactions between these discrete variables, such that—for example—DTI ratios are a stronger predictor of default for higher- than lower-loan-to-value (LTV) mortgages.

Some evidence does suggest that better underwriting can mitigate the impact of a higher DTI ratio on default risk: mortgage loans above the 2013 Rule's DTI limit for the general category of QM loans had higher delinquency rates when they met the conditions of the "patch" than when originated under the 2013 Rule's ATR requirements.[32] In other words, compensating factors—such as a lower LTV ratio—that are more often present in high-DTI non-QM loans than in high-DTI "patch" loans seem to reduce default probability.

In fact, rates of early delinquency for higher-DTI mortgages purchased by the GSEs *increased* after the "patch" went into effect.[33] A possible interpretation of this result is that the QM "patch" created moral hazard—that is, the regulatory sanction implied by the "patch" increased incentives for lenders to engage in riskier originations and for the GSEs to make riskier loan purchases.

The uncompetitive nature of the guarantor market and the explicit Treasury backstop for the GSEs further complicate effective risk management. The lack of competition between guarantors means Fannie Mae and Freddie Mac cross-subsidize the mortgages they purchase: riskier mortgages are cheaper, and less risky mortgages more expensive, than they would be in a market with many

27 Karan Kaul and Laurie Goodman, "What, If Anything, Should Replace the QM GSE Patch," Urban Institute, 5, https://www.urban.org/sites/default/files/publication/98949/qualified_mortgage_rule_0.pdf.
28 Lynn Fisher, Norbert Michel, Tobias Peter, and Edward Pinto, "Analysis of the BCFP's (CFPB's) temporary Qualified Mortgage category announced in January 2013, commonly known as the 'Patch'," AEI Working Paper, March 1, 2019, 13-14, http://www.aei.org/wp-content/uploads/2019/03/BCFP-Analysis-of-the-temporary-QM-category-the-Patch-3.1.19-FINAL.pdf.
29 77 FR 33123.
30 CFPB, "ATR/QM Rule Assessment Report," 102-105.
31 For recent evidence on cash-flow underwriting in unsecured consumer and small-business lending, see generally FinRegLab, "The Use of Cash-Flow Data in Underwriting Credit," July 2019, https://finreglab.org/wp-content/uploads/2019/07/FRL_Research-Report_Final.pdf.
32 CFPB, "ATR/QM Rule Assessment Report," 83.
33 Ibid., 113.

guarantors. Additionally, the Treasury backstop makes poor underwriting less consequential because taxpayers stand behind the GSE guarantees.

The goal of the 2013 ATR/QM Rule is to minimize early delinquencies. Because higher DTI ratios correlate with higher risk of early delinquencies, especially for mortgages that meet the "patch's" underwriting requirements, the CFPB should let the "patch" expire.

The "Patch" Reduces the Pressure to Improve the CFPB's ATR/QM Rules

One of the less-noted consequences of the "patch" is that it limits the impetus for reforming the CFPB's 2013 ATR/QM Rule in order to make compliance less burdensome and increase legal certainty for originators. Existence of the "patch" makes the need to change ATR/QM regulations less urgent, because lenders can shift much of their origination activity to QM loans, even when those loans do not meet the 2013 Rule's general category. Paradoxically, the "patch" can lead to both fewer overall originations *and* a riskier mortgage pool, if it causes lenders to retreat from legally uncertain but economically sound underwriting in favor of the "patch's" regulatory safe harbor, for which early delinquency rates are higher and underwriting requirements looser.[34]

Allowing the "patch" to expire eliminates a perverse safety valve that stands in the way of better mortgage lending policy.

How to Improve the 2013 ATR/QM Rule

The U.S. mortgage market is far from a free and competitive one. There is a long history of pernicious government interventions in the primary and secondary markets that have caused unsound lending, increased financial instability, and made consumers worse off.[35] Despite having copious evidence of the unintended consequences of much existing mortgage-market regulation, Congress included highly prescriptive language in the Dodd-Frank Act instructing the CFPB to issue comprehensive regulations on how lenders should verify a borrower's ability to repay a mortgage loan.

But there is scope for improvement of the ATR/QM Rule as the "patch" expires. The CFPB should seek to create conditions for a competitive mortgage market in which lenders have an incentive to supply credit and innovate in their underwriting methods. ATR/QM rules should aim at eliminating incentives to originate unsound loans, without hampering originations that do not cause financial distress or put taxpayers at risk. Finally, the safe harbor QM designation should apply only to loans that meet the Rule's objective of minimizing early delinquencies. Measures to provide a safe harbor for mortgages should reflect a loan's underlying credit risk.

In practice, that means retaining a DTI limit for QM loans, since the main alternative that some analysts have called for (an interest rate measure) is not equally reflective of default risk. The

34 CFPB, "ATR/QM Assessment Report," 9.
35 See generally Peter J. Wallison, *Hidden in Plain Sight: What Really Caused the Worst Financial Crisis and Why It Could Happen Again* (New York: Encounter, 2015); Edward J. Pinto, "Government Housing Policies in the Lead-Up to the Financial Crisis: A Forensic Study," American Enterprise Institute discussion draft, February 5, 2011, http://www.aei.org/wp-content/uploads/2010/10/Pinto-Government-Housing-Policies-in-the-Lead-up-to-the-Financial-Crisis-Word-2003-2.5.11.pdf.

CFPB should also consider using an aggregate measure that combines DTI with other predictive factors such as LTV ratios and the historical performance of loans, to more comprehensively capture loan default risk.

The CFPB should, however, also provide a safe harbor for non-QM loans without delinquent payments after some specified amount of time.[36] Since the CFPB assumes as "early delinquent" loans that are 60 or more days delinquent within the first year or two years of origination,[37] that safe harbor should apply somewhere between the first 12 and 24 months of the life of the loan.

Finally, the CFPB should allow lenders to use a "reasonable method" to verify borrower income and ability to repay, based on commonly accepted underwriting standards and historical loan performance. This will promote competition between lenders and encourage the use of predictive borrower information, while reducing the burden of income verification that Appendix Q currently poses. Because the proposed alternative safe harbor will only apply to mortgages that have no delinquencies in their first 24 months of existence, there will not be an incentive for lenders to originate risky mortgages using dubious income verification methods.

A DTI Limit is a Better Predictor of Default than the Loan Interest Rate

Some analysts have proposed having the CFPB replace the 43 percent DTI limit in the general category of QM loans with an interest-rate-based measure. Under the most common such proposal, all mortgage loans with an interest rate no higher than the Average Prime Offered Rate (APOR) plus 150 basis points would earn QM status.[38]

In a competitive market, one might expect the loan interest rate to more conclusively reflect default risk than other measures, since it would capture the price of credit given the borrower's own specific circumstances and all the features of the loan. In our current market, however, government-owned or -sponsored entities purchase four-fifths of U.S. mortgage originations. Government dominance means that mortgage interest rates are subject to significant cross-subsidies, whereby lower-risk borrowers pay a higher rate than they would in a competitive market; higher-risk borrowers pay a lower rate; and taxpayers ultimately stand behind the pool of mortgages that government entities acquire and guarantee. Consequently, interest rates do not accurately reflect default risk in today's marketplace.[39]

DTI ratios, on the other hand, are predictive of default risk, especially in distressed circumstances. Therefore, the CFPB should retain a DTI limit for the general category of QM loans. It should also be noted that retaining a 43 percent DTI limit for QM loans does not preclude lenders from originating non-QM loans above that limit. Indeed, the CFPB's ATR/QM Assessment Report

[36] Norbert J. Michel, "The Best Housing Finance Reform Options for the Trump Administration," *Forbes*, July 15, 2019, https://www.forbes.com/sites/norbertmichel/2019/07/15/the-best-housing-finance-reform-options-for-the-trump-administration/#7a13a7b77d3f.
[37] CFPB, "ATR/QM Assessment Report," 15 and footnote 10.
[38] Kaul and Goodman, "What, If Anything, Should Replace the QM GSE Patch," 6.
[39] Norbert Michel, Tobias Peter, and Edward Pinto, "The Housing Lobby's APOR Solution for Replacing the QM 'Patch' Is Fatally Flawed," American Enterprise Institute working paper, June 14, 2019, 5-6, http://www.aei.org/wp-content/uploads/2019/06/The-Housing-Lobbys-APOR-Solution-is-fatally-flawed-final.pdf.

showed that non-QM loans above the current limit have been originated *and* performed better than similar loans under the GSE "patch."[40]

Create a Safe Harbor for Non-Delinquent Loans After a Reasonable Period Following Origination

To provide certainty to lenders and encourage the origination of sound loans under competitive underwriting, the CFPB should create a safe harbor for non-QM loans, if they have not become delinquent by a specific date from the time of origination.

There are two advantages to this proposal. First, it would make compliance with ATR requirements more straightforward by assuring lenders that they would not be liable for failed loans long after their origination. Second, this type of safe harbor protection would be harder to game: lenders could not easily "time" harmful loans to go delinquent only after a given period following their origination. Indeed, such a standard would reflect the fact that, if loans go delinquent long after their origination, it is likely the consequence of the borrower's idiosyncratic circumstances or of general economic trends, rather than the lender's supposedly poor underwriting.

There may be a concern that the proposed safe harbor might encourage origination of mortgages whose terms are favorable to the borrower for the first few years and become more expensive once the seasoning period expires. If a lender holds such a loan in its portfolio, however, it cannot benefit from engaging in this practice. Moreover, a competitive guarantor market such as the Treasury envisages in the long term is unlikely to tolerate such behavior, as it would shift delinquencies from the lender to the guarantor. However, if the CFPB is concerned about the impact of a broad safe harbor on the current market, it could restrict the seasoning period exemption to either mortgages held in portfolio or those that meet the QM requirements on amortization, points and fees, and other loan characteristics.

How long should this "seasoning period"[41] last before a mortgage loan earns QM status? Given the CFPB's view that "early payment defaults" are those that occur within a year of origination, and given its "more expansive definition," which includes loans that go 60 days delinquent within the first two years of origination,[42] a seasoning period of between 12 and 24 months seems suitable. The CFPB could start with a 24-month seasoning period and review the safe harbor in light of loan performance five years after its implementation.

Finally, the CFPB should allow lenders to use a "reasonable method," based on current knowledge about the accuracy of consumer data, to verify the income of borrowers. This provision should complement or replace Appendix Q. The CFPB should also specify a safe harbor that uses reliable consumer data, such as individual income tax returns and financial statements. At present, Appendix Q is burdensome, unclear, and regarded as out-of-date. Furthermore, the GSEs' dominance since the 2013 Rule came into effect renders them essentially standard-setters for mortgage underwriting. By exhibiting greater openness to reasonable methods of income verification and implementing a clear safe harbor that uses only reliable measures of household income, the CFPB can foster more competitive underwriting without increasing risk.

[40] CFPB, "ATR/QM Assessment Report," 83.
[41] U.S. Treasury, "Housing Reform Plan," 40.
[42] CFPB, "ATR/QM Assessment Report," 15 and footnote 10.

Conclusion

The forthcoming expiration of the QM "patch" provides the CFPB with an opportunity to begin crafting policy that increases competition in mortgage underwriting, reduces taxpayers' exposure to unsound loans, and ensures both consumer protection and financial stability. For that to happen, the role of the GSEs in secondary markets must decline and private underwriting of sound non-QM loans must have the room to flourish. By retaining a 43 percent DTI limit and providing a safe harbor for all mortgages after a seasoning period, the CFPB can set the foundations for gradual change in this direction.

Thank you again for your leadership on this important issue and the opportunity to comment on the CFPB's ANPR on the Qualified Mortgage Definition under the Truth in Lending Act.

Sincerely,

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