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Patricia A. McCoy
Boston College Law School, patricia.mccoy@bc.edu

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Comment of Professor Patricia A. McCoy
on Docket No. CFPB-2019-0039
RIN 3170-AA98

Boston College Law School
885 Centre Street
Newton Centre, MA 02459
617-552-2927
mccoyp@bc.edu
September 16, 2019

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

Dear Director Kraninger:

Thank you for the opportunity to comment on the CFPB's recent Advance Notice of Proposed Rulemaking (ANPR) on the definition of a Qualified Mortgage (QM). I am a law professor at Boston College Law School and previously had the honor of heading the Bureau's Mortgage Markets group.[1]

I. <u>Executive Summary</u>

This ANPR revisits the special definition of Qualified Mortgages purchased by Fannie Mae and Freddie Mac (the so-called "GSE Patch"). The GSE Patch is due to expire on January 10, 2021. On the surface, the issue is whether the GSE Patch should be renewed or scrapped. The real issue, however, is whether *any* definition of a QM should impose a debt-to-income (DTI cap). Currently, the Bureau's definition of a General QM has a 43 percent DTI cap, while its other definitions of QMs do not. As a result, QMs purchased by the GSEs are free from a CFPB-mandated DTI limit, yet are insulated from legal exposure.

A coalition of industry representatives and some consumer groups are arguing for repeal of the GSE Patch and elimination of the 43 percent DTI cap from the definition of a General QM.[2] Some of the coalition members would lift the DTI cap *in toto*, while other members would only eliminate it for prime and near-prime loans.[3] Removing the DTI cap from the General QM would effectively leave no mandatory DTI cap in place for *any* mortgages, including both QM and non-QM loans.

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[1] The comments in this letter are based on a forthcoming law review article titled *The Macroprudential Implications of the Qualified Mortgage Debate*, J. L. & CONTEMP. PROBS. (forthcoming 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3453511, coauthored with economist Susan M. Wachter from The Wharton School.

[2] Kate Berry, *Consumer groups, lenders find common cause against CFPB mortgage provision*, AM. BANKER, Aug. 27, 2019.

[3] *Id.*

In support of its position, the coalition argues that debt-to-income ratios are only weakly predictive of mortgage defaults. At the same time, DTI caps disproportionately restrict access to credit for minority and lower-income applicants. This adverse effect on mortgage availability poses particular concern given the continued depressed homeownership rate post-2008[4] and entrenched wealth disparities in the United States.

I wholeheartedly concur that increased access to mortgage credit for low-income and minority borrowers is of pressing concern. Home equity is the single biggest source of wealth for low-income and minority households[5] and the most powerful channel of intergenerational wealth transmission for those groups.

However, the coalition's proposal presents a false dichotomy between risk and access to credit. Access to credit has more dimensions than the coalition acknowledges. Underwriting standards are not the only constraint on credit availability. Policies that fuel rapidly rising housing prices also shut underserved borrowers out of credit markets. And where home price appreciation accelerates into a bubble and then a bust, minority and lower-income borrowers will bear the brunt of the toll. This is why, in the QM debate, consumer welfare crosses paths with systemic risk.

In order to curb rapidly inflating home prices that especially hurt underserved borrowers, there are better ways of expanding access to credit than repealing the DTI cap for all loan applicants, regardless of income or wealth. Taking a more nuanced approach to access to credit is furthermore a matter of urgency because rescinding a general DTI cap would remove an important safeguard to U.S. financial stability.

During incipient housing bubbles, DTI limits provide a brake on excessive housing price appreciation. By tying loan applicants' debt obligations to the income they have to service those debts, a general DTI cap acts as a circuit breaker to an unsustainable spiral in housing prices. Otherwise, left to their own devices, mortgage lenders and investors have incentives to relax their own internal DTI tests when home prices are rising in order to maintain their origination volumes. Because market discipline will not halt an inflating housing bubble occasioned by deteriorating DTI levels, the CFPB needs to mandate a general DTI cap as part of the definition of a QM. This cap would apply to private-label, portfolio, and GSE QM loans with no carve outs for automated underwriting.

However, I would temper that DTI cap in two important respects. First, the CFPB's Research group should examine whether the 43 percent DTI limit could be modestly raised without significantly raising housing prices or default risk, that is, without increasing systemic risk. Second, the CFPB should further relax the DTI cap for loans that meet the affordable housing

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4 In second quarter 2019, the U.S. homeownership rate stood at 64.1%, off from a high of 69.2% at year-end 2004. *Homeownership Rate for the United States*, FRED ECON. DATA (Fed. Res. Bank of St. Louis) (viewed Sept. 7, 2019), https://fred.stlouisfed.org/series/RHORUSQ156N.

5 Christopher E. Herbert, Daniel T. McCue & Rocio Sanchez-Moyano, *Update on Homeownership Wealth Trajectories Through the Housing Boom and Bust* 2 (Joint Center for Housing Studies of Harvard University Working Paper, February 2016), http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/2013_wealth_update_mccue_02-18-16.pdf.

goals established by the Federal Housing Finance Agency (FHFA). Providing targeted DTI relief to affordable housing goal loans would expand credit availability to those who really need it without creating inflationary pressures culminating in a future real estate bubble.

II. Why Residential Mortgages Pose Systemic Risk

It is critical for the CFPB to consider financial stability when revisiting the GSE Patch because residential mortgages are *the* leading source of systemic risk.[6] Indeed, the worst financial crises for centuries have been caused by real estate bubbles financed by loose credit.[7] One needs only recall the toll from the 2008 financial crisis, after the last housing bubble burst, to appreciate the dangers of lax mortgage lending.

Rapid housing price appreciation and loose credit typically march in tandem because skyrocketing prices pressure lenders (and regulators) to relax incentives to engage in sound underwriting, absent legal or other constraints.[8] When home values are rising, borrowers having trouble making payments can usually steer clear of default by refinancing their mortgages or paying off their loans by selling their homes.[9] These escape routes suppress delinquency rates during periods of home price appreciation, which emboldens lenders to ease lending standards.[10]

As underwriting standards relax, borrowers flood the housing market, artificially stoking demand for houses and, with it, home prices.[11] At that point, housing values become apt to balloon

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6 *See, e.g.*, INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: VULNERABILITIES IN A MATURING CREDIT CYCLE 62 (2019), https://www.imf.org/en/Publications/GFSR/Issues/2019/03/27/Global-Financial-Stability-Report-April-2019 ("More than two-thirds of the nearly 50 systemic banking crises in recent decades were preceded by boom-bust patterns in house prices").

7 MARKUS K. BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 32 (Geneva Reports on the World Economy 11, 2009), http://www.princeton.edu/~markus/research/papers/Geneva11.pdf; Richard J. Herring & Susan M. Wachter, *Real Estate Booms and Banking Busts: An International Perspective* 2-3 (The Wharton School Research Paper No. 99-27, July 1999); CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY xliv–xlv, 158–62 (Princeton: Princeton Univ. Press, 2009); Moritz Schularick & Alan M. Taylor, *Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870–2008*, 102 AM. ECON. REV. 1029, 1032 (2012). As this suggests, in important respects, the housing cycle *is* the business cycle. E.E. Leamer, Housing *is* the business cycle (Nat'l Bureau Econ. Research No. w13428); Y. Huang, Q. Li, K.H. Liow, & X. Zhou, Is Housing the Business Cycle? A Multi-resolution Analysis for OECD Countries (2018).

8 Ben Bernanke & Mark Gertler, *Agency costs, net worth, and business fluctuations*, 79 AM. ECON. REV. 14, 15 (1989); Herring & Wachter, *supra* note 7, at 11-12.

9 SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 130 (New York: Pantheon Books, 2010).

10 The run-up to the 2008 financial crisis was the latest example of this type of deterioration. Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* (Fed. Res. Bank of St. Louis working paper, 2008). *See also* Susan Wachter, *The Housing and Credit Bubbles in the United States and Europe: A Comparison*, 47 J. MONEY, CREDIT & BANKING 37, 39 (2015) (documenting similar loosening of mortgage lending standards during the Asian Financial Crisis and other prior bubbles).

11 Johnson & Kwak, *supra* note 9, at 130; Atif Mian & Amir Sufi, *Fraudulent Income Overstatement on Mortgage Applications During the Credit Expansion of 2002 to 2005*, 30 REV. FINAN. STUDIES 1831, 1832-37 (2017); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 204-06 (Princeton: Princeton University Press, 3d ed. 2015).

because creditors and investors cannot gauge the true extent of the credit risk that has mounted in the system.[12]

A feedback loop kicks in, in which rising prices stimulate looser credit, which then further fuels prices. At some point, however, additional easing of credit no longer fans demand at the same rate. As the cycle heads downward, housing prices decelerate, and lenders stop make mortgages based on the expectation of constant or increasing home values. The housing price boom becomes a housing price bust.[13]

There are four reasons why housing bubbles are so dangerous to financial stability.[14] First, most purchasers finance their homes with mortgages granted by banks or nonbank lenders. As 2008 demonstrated, both types of lenders are susceptible to runs and thus to financial contagion. Second, since investors cannot sell homes that they do not own, there are no effective short-sale techniques to rein in house prices.[15] Third, as credit contracts in the wake of the housing slump, loans will become difficult to come by, forcing households to cut back on spending. Finally, foreclosure is the main way of resolving distressed mortgages in default, which dumps abandoned homes on the real estate market and further depresses house prices.

In the Dodd-Frank Act, Congress mandated the ability-to-repay (ATR)/QM requirements to stop a future deterioration in lending standards that could precipitate another housing crisis. Dodd-Frank designated the category of qualified mortgages (QM) as loans that would provide a presumption against liability for ability-to-repay violations. In return, General QMs insure safety against borrower and systemic risk, specifically by including a debt-to-income maximum ratio. Removing this DTI limit effectively for all loans is equivalent to removing all such lending limits through regulation.

While risk-averse lenders may maintain such or similar lending constraints internally, some lenders may not and they will still be able to claim to funders that their loans are QMs. This could lead, with the growth in the share of such lenders and the resulting competitive pressures, to the removal of DTI constraints entirely.

Once a competitive race to the bottom in lending standards is underway, even lenders who nominally have proprietary DTI limits may do everything they can to override those limits by

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12 Adam J. Levitin & Susan M. Wachter, *Why Housing?*, 23 HOUSING POL'Y DEBATE 5, 18-19 (2013); Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1184, 1189, 1254 (2012) [hereinafter Explaining the Housing Bubble].

13 Johnson & Kwak, *supra* note 9, at 157.

14 For in-depth discussion of these dynamics, see, *e.g.*, Patricia A. McCoy & Susan M. Wachter, *Why the Ability-to-Repay Rule Is Vital To Financial Stability*, ___ GEO. L.J. ___ (forthcoming 2020) [hereinafter ATR Rule and Financial Stability], https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3444360.

15 Herring & Wachter, *supra* note 7. Some investors came up with ways to short mortgage-backed securities and collateralized debt obligations during the years culminating in 2008. However, that shorting activity actually increased the amount of leveraged lending and did not cause mortgage lending default premia (adjusted for risk) to rise or housing prices to fall. *See* Patricia A. McCoy & Susan Wachter, *Why Cyclicality Matters to Access to Mortgage Credit*, 37 BOSTON COLLEGE J. L. & SOC. JUSTICE 361, 366 (2017); Explaining the Housing Bubble, *supra* note 12, at 1243-49. In fact, the risk-adjusted price of the put option continued to fall throughout the bubble. Such a decline in the put option should in theory cause a rise in asset prices. Explaining the Housing Bubble, *supra*, at 1203-06.

finding compensating factors to underwrite these QM loans. Their job is to get the loans done and that is how they are paid in the originate-to-distribute model.[16] Investors are not able to observe the compensating factors, which are soft data, and compensating factors override the safety constraints that hard data in the form of DTI would provide.[17] Nonbank lenders would not need to retain additional capital and given their scant equity cushion, they would be incentivized to take heightened risks. The potential for destabilization from banks to nonbanks that has been noted under the current system worsens.[18] This is the scenario that the ability-to-repay provisions in the Dodd-Frank Act and the DTI cap in the definition of a General QM are designed to prevent.

III. Debt-to-Income Ceilings And Other Sectoral Regulatory Tools

The DTI cap in the General QM definition is a prime example of a sectoral tool in mortgage regulation designed to reduce systemic risk.[19] DTI limits and other sectoral tools seek to curb the build-up of excessive risk in systemically important industries such as housing. In the home mortgage arena, countries have used sectoral tools including leverage (loan-to-value) limits, debt-to-income caps, provisioning rules, and capital adequacy risk weights to help avoid housing booms and busts.[20]

In the United States, regulators use capital adequacy risk weights and DTI limits (as part of the General QM test) to limit systemic risk from residential mortgages.[21] But the U.S. firmly rejected mandatory loan-to-value (LTV) limits[22] for residential mortgages due to access to credit

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16 Johnson & Kwak, *supra* note 9, at 127-28, 132.

17 One of the ability-to-repay rule's strongest benefits lies in imposing a number of objective requirements, including ones that generate hard data that facilitate outside monitoring of risk by investors and regulators. ATR Rule and Financial Stability, *supra* note 14, working draft at 52-54. If the CFPB permitted QM lenders to override a DTI cap with compensating factors, this would undermine the production and meaning of that valuable hard data.

18 You Suk Kim, Steven M. Laufer, Karen Pence, Richard Stanton & Nancy Wallace, *Liquidity crises in the mortgage market* (BPEA Conference Draft 2018), https://www.brookings.edu/bpea-articles/liquidity-crises-in-the-mortgage-market/; Patricia A. McCoy & Susan M. Wachter, *Representations and Warranties: Why They Did Not Stop The Crisis*, *in* EVIDENCE AND INNOVATION IN HOUSING LAW AND POLICY 289, 303-04 (L. Fennell & B. Keys, eds., Cambridge University Press, 2017), https://www.cambridge.org/core/services/aop-cambridge-core/content/view/5B65B670D71709EEBA5DD31F0549338A/9781107164925AR.pdf/Evidence_and_Innovation_in_Housing_Law_and_Policy.pdf?event-type=FTLA.

19 Patricia A. McCoy, *Countercyclical Regulation and Its Challenges*, 47 ARIZ. ST. L.J. 1181, 1208-13 (2015) [hereinafter Countercyclical Regulation]; International Monetary Fund, *supra* note 6, at 44.

20 *See* Countercyclical Regulation, *supra* note 19, at 1208-13; OFFICE OF FINANCIAL RESEARCH, 2013 OFR ANNUAL REPORT 35–38 & fig. 27 (2013) (cataloguing sectoral tools used in the United States), http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2013.pdf.

21 Under the Basel regime, the risk-weighted capital standards for depository institutions include risk weights for residential mortgages. Countercyclical Regulation, *supra* note 19, at 1199-1205, 1209.

22 While the GSEs and FHA have internal caps on LTVs, they retain discretion to relax those caps. The GSEs set their current limits relatively high, at 97%. Fannie Mae, 97% LTV Options, https://www.fanniemae.com/singlefamily/97-ltv-options (last viewed Jan. 11, 2019); Freddie Mac, Home Possible® Mortgage, http://www.freddiemac.com/homepossible/ (last viewed Jan. 11, 2019). Meanwhile, FHA insures home mortgages with LTVs of 90% to 96.5%, depending on the borrower's credit score. U.S. Department of Housing & Urban Development, HUD Home Store Frequently Asked Questions (FAQs): Consumers and the General Public 2 (May 2015), https://www.hud.gov/sites/documents/PUBLICFAQ.PDF; U.S. Department of Housing & Urban Development, Summary of FY 2015 FHA Annual Report to Congress on the Financial Health of the Mutual

concerns. This question reared its head in 2013, when the CFPB decided against incorporating an LTV limit into the ATR/QM rule on grounds that down payments do not reflect repayment capacity.[23] Around that same time, other federal financial regulators floated a proposal to impose a tough LTV cap through the back door by requiring securitizations backed by residential loans with loan-to-value ratios exceeding 70 percent to hold risk retention of 5 percent.[24]

This risk retention proposal ignited protest due to its likely adverse effect on mortgage availability and household wealth, particularly for lower-income and minority borrowers.[25] According to an influential 2012 study, 75 percent of African-American borrowers and 70 percent of Latino borrowers with performing loans could not have afforded a 20 percent down payment requirement when they first obtained their mortgages.[26] In the end, federal regulators eliminated the 70 percent leverage limit from the final risk retention rule and replaced it with a risk retention exemption for securitizations backed solely by qualified mortgages.[27]

As a result of these events, the United States does not use mandatory LTV ratios or credit score cutoffs to constrain mortgage risk. Instead, the federal government turned to other sectoral tools that would impinge less on credit access. Notably, these included the income documentation and verification requirements in the ability-to-repay rule and the DTI cap in the General QM definition. If these are weakened – by eliminating any DTI limit for QMs and throwing out Appendix Q – then the United States effectively will have abandoned its most important sectoral tools for avoiding future mortgage crises.

IV. Why Debt-to-Income Caps Provide Critical Protections

The crux of the debate over the expiration of the GSE Patch is the controversy over DTI caps. Opponents of the 43 percent DTI cap maintain that there is no justification for mandating a maximum debt-to-income ratio for QMs, arguing that DTI ratios are weakly correlated with mortgage default risk. However, the empirical evidence on that point is split. Some recent studies report a stronger relationship between DTI ratios and the incidence of home loan defaults. This section reviews that evidence.

Even more importantly, and lost in the current debate, debt-to-income ratios are important in constraining systemic risk from incipient housing bubbles. For justifiable reasons, the United

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Mortgage Insurance Fund 9 (Nov. 16, 2015), https://archives.hud.gov/news/2015/pr15-146-FHAAnnRptDeck111315.pdf.

[23] *Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act* (Regulation Z), 78 Fed. Reg. 6408, 6527 (Jan. 30, 2013).

[24] Credit Risk Retention, 78 Fed. Reg. 57928, 57932 (proposed Aug. 28, 2013).

[25] DARRYL E. GETTER, CONG. RESEARCH SERV., ABILITY TO REPAY, RISK-RETENTION STANDARDS, AND MORTGAGE CREDIT ACCESS 13–15 (R7-5700, 2012), http://www.fas.org/sgp/crs/misc/R42056.pdf; ROBERTO G. QUERCIA ET AL., BALANCING RISK AND ACCESS: UNDERWRITING STANDARDS AND QUALIFIED RESIDENTIAL MORTGAGES 10–11 (2012) [hereinafter Balancing Risk], http://www.responsiblelending.org/mortgage-lending/research-analysis/Underwriting-Standards-for-Qualified-Residential-Mortgages.pdf; *Revitalizing the Private Mortgage Market: 'Skin in the Game' and the Consequences for Future Homebuyers*, KNOWLEDGE@WHARTON (May 11, 2011), http://knowledge.wharton.upenn.edu/article.cfm?articleid=2775.

[26] Balancing Risk, *supra* note 25, at 10–11, 27–28.

[27] Credit Risk Retention, 79 Fed. Reg. 77602, 77607, 77685, 77688–89 (Dec. 24, 2014). Mortgages that qualify for this exemption are known as "qualified residential mortgages" or QRMs.

States previously nixed another important sectoral technique – mandatory loan-to-value caps – to curb the systemic risk from home loans in the QRM debate. Federal financial regulators made that decision even though combined loan-to-value ratios are strongly correlated with mortgage defaults[28] and even though global regulators strongly advise LTV caps to constrain systemic risk.[29] Now that the United States has jettisoned leverage caps as a brake on housing bubbles, it is critical for the CFPB to take cognizance of the systemic risk implications of scrapping a DTI cap as well. As this section discusses, there are strong financial stability reasons to retain a DTI cap in the QM definition. First, however, I will re-examine the relationship between debt-to-income ratios and default propensities on home mortgages.

A. <u>Debt-to-Income Ratios and Mortgage Default Rates</u>

Under the double trigger theory of mortgage default, negative equity alone is not the leading reason why households default on home mortgages. Instead, underwater borrowers default when they no longer have the income to make timely mortgage payments.[30] Accordingly, one might think that keeping mortgage payments reasonable through DTI caps could help reduce defaults.

The bulk of studies on debt-to-income ratios conclude that those ratios are not strongly predictive of defaults when compared to leverage ratios and loan documentation standards.[31] However,

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[28] *See, e.g.,* John Y. Campbell & João F. Cocco, A Model Of Mortgage Default 3 (working paper Oct. 2011); Yuliya Demyanyk, *Quick Exits of Subprime Mortgages*, 91 FED. RES. BANK OF ST. LOUIS REV. 79 (2009); Yuliya Demyanyk, Ralph S.J. Koijen & Otto A.C. Van Hemert, Determinants and Consequences of Mortgage Default 13-15 (Working Paper Jan. 2011), http://ssrn.com/abstract=1706844; Ronel Elul, Nicholas S. Souleles, Souphala Chomsisengphet, Dennis Glennon & Robert Hunt, What "Triggers" Mortgage Default?, Working Paper No. 10-13, at 6-7 & tbl. 1 (Fed. Res. Bank of Phila. Research Dept., Apr. 2010); Chris Foote, Kristopher Gerardi & Paul Willen, Negative equity and foreclosures: theory and evidence (Fed. Res. Bank of Boston Public Pol'y Discussion Paper No. 08-3, 2008); Julapa A. Jagtiani & William W. Lang, Strategic Default on First and Second Lien Mortgages During the Financial Crisis 16, 21 (Fed. Res. Bank of Philadelphia Working Paper No. 11-3, 2009), http://ssrn.com/abstract=1724947; Johnson & Kwak, *supra* note 9, at 127; Christopher Mayer, Karen Pence & Shane M. Sherlund, *The Rise in Mortgage Defaults*, 23 J. ECON. PERSPECTIVES 42-43 (2009); Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages*, 38 REAL ESTATE ECON. 399, 413-16 (2010); John Quigley & Robert Van Order, *Explicit tests of contingent claims models of mortgage default,* 11 J. REAL EST. FIN. & ECON. 99-117 (1995); Shane M. Sherlund, The Past, Present, and Future of Subprime Mortgages 9-10 & tbl. 5 (Federal Res. Bd. Finance & Econ. Discussion Series Working Paper 2008-63, 2008), http://www.federalreserve.gov/pubs/feds/2008/200863/200863pap.pdf; U.S. Government Accountability Office, Nonprime Mortgages: Analysis of Loan Performance, Factors Associated with Defaults, and Data Sources 22 (GAO-10-805, 2010).

[29] *See, e.g.,* Countercyclical Regulation, *supra* note 19, at 1210 & n.139, 1212 & n.148; International Monetary Fund, *supra* note 6, at 44.

[30] Most homeowners with negative equity continuing paying their mortgages if they can. *See, e.g.,* Elul et al., *supra* note 28, at 2; Chester Foster & Robert Van Order, *An Option-based Model of Mortgage Default*, 3 HOUSING FINANCE REV. 351 (1984); Kerry D. Vandell, *How Ruthless is Mortgage Default? A Review and Synthesis of the Evidence*, 6 J. HOUSING RESEARCH 245 (1995). Strikingly, strategic defaults were relatively uncommon in the aftermath of the 2008 financial crisis and being underwater on loans was not sufficient alone for most homeowners in that position to default on their loan payments. Neil Bhutta, Jane Dokko & Hui Shan, The Depth of Negative Equity and Mortgage Default Decisions (Fed. Res. Bd. Finan. & Econ. Discussion Series Working Paper 2010-35, 2010), https://www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf.

[31] *See, e.g.,* Yuliya Demyanyk & Otto Van Hemert, Understanding the Subprime Mortgage Crisis 2, 19 (working paper 2008), http://ssrn.com/abstract=1020396; Marsha Courchane, Leonard C. Kiefer & Peter M. Zorn, Underwriting Standards, Loan Products and Performance: What Have We Learned? 6 (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2341818;Yongheng Deng & Stuart Gabriel, Modeling the

most of these studies examined mortgage originations before 2008, when no- and low-documentation mortgages were prevalent. Indeed, there was such a large surge in reduced-documentation mortgages that by 2006, those loans accounted for about two-thirds of prime adjustable-rate mortgages (ARMs), four-fifths of Alt-A ARMs,[32] and virtually half of subprime ARMs.[33] Researchers have concluded that for millions of mortgages originated pre-2008 without full documentation or verification of income, the borrowers' income was overstated, which artificially suppressed the DTI ratios for those loans.[34] Since the ability-to-repay was instituted effective 2014, reported incomes have become much more accurate and so have DTI ratios.[35]

In view of today's improved reliability of reported income and thus DTI, it is time to reassess the predictive value of DTI ratios. Two new studies find DTI levels more probative of default. This year's CFPB assessment of the ATR rule reported that "after controlling for other underwriting criteria, . . . higher DTI . . . independently increase[s] expected early delinquency, regardless of the other factors."[36] Another 2019 study, by DeFusco and colleagues, found a similar but smaller positive relationship between DTI levels and likelihood of default.[37] In another data point, Freddie Mac recently reported to its regulator's inspector general that on average, Freddie Mac "mortgages from 2017-2018 with a maximum allowable DTI perform[ed] worse than mortgages with lower DTIs."[38] The Bank of England also concluded that mortgage arrears of at least two months rose sharply in the United Kingdom when debt servicing ratios exceeded 40 percent.[39]

Performance of FHA-Insured Loans: Borrower Heterogeneity and the Exercise of Mortgage Default and Prepayment Options 13 (U.S. Department of Housing and Urban Development, 2002); Richard Green, *The Trouble with DTI as an Underwriting Variable—and as an Overlay*, RICHARD'S REAL ESTATE AND URBAN ECONOMICS BLOG, Dec. 7, 2016; Karan Kaul & Laurie Goodman, *Updated: What, If Anything, Should Replace the QM GSE Patch?* 6-10 (Urban Inst. Oct. 2018), https://www.urban.org/sites/default/files/publication/99268/2018_10_30_qualified_mortgage_rule_update_finalized_4.pdf.

[32] The term "Alt-A" partly referred to mortgages with reduced-documentation or high DTI ratios made to borrowers with stronger credit. Sumit Agarwal & Calvin T. Ho, *Comparing the prime and subprime mortgage markets*, 241 CHICAGO FED LETTER 1, 2 (Aug. 2007).

[33] Patricia A. McCoy, Andrey D. Pavlov & Susan M. Wachter, *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 493, 505 fig. 3 (2009).

[34] W. Jiang, A. Nelson & E. Vytlacil, *Liar's Loans? Effects of Loan Origination Channel and Loan Sale on Delinquency*, 96 REV. ECON. & STATISTICS 1 (2014); Michael LaCour-Little & Jing Yang, *Taking the Lie Out of Liar Loans: The Effect of Reduced Documentation on the Performance and Pricing of Alt-A and Subprime Mortgages*, 35 J. REAL ESTATE RESEARCH 507 (2013), http://pages.jh.edu/jrer/papers/pdf/past/vol35n04/05.507_554.pdf.

[35] Federal Housing Finance Agency Office of Inspector General, An Overview of Enterprise Debt-to-Income Ratios 6 (WPR-2019-002, March 27, 2019) [hereinafter IG Report], https://www.fhfaoig.gov/sites/default/files/WPR-2019-002.pdf.

[36] Bureau of Consumer Financial Protection, Ability-to-Repay and Qualified Mortgage Rule Assessment Report 104-05 (Jan. 2019) [hereinafter CFPB ATR Assessment], https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf; *id.* at 100-05, 112-15; *accord* IG Report, *supra* note 35, at 7.

[37] Anthony DeFusco, Stephanie Johnson & John Mondragon, Regulating Household Leverage 5 (working paper 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3046564.

[38] IG Report, *supra* note 35, at 16.

[39] Bank of England, Financial Stability Report 4 & chart A.6 (June 2019), https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/june-

At a minimum, these newer studies up-end any definitive conclusion that DTI ratios have little or no effect on default risk. Research findings now point both ways. Thus, scrapping a QM DTI cap raises the risk that U.S. regulators may be increasing default risk for a wide swath of residential mortgage loans. When one adds to that the fact that the United States has no loan-to-value cap or credit score cutoffs, the added danger of layering one risk on another[40] during a time of rising home prices in the form of high DTIs, high LTVs, and lower credit scores poses serious concern.

In sum, there *is* a danger that abolishing a DTI cap for QM loans will boost default risk throughout the mortgage system. Beyond that, DTI caps have a separate, important and unheralded effect in constraining price inflation during housing bubbles. This effect, as I now discuss, is a crucial independent reason for defining Qualified Mortgages to retain a DTI cap.

B. DTI Caps and Housing Bubbles

The GSE Patch debate has largely focused on the effects of DTI caps on default rates and access to credit. But there has been next to no discussion of the beneficial restraints that DTI caps place on housing bubbles. It would be short-sighted to eliminate a DTI cap from the definition of a QM loan because doing so would remove an important brake on runaway home prices.

DTI limits provide an important constraint on housing bubbles in a rising price environment. As a home's value rises above a specific price, the monthly loan payments on that home will outstrip the DTI limit of more and more homebuyers as they become income-constrained. In the process, that DTI cap will stop most of those buyers from qualifying for a loan to purchase the home regardless how much the house is worth.[41] Without financing, these customers are unlikely to bid on that home, reducing demand and with it the price pressures that fuel a housing

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2017.pdf?la=en&hash=EB9E61B5ABA0E05889E903AF041B855D79652644. The UK debt servicing ratio includes an interest rate component.

[40] Mortgage loans that feature two or more predictors of default risk pose a higher chance of delinquency. Campbell & Cocco, *supra* note 28, at 3, 21-22, 24-27 & figs. 3-4; Shirish Chinchalkar & Roger M. Stein, Comparing loan-level and pool-level mortgage portfolio analysis 20 (Moody's Research Labs 2010) ("[i]n the mortgage setting, research suggests that the relationship between, e.g., default probability and loan factors is non-linear, and in some cases highly so . . ."); Kristopher S. Gerardi, Andreas Lehnert, Shane M. Sherlund & Paul Willen, *Making Sense of the Subprime Crisis, in* LESSONS FROM THE FINANCIAL CRISIS: CAUSES, CONSEQUENCES, AND OUR ECONOMIC FUTURE 109, 112 & Exh. 15.2 (New York: John Wiley & Sons, Robert W. Kolb ed., 2010); General Accountability Office, Housing: Information on Recent Default and Foreclosure Trends for Home Mortgages and Associated Economic and Market Developments 47 (GAO-08-78R, Oct. 16, 2007); Clifford V. Rossi, Anatomy of Risk Management Practices in the Mortgage Industry: Lessons for the Future 34 (Research Institute for Housing America 2010) (in an option-pay ARM, "[t]he combination of reduced FICO together with a simultaneous second lien, a higher loan amount and stated income, stated asset documentation presents incremental default risk beyond the individual risk factors"); Shane M. Sherlund, Mortgage Defaults 2-3 & fig. 2 (working paper 2010) (a report prepared by Amherst Securities for the Securities & Exchange Commission concluded that "[n]egative equity and the layering of risk are the largest components of default across mortgage products").

[41] Daniel L. Greenwald, The Mortgage Credit Channel of Macroeconomic Transmission 8 & fig. 1 (working paper, Nov. 3, 2017), https://bcf.princeton.edu/wp-content/uploads/2017/11/DG-Paper-mortgage_credit_channel_nov_2017.pdfGreenwald.

bubble.[42] With a binding DTI cap, aspiring homebuyers will respond by increasing their down payments, buying cheaper homes or waiting until a later time to embark on homeownership. Conversely, absent that cap, demand for houses would automatically rise,[43] perpetuating a vicious cycle of inflating home prices in the face of inelastic supply. The inflating house prices come not only from aspiring previously closed out renters, but also from those who wish to buy a larger home or a trade-up home. The change in the rule generally enables the increase in indebtedness pro-cyclically across the income distribution.[44]

A new study has specifically studied this effect for QM loans. In a recent landmark paper, Daniel Greenwald simulated the effect of the CFPB's 43 percent DTI cap for General QMs on the housing bubble culminating in the 2008 financial crisis. Greenwald concluded that the 43 percent cap could have reduced the bubble by over one-third had it been in place back then.[45]

Moreover, it is essential to stress that DTI caps kick in to retard future price increases when LTV limits are no longer binding. Normally, LTV limits are the biggest constraint on borrowing by mortgage applicants.[46] However, the United States has no mandatory LTV limit for residential mortgages. Furthermore, even if it did, LTV ratios are misleading during bubbles because they disguise housing price inflation.[47]

The misleading nature of LTV ratios during bubbles arises from the fact that loan-to-value is by definition a ratio and therefore the numerator and denominator covary. Rising home prices will push up the denominator even as loan sizes rise, which will help keep LTV ratios level even as risk is mounting in the system. What results is a deceptive impression of safety even as prices exceed fundamentals.[48] This was apparent from LTV ratios at the height of the last bubble in

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[42] David Aikman, Jonathan Bridges, Anil Kashyap & Caspar Siegert, *Would Macroprudential Regulation Have Prevented the Last Crisis?*, 33 J. ECON. PERSPECTIVES 107, 120-21 (2019).

[43] P. Linneman & S. Wachter, *The impacts of borrowing constraints on homeownership*, 17 AM. REAL EST. & URB. ECON. ASS'N J. 4 (1989); Edward J. Pinto, Tobias Peter & Neil Filosa, *The QM patch: The seen, unseen, and foreseeable* (Am. Enterprise Inst., Aug. 22, 2019), http://www.aei.org/publication/the-qm-patch-the-seen-unseen-and-foreseeable/print/?mkt_tok=eyJpIjoiTkRZMlkyUXlOakpqWXpkbSIsInQiOiIyQStJTEhUWDFlalV1amFmSlFoK1d6Z1g1TTRBeTk1SEFva3BqXC85R3NVOUw1KzhUWGZFQ0J4aTJzRTVKbmhMN0hib3huRWxoejcybGJ2bGtqeFoydVNnRFd1MGdacnhlVkpYM3hieDlcL2U3VnpTY0JqVTlIckQ2NWNzSW5xeHBQIn0%3D; J.E. Stiglitz & A. Weiss, *Credit rationing in markets with imperfect information*, 71 AM. ECON. REV. 393 (1981).

[44] Arthur Acolin, Xudong An, Raphael Bostic & Susan Wachter, *Homeownership and Nontraditional and Subprime Mortgages*, 27 HOUSING POL'Y DEBATE 393 (2017) (demonstrating that credit extension for homeownership, contrary to received opinion, did not particularly go to underserved populations).

[45] Greenwald, *supra* note 41, at 4. Similarly, Pinto et al., *supra* note 43, recently found that for the period 2012 to 2018, "census tracts that had above average DTIs (those above 37%) experienced [housing price appreciation] that is faster, and in many cases much faster, than the county average."

[46] A. Acolin, J. Bricker, P. Calem & S. Wachter, *Borrowing constraints and homeownership*, 106 AM. ECON. REV.: PAPER & PROCEEDING 625 (2016); I. Barakova, P. Calem & S. Wachter, *Borrowing constraints during the housing bubble*, 24 J. HOUSING ECON. 4 (2014); Linneman & Wachter, *supra* note 43.

[47] Jose G. Montalvo & Josep Raya, Constraints on LTV as a Macroprudential Tool: A Precautionary Tale 6-9 (Barcelona GSE Working Paper Series No. 1008, Dec. 2017), https://www.barcelonagse.eu/sites/default/files/working_paper_pdfs/1008.pdf.

[48] LTV limits can also be manipulated when home values are inflating by incurring added debt as a home's value soars through junior liens, either in the form of simultaneous piggyback second loans or later on through refinance transactions. This is one more way LTV ratios can stay deceptively flat while home prices increase.

2006, when LTV ratios were almost the same as in 2014, when credit standards generally had tightened.[49]

During housing bubbles, home price appreciation becomes impounded in the "V" of LTV ratios through the appraisal process. In boom environments, mortgage actors expect prices to continue to increase based on recent past appreciation. This becomes a self-fulfilling prophecy driving up demand and home values.[50] As property prices increase, appraisers use these market prices as comparables when conducting appraisals. Appraisers further face pressure to inflate their appraisals to satisfy lenders' goal of closing loans and thus to secure repeat business from lenders.[51] Inflated appraisals create a feedback loop, as new sales based on those appraisals provide the basis for a fresh round of inflated comparables, which prop up even higher appraised home values in future sales. This artificial feedback loop then ratchets up the denominator of LTV ratios, which undercuts their power as a constraint on artificial price rises. This is why DTI limits are "the more effective tool for limiting the size of boom-bust cycles," compared to LTV caps, as Greenwald's analysis shows.[52]

Greenwald's findings have powerful implications for the debate over the GSE patch. Right now, the GSE Patch requires no DTI cap. As a result, the effective DTI limits on GSE loans are the proprietary internal limits set by the GSEs. In April 2017, the Federal Housing Finance Agency (FHFA) relaxed the GSEs' DTI cap for mortgages processed through automated underwriting by prohibiting the GSEs from rejecting mortgage applicants who have DTI ratios of up to fifty percent, based solely on DTI.[53] The FHFA directive liberalized the DTI cap for all GSE loans, including for affluent borrowers who would have been able to obtain home loans anyway without relaxing the cap. As a result, *all* GSE borrowers have the ability to buy more expensive houses within the conforming limits than they did before, holding income constant.

As the 2017 directive demonstrates, the GSEs can raise their internal DTI caps under the GSE Patch without the CFPB's permission. This poses serious concerns because average DTI ratios have risen under the GSE Patch for GSE loans. After the FHFA directive in 2017, the GSEs' DTI ratios jumped. By fourth quarter 2018, 26 percent of mortgage purchases by Fannie Mae and 18 percent of those by Freddie Mac had DTI ratios of over 45 percent.[54] In Fannie Mae's case, this represented a *three-fold* increase from mid-2017.[55] From mid-2017 to the end of 2018, the proportion of GSE loans with maximum allowable DTI ratios and LTV ratios of over 95

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49 Greenwald, *supra* note 41, at 9-12 & fig. 2.

50 K.E. Case & R.J. Shiller, *Forecasting prices and excess returns in the housing market*, 18 REAL ESTATE ECON. 253 (1990); C. Himmelberg, C. Mayer & R. Sinai, *Assessing high house prices: Bubbles, fundamentals and misperceptions*, 19 J. ECON. PERSPECTIVES 67 (2005).

51 Montalvo & Raya, *supra* note 47, at 6 (reviewing literature); Leonard Nakamura, *How much is that home really worth? Appraisal bias and house-price uncertainty*, BUS. REV. 11 (2010).

52 Greenwald, *supra* note 41, at 45*; accord* Aikman et al. *supra* note 42, at 119-20.

53 IG Report, *supra* note 35, at 11. The directive also forbade the GSEs from imposing overlays related to DTI ratios for mortgages with DTI ratios of up to 50%. *Id.* Over 90% of the mortgages bought by the GSEs go through one or the other of their automated underwriting programs (Desktop Underwriter (DU) for Fannie Mae and Loan Product Advisor (LPA) for Freddie Mac). *Id.* at 6-7.

54 *Id.* at 12 fig. 2 & 13.

55 *Id.*; *see also* Archana Pradhan, DTI Has Risen for Conventional Conforming Loans, CORELOGIC INSIGHTS BLOG (March 20, 2019), https://www.corelogic.com/blog/2019/03/dti-has-risen-for-conventional-conforming-loans.aspx.

percent or a credit score under 680 also increased.[56] Because the GSEs' home purchase mortgages have generally higher DTIs than their refinance loans,[57] this risk layering has placed upward pressure on home prices while ramping up the risk in the GSEs' loan portfolios.

A CoreLogic analyst attributed the rise in DTI levels to pressures to ease credit posed by rising home prices combined with stagnant wage growth:[58]

> [H]ome-sale price[s] continued to rise throughout the last quarter of 2018 while wage growth was almost stagnant. The rise in share of loans with a DTI ratio above 45 percent reflects the affordability pressure caused by the widening gap between home-price appreciation and wage growth.

FHFA's Inspector General reached the same conclusion.[59] Thus, we are seeing the classic precursor to a potential bubble where lenders respond to rising home prices by cutting lending standards in order to maintain the same volume of borrowers.

Finally, mandatory DTI caps serve another crucial macroeconomic purpose by increasing borrowers' resilience.[60] When family debt service ratios at origination are stretched to the maximum, that leaves them with no cash-flow cushion if a recession or other economic shock hits. If those borrowers then have trouble making their mortgage payments, they will cut other spending, amplifying economic downturns.[61]

Significant segments of the mortgage industry are urging the CFPB to lift the DTI cap across-the-board, irrespective of applicants' income or wealth.[62] That would be a serious mistake. To the contrary, it is more important than ever for the CFPB to retain a DTI cap, both to constrain default risk and future housing bubbles.

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[56] IG Report, *supra* note 35, at 13-14 & fig. 3.

[57] *Id.* at 15.

[58] Pradhan, *supra* note 55 (footnote omitted).

[59] IG Report, *supra* note 35, at 15 (according to FHFA, "rising interest rates and home prices increased the cost of homeownership, and in turn debt burden, which caused an increase in DTI during these years").

[60] Most lower-income families have troublingly little financial resilience. In a sobering statistic, the median family in the bottom income quintile in 2016 only had $900 in total financial assets and the median family in the second lowest quintile only had $5000. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, 2016 SCF CHARTBOOK 115 (2017). This number is conditional on owning a financial asset. In 2016, 95.2% of bottom-quintile families and 97.4% of second-quintile families did own financial assets. *Id.* at 114.

[61] Bank of England, *supra* note 39, at 3; Anil Kashyap, *My reflections on the FPC's strategy* 5, 7-8 (March 28, 2019). https://www.bankofengland.co.uk/speech/2019/anil-kashyap-the-50th-anniversary-of-the-journal-of-money-credit-and-banking-conference; Anil K. Kashyap & Caspar Siegert, Financial Stability Considerations and Monetary Policy 3 (May 2019) ("for households, the distribution of the debt service to income ratio (DSR) merits special attention [because] when the right hand tail of that distribution rises, it signals that the number of at-risk households has risen and deleveraging risk is higher"), https://www.federalreserve.gov/conferences/conference-monetary-policy-strategy-tools-communications-20190605.htm.

[62] CFPB ATR Assessment, *supra* note 36, at 257-59.

V. **This Is Not The Time To Remove A DTI Cap**

The upcoming decision about the fate of the GSE Patch comes at a perilous moment in the country's economic cycle. The current ten-year expansion eclipsed the U.S. record in July[63] and is long in the tooth. Fears are circulating about an upcoming recession. The growth in gross domestic product "has been the most anemic on record" and "[w]age growth also has been slow."[64]

Inflated home prices pose a particular concern. U.S. housing prices have steadily trended upward for 32 straight quarters and are starting to soften, according to the latest FHFA report.[65] Meanwhile, the price-to-rent ratio remains high.[66] This is just when--near or at the top of the housing cycle--history would predict credit standards to loosen. And that is what we see. Top DTI ratios are on the rise[67] and the median combined LTV ratio at origination is "relatively high,"[68] partly due to "credit-loosening policies" by the GSEs.[69] Similarly, this is the point in the cycle when market participants can be expected to push for even looser credit. Although delinquencies are low, rising home prices make it difficult to gauge the amount of risk in the mortgage system.

Accordingly, the CFPB should proceed with caution as it decides what to do with the GSE Patch. Loosening QM credit standards could have an adverse procyclical effect by adding fuel to any bubble. Furthermore, if debt-to-income levels become unmoored from the CFPB's standard setting, market competition could eliminate meaningful internal DTI caps altogether. The danger is a disaster in the making when asset prices are already high relative to rents.

VI. **The CFPB Has The Jurisdiction And Responsibility To Consider Systemic Risk In Its Rulemaking Decisions**

The 43 percent DTI cap in the General QM definition serves at least two important roles: one, by reducing default risk, and two, by constraining potential housing bubbles and the systemic risk they pose. That DTI limit has added importance in view of the fact that the United States has rejected safeguards against systemic risk in the form of loan-to-value caps. Furthermore, the General QM DTI limit serves a third role, by preventing lenders' internal DTI caps from unraveling under competitive pressure.

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63 Yun Li, *This is Now the Longest U.S. Expansion in History*, CNBC.COM, July 2, 2019, https://www.cnbc.com/2019/07/02/this-is-now-the-longest-us-economic-expansion-in-history.html.

64 Jon Hilsenrath, *After Record-Long Expansion, Here's What Could Knock the Economy Off Course*, WALL ST. J., June 3, 2019, https://www.wsj.com/articles/after-record-long-expansion-heres-what-could-knock-the-economy-off-course-11559591043.

65 Federal Housing Finance Agency, U.S. House Prices Rise 1.0 Percent in Second Quarter; Up 5.0 Percent from Last Year 1 (Aug. 27, 2019), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/HPI_2019Q2.pdf.

66 *Real House Prices and Price-to-Rent Ratio in May*, CALCULATED RISK BLOG, Aug. 7, 2019, https://www.calculatedriskblog.com/2019/08/real-house-prices-and-price-to-rent.html.

67 Pradhan, *supra* note 55.

68 Urban Institute, Housing Policy Finance Center, *Housing Finance at a Glance: A Monthly Chartbook* 15 (Aug. 2019), https://www.urban.org/sites/default/files/publication/100866/august_chartbook_2019_0.pdf [hereinafter Chartbook].

69 Pradhan, *supra* note 55.

Naturally, this discussion raises the question whether the CFPB has the authority to take systemic risk into account. An examination of Dodd-Frank's provisions reveals not only that the Bureau has the jurisdiction to consider systemic risk in its rulemaking, but that the Bureau has a statutory responsibility to do so.

The CFPB's responsibility to safeguard financial stability is grounded in two provisions of the Dodd-Frank Act. First, the Director of the Bureau by law is a voting member of the Financial Stability Oversight Council (FSOC),[70] which is the body ordained by Congress to oversee financial stability and respond to emerging systemic risks.[71] As a voting member of FSOC, the Director thus is charged with official responsibility for safeguarding the financial stability of the United States.

Second, Congress in Dodd-Frank gave FSOC the authority to overturn any CFPB rule if it determines "that the regulation or provision would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk."[72] By implication, this provision not only permits the CFPB to take systemic risk into account when promulgating rules such as the QM rule but means that Congress *expected it to do so*, on pain of potential FSOC reversal.

In addition to these two provisions in Dodd-Frank, any relaxation of the QM definition has repercussions for the definition of a qualified residential mortgage. In the final QRM rule, federal financial regulators defined qualified residential mortgages as all QMs and thus excused securitizations consisting solely of QMs from the risk retention requirements (see discussion on page 6 *supra*). Congress instituted the risk retention requirements as an added financial stability safeguard to ensure that securitizers have skin in the game. Removing the DTI cap from the General QM definition would inadvertently dilute the risk retention protection as well.

For all of these reasons, it is important for the CFPB to discharge its responsibility to protect financial stability. Under our federal system, mortgage regulation is highly fragmented and no federal prudential regulator supervises the entire home mortgage market for systemic risk.[73] FHFA can mandate investor standards, but only for the GSEs. FSOC has no power to mandate mortgage lending standards.[74] The Board of Governors of the Federal Reserve System is the closest thing to a financial stability supervisor that the United States has, yet the large swath of mortgages originated by independent nonbank lenders escapes its purview almost entirely.[75]

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[70] 12 U.S.C. § 5321(b)(1)(D).

[71] *Id.* § 5322(a)(1).

[72] *Id.* § 5513(a).

[73] At the federal level, mortgage regulation is shared among the three federal prudential banking regulators, FHFA, the Department of Housing and Urban Development, the Department of Agriculture, the Department of Veterans Affairs, and the CFPB. Jeremy C. Kress, Patricia A. McCoy, & Daniel Schwarcz, *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 SO. CAL. L. REV. ___, working paper at 55-57 (forthcoming 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3238059.

[74] *Id.*, working paper at 20; Alan S. Blinder, *Empower Regulators to Stop Risky Financial Business: The FSOC, created by the Dodd-Frank Act of 2010, doesn't have enough power to do the job right*, WALL ST. J., June 19, 2019.

[75] The only time the Federal Reserve would have jurisdiction over an independent nonbank mortgage lender would be where FSOC designated a lender as systemically risky. No lenders are so designated today and no more designations are on the horizon.

This gap in systemic risk oversight is worrisome, given that nonbank lenders account for two-thirds of home mortgage originations and 85 percent of FHA mortgage originations today[76] but are free from another important sectoral tool in the form of minimum capital requirements.[77]

In the face of this fragmentation, the CFPB is the only federal agency that has rulemaking authority over the entire residential mortgage market. It oversees the entire market and is able to mandate consumer-facing regulations that also further the nation's financial stability. The unique position that the CFPB holds as the one federal regulator with jurisdiction over the complete home mortgage market is another reason why it is important for the Bureau to take cognizance of systemic risk.

A stable financial system is in the long-term interests of every American consumer. Mortgages are an area where the welfare of American families and financial stability coincide. Housing bubbles and the crises that they wreak hurt families in the form of mass unemployment, foreclosures, and contractions in credit. Indeed, the 2008 financial crisis inflicted the largest wealth losses on younger, minority, and less-educated households.[78] These are the same families who are of concern in the access to credit debate. As this suggests, in deliberations over the future shape of Qualified Mortgages, it is vital to craft a definition that will help shield these households from a future financial crisis and potential catastrophic financial harm to their household budgets. It is possible to achieve this longer-term objective while still providing underserved households greater access to credit.

VII. How To Balance The DTI Cap With Access To Credit

Three objectives--default risk, financial stability, and access to mortgage credit--should be uppermost in the CFPB's deliberations when evaluating the future of the GSE Patch. It is eminently feasible to redefine the QM definition going forward to achieve all three goals.

A. A Better Way To Protect The Financial System While Protecting Access To Credit

For reasons of systemic risk, it would be a serious mistake to scrap the DTI cap. It is critical to financial stability to retain a DTI cap in the definition of a General QM and to extend it to GSE loans. This cap would apply both to mortgage decisions underwritten manually and to loans that undergo automated underwriting.[79] Furthermore, originators would not be allowed to deviate from that cap based on compensating factors.[80]

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76 Chartbook, *supra* note 68, at 11.

77 *Id.*

78 William R. Emmons & Bryan J. Noeth, *Household Financial Stability: Who Suffered the Most From the Crisis?*, REGIONAL ECONOMIST (Fed. Res. Bank of St. Louis 2012), https://www.stlouisfed.org/publications/regional-economist/july-2012/household-financial-stability--who-suffered-the-most-from-the-crisis.

79 One proposal would base the selection of QM loans with annual percentage rates of under 250 or 300 basis points above APOR on the use of validated automated underwriting systems. Eric Stein & Michael Calhoun, *A Smarter Qualified Mortgage Can Benefit Borrowers, Taxpayers, and the Economy* 17-18 (Center for Responsible Lending 2019), https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-a-smarter-qualified-mortgage-july2019.pdf. This proposal would include both the GSEs' AU systems and proprietary

Importantly, there are other ways of building flexibility into this system without posing a systemic threat. Specifically, the CFPB should modify the DTI limit in one and perhaps two important respects. First, the Bureau's economic researchers should re-examine the effect of the DTI on two key outcomes--default rates and housing price appreciation--to decide whether to keep the cap at 43 percent or raise it slightly. If research shows that the cap could be modestly relaxed without an unacceptable uptick in risk, that would help expand credit across-the-board.

Second, and apart from any slight loosening of the general 43 percent cap, the CFPB should liberalize that cap for mortgages to creditworthy borrowers from targeted underserved groups. Under this approach, the CFPB would retain a general DTI cap for the large majority of borrowers, while carving out an exception for affordable housing goal loans to low-income and very-low-income borrowers.[81] The benefit of this approach is that it would not place upward pressure on housing price appreciation because only the limited number of lower-income borrowers would qualify for relief from the general DTI cap, rather than all U.S. borrowers indiscriminately. Meanwhile, DTI limits would encourage more affluent borrowers who have ample access to credit to buy smaller, cheaper homes.

Pending any major housing finance reform initiative, the DTI exception for underserved borrowers should be limited to loans that meet FHFA's affordable housing goals.[82] There are two important reasons for this limitation. First, FHFA carefully defines the loans that satisfy the affordable housing goals and also requires them to meet the conforming limits on loan size. Together, these two features limit the total outstanding balance that would qualify for a DTI cap exception and thus keep that exception small enough to safeguard the financial system. Within the outer limits established by the affordable housing goals, the credit risk transfer system is designed to make the market judgment whether tighter lending constraints are needed to ensure safety and soundness.[83]

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automated underwriting systems developed by lenders. This proposal should be rejected because the CFPB does not have the capacity to validate so many proprietary systems or to ensure that, once validated, the algorithms to those systems are not altered unilaterally by lenders.

[80] *See* notes 16-17 *supra* and accompanying text.

[81] This could be accomplished by retaining but amending the GSE patch or by abolishing the Patch but amending the General QM definition.

FHFA defines "low-income" families as those with annual incomes of 80% or less of the area median income (AMI). The Agency defines "very-low-income" families as ones with annual incomes of 50% or less of AMI. 12 C.F.R. § 1282.1(b).

[82] In the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Congress imposed on the GSEs "an affirmative obligation to facilitate the financing of affordable housing for low- and moderate-income families in a manner consistent with their overall public purposes, while maintaining a strong financial condition and a reasonable economic return." 12 U.S.C. § 4501(7). FHFA sets and enforces annual affordable housing goals. 12 U.S.C. §§ 4561, 4566.

In its latest affordable housing goals, FHFA established separate categories of annual goals for home purchase, single-family mortgages for low-income families (24%) and very low-income families (6%). In the single-family space, FHFA set a separate annual goal of 21% for refinancing mortgages for low-income families. Federal Housing Finance Agency, *2018-2020 Enterprise Housing Goals: Final rule*, 83 Fed. Reg. 5878, 5887-91 (Feb. 12, 2018); 12 C.F.R. § 1282.12.

[83] We saw that type of judgment in 2018, after FHFA liberalized the GSEs' DTI limit. Following that decision, in early 2018, the percentage of GSE mortgages with maximum allowable DTIs increased along with the percentage of those mortgages with credit scores below 680. Five of six private mortgage insurers for GSE loans

Second, while FHFA oversees loans that meet the affordable housing goals for the all-important purpose of solvency, non-GSE QM loans have critical gaps in prudential supervision.[84] Unless and until those QM loans undergo the same demanding federal oversight and meet the same definitional standards and conforming loan limits, creating a DTI cap exception for those loans would likely swallow the rule.

Naturally, the Treasury Department's and other proposals for housing finance reform[85] complicate the question of the QM definition long-term. Housing finance is in a period of flux and possible transition. Much remains unclear, including when or if the GSEs will be released from conservatorship and privatized, the scope of FHFA's future mandate and jurisdiction, and the future of the affordable housing goals. In view of that uncertainty, I encourage the CFPB to adopt my more tailored proposal for today's housing finance market and to revisit the QM definition later on if housing finance reform becomes law.[86]

Finally, the CFPB should require adherence to Appendix Q for loans that are currently defined as General QMs as well as for GSE loans. The ability-to-repay rule means nothing if the requirements for documenting and verifying income, assets and financial resources are not rigorous or standardized. Appendix Q provides the vehicle for making that happen. But the CFPB should update Appendix Q in light of recent data and technological advances to examine whether there are more flexible but dependable methods for documenting and verifying the financial resources of self-employed borrowers, seasonal workers, and retirees,[87] consistent with safe and sustainable loans.

B. <u>Other Proposals For Revising The QM Definition Are Overbroad And Would Pose Systemic Risk</u>

A number of other proposals are on the table for amending the QM definition. Among those recommendations, a well-publicized proposal from a coalition of industry representatives and certain consumer groups would remove a DTI cap from the QM definition altogether, at least for prime and near-prime loans. The coalition would also eliminate Appendix Q, with no replacement.[88]

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responded by announcing that they would not insure mortgages with maximum allowable DTIs and credit scores below 700. IG Report, *supra* note 35, at 13-14.

[84] Mortgages by independent nonbank lenders that are not federally guaranteed or insured lack any federal prudential supervision. Similarly, mortgages originated by insured banks and thrifts undergo lighter federal solvency oversight if they are securitized on the private-label market because those loans are no longer held on the institutions' books.

[85] *See, e.g.*, U.S. Department of the Treasury, Housing Reform Plan (Sept. 2019), https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.

[86] In that connection, if future housing finance reform leads to substantial growth in private-label mortgage securitization, non-bank lenders who otherwise are subject to GSE and FHA controls today could and likely would escape those controls by shifting their lending to the private-label market and its weaker investor controls. This danger underscores the continued need for a CFPB definition of qualified mortgages that includes a DTI cap.

[87] Kate Berry, *New Villain in CFPB Mortgage Rule: Appendix Q*, AM. BANKER, Aug. 12, 2019.

[88] Berry, *supra* note 2.

The coalition defends its proposal in the name of expanded access to credit. Despite the superficial appeal of this alternative, it is overbroad and would hurt underserved borrowers while ramping up systemic risk.

First, on the topic of overbreadth: a subset of the supporters of the coalition proposal would indiscriminately lift the CFPB's DTI cap for *all* QM borrowers, including higher-income borrowers and wealthy borrowers. Expanding mortgage credit to underserved applicants does not justify a change of this breadth, particularly because it would have a troubling inflationary effect on housing prices. In fact, scrapping the QM DTI cap for borrowers regardless of income or assets would *disserve* access to credit by pushing average home prices even higher and further out of reach of low-income families.[89] The proposal I advance is superior because it would limit DTI relief to creditworthy lower-income families who really need it, without exerting needless upward pressure on home values.

As this discussion suggests, the second serious concern is financial stability. Right now, the CFPB's current DTI cap provides a guard rail against systemic risk by governmentally mandating a ceiling on DTI levels. Lifting that cap and leaving DTI limits lenders' or guarantors' discretion, as the coalition's proposal would do, would open the door to another destructive race to lower lending standards, free from ability-to-repay liability.[90] We cannot afford to ignore the dangerous ramifications of that approach for financial stability, as the coalition's proposal does.

Here, it is important to mention that some of the coalition supporters favor a slightly different approach. Under this alternative, the CFPB would retain a DTI cap strictly for QM loans that are not "prime or near-prime"—defined as QM loans with a rate spread of at least 250-300 basis points over the Average Prime Office Rate (APOR).[91] Loans priced under that rate spread could qualify for QM status free from a mandatory DTI cap. This so-called "rate spread" option keys off of a 2018 proposal advanced by Laurie Goodman and Karan Kaul at the Urban Institute.[92]

However, as Goodman and Kaul expressly recognized, this approach poses a distinct danger of fueling another housing bubble. In terms of financial stability, the rate-spread approach poses:[93]

> [A] couple of downsides. First, it assumes the market would always price credit risk accurately, which is hardly assured. Rate spreads would be lowest when real estate prices have increased rapidly and are expected to continue to do so, such as during economic

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89 Pinto et al., *supra* note 43, report that under the GSE Patch, housing prices rose more quickly for entry-level homes, compared to higher-priced homes.

90 The fact that most QMs with APRs exceeding APOR by 150 basis points or more for comparable loans only receive a rebuttable presumption of compliance with the ability-to-repay requirement, not a safe harbor, does not allay this concern. That argument assumes that lenders will not underprice home mortgages, as happened during the last housing bubble. Kaul & Goodman, *supra* note 31, at 10. Moreover, lenders have an incentive to game the 150 basis point threshold by pricing loans right below that threshold in order to gain safe harbor status. *Id.* Originators similarly gamed the high-cost loan thresholds under the Home Ownership and Equity Protection Act (HOEPA) in the lead-up to the last financial crisis. EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 28 (Washington, D.C.: Urban Inst. Press, 2007).

91 Stein & Calhoun, *supra* note 79, at 15-16.

92 Kaul & Goodman, *supra* note 31, at 6-10.

93 *Id.* at 10.

booms. Credit is also likely to be more loosely available during such periods, increasing the risk of borrowers getting overextended. Mispricing could also occur because of perceptions that certain borrowers are riskier or less risky, steering borrowers into high-cost loans, or other market failures. Finally, a rate spread-based regime could give lenders an incentive to price mortgages just below the threshold to qualify for the safe harbor.

To get some sense of the magnitude of this threat, FHFA's latest statistics are instructive. In 2017, only 2.4 percent of the single-family mortgages purchased by the GSEs had rate spreads of 150 basis points or more over APOR.[94] Presumably, the percentage of GSE loans with APRs of 250-300 basis points over APOR was even less. This means that under the rate-spread proposal, *over 97 percent of all GSE loans* would continue to have QM status without having to meet a DTI cap. If we add to that all of the non-conforming QM loans below the rate-spread threshold that now must meet the 43 percent cap, virtually all QM loans (not to mention all non-QM loans) would escape a mandatory DTI limit. This would exert substantial upward pressure on housing prices, hurting lower-income homebuyers and boosting the risk of a future housing bubble with no justification. This is the danger of the coalition's overbroad proposal.

Discussion of systemic risk is the missing factor in the current QM debate. Repealing the DTI cap for essentially all home mortgages will increase the chance of another housing bubble and bust by artificially fueling home values and leaving borrowers less resilient. Instituting a DTI cap for all QMs, but modestly increasing that cap if the data justify doing so and relaxing the cap for loans that meet the affordable housing goals, is a better-tailored alternative that would ensure access to credit for the people who really need it--lower-income borrowers--while safeguarding financial stability.

Sincerely,

Patricia A. McCoy

Patricia A. McCoy
Professor of Law, Boston College Law School
Former Assistant Director, Mortgage Markets, Consumer Financial Protection Bureau

[94] Federal Housing Finance Agency, Annual Housing Report—2018, at 25, 36 (2018), https://www.fhfa.gov/AboutUs/Reports/Pages/Annual-Housing-Report-2018.aspx.