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Susan M. Wachter

*University of Pennsylvania*, [wachter@wharton.upenn.edu](mailto:wachter@wharton.upenn.edu)

Patricia A. McCoy

*Boston College Law School*, [patricia.mccoy@bc.edu](mailto:patricia.mccoy@bc.edu)

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# THE MACROPRUDENTIAL IMPLICATIONS OF THE QUALIFIED MORTGAGE DEBATE

PATRICIA A. MCCOY\* & SUSAN M. WACHTER\*\*

## I

### INTRODUCTION

In January 2021, the Consumer Financial Protection Bureau (CFPB or Bureau) will face a decision: renew its special definition for Qualified Mortgages (QMs) made by Fannie Mae and Freddie Mac, abolish that definition, or adopt some other approach to QMs. This seemingly arcane issue, which concerns the so-called Government-Sponsored Enterprise (GSE) Patch,<sup>1</sup> is the subject of fierce debate and a recent Advance Notice of Proposed Rulemaking (ANPR) by the CFPB.<sup>2</sup>

While ostensibly inconsequential to those unfamiliar with the topic, this decision may open the floodgates again to a private-label mortgage system without the necessary regulatory controls to prevent ruinous competition. Today's mortgage market and existing law preclude many toxic mortgage products. But reckless firms offering underpriced credit to weak borrowers can still fuel a future bubble and bust. Moreover, today's market is more vulnerable to such shortsighted lending behavior because of the rise of nonbanks with limited capital.<sup>3</sup>

The GSE Patch is part of a larger 2013 CFPB rule, known as the Ability-to-Repay/Qualified Mortgage Rule (ATR/QM Rule). Congress mandated the ATR/QM Rule in the Dodd-Frank Wall Street Reform and Consumer Protection

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\* Liberty Mutual Insurance Professor, Boston College Law School; [patricia.mccoy@bc.edu](mailto:patricia.mccoy@bc.edu). Our thanks to Simon Johnson, Anna Gelpern, Adam Levitin, and the participants in the Law and Macroeconomics Conference at Georgetown Law on September 27–28, 2019 for their insights and comments.

\*\* Albert Sussman Professor of Real Estate, The Wharton School; [wachter@wharton.upenn.edu](mailto:wachter@wharton.upenn.edu).

1. “GSE” refers to the two Government Sponsored Enterprises: Fannie Mae and Freddie Mac.

2. Consumer Fin. Prot. Bureau, Qualified Mortgage Definition Under the Truth in Lending Act (Regulation Z), 84 Fed. Reg. 37,155 (July 31, 2019) (to be codified at 12 C.F.R. pt. 1026).

3. See, e.g., 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 (Lee Anne Fennell & Benjamin J. Keys eds., 2017) [hereinafter *Representations and Warranties*]; Paul Calem, Lauren Lambie-Hanson, & Susan M. Wachter, *Is the CRA Still Relevant to Mortgage Lending? HOUSING POL’Y DEBATE* (forthcoming); see also SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 84 (2010).

Act in 2010, but left it to the Bureau to work out the details in many respects.<sup>4</sup> As its name suggests, the rule has two components: an ability-to-repay (ATR) requirement and preferential treatment for QMs. The ATR requirement applies to all residential mortgage loans and prohibits creditors from extending those loans unless they first make a reasonable and good faith determination of the borrowers' ability to repay.<sup>5</sup> Lenders who violate this rule and their assignees are liable to borrowers.<sup>6</sup>

The QM provision goes hand-in-hand with this liability provision. QMs are home loans with safer features that receive preferential legal treatment in the form of a presumption of compliance with the ATR requirement.<sup>7</sup> QMs are fully amortizing residential mortgages with terms of thirty years or less, restrictions on prepayment penalties, and points and fees of up to three percent.<sup>8</sup> Importantly, the borrower's debt-to-income (DTI) ratio may not exceed forty-three percent under the general definition of a QM (the General QM).<sup>9</sup> However, the GSE Patch, an exception to the General QM definition, provides that QM loans eligible for GSE purchase are exempt from the forty-three percent DTI cap.<sup>10</sup>

The GSE Patch is due to expire on January 10, 2021, which is why the definition of a QM is up for debate. 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 DTI cap. Industry trade associations have joined forces with some consumer groups, arguing for abolition of the GSE Patch and elimination of the forty-three percent DTI cap from the definition of a General QM.<sup>11</sup> Some members of this coalition advocate lifting the DTI cap *in toto*, while others would only eliminate it for prime and near-prime loans.<sup>12</sup> Removing the DTI cap from the General QM would effectively leave no mandatory DTI cap in place for *any* mortgages, including QM and non-QM loans.<sup>13</sup>

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4. Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, § 1411(a)(2), 124 Stat. 1376 (2010) (codified at 15 U.S.C. § 1639c(a) (2018)).

5. *Id.*

6. *Id.*; see also 15 U.S.C. § 1640(a); ANDREW G. PIZOR, MORTGAGE LENDING: LOAN ORIGINATION, PREEMPTION, AND LITIGATION § 3.4.2 (2d ed. 2014) (discussing applicable Truth in Lending Act cause of action).

7. CONSUMER FIN. PROT. BUREAU, BASIC GUIDE FOR LENDERS: WHAT IS A QUALIFIED MORTGAGE? 1, [https://files.consumerfinance.gov/f/201310\\_cfpb\\_qm-guide-for-lenders.pdf](https://files.consumerfinance.gov/f/201310_cfpb_qm-guide-for-lenders.pdf) [<https://perma.cc/PZG3-T6U5>].

8. *Id.*

9. *Id.*

10. *Id.*

11. Kate Berry, *Consumer Groups, Lenders Find Common Cause Against CFPB Mortgage Provision*, AM. BANKER (Aug. 27, 2019), <https://www.americanbanker.com/news/consumer-groups-lenders-find-common-cause-against-cfpb-mortgage-provision> [<https://perma.cc/W79W-CQC�>]; Letter from the Am. Bankers Ass'n et al., to Hon. Kathleen L. Kraninger (Sept. 9, 2019) (on file with authors) [hereinafter ABA Letter].

12. Berry, *supra* note 11; ABA Letter, *supra* note 11, at 1, 1 n.1.

13. See *infra* Part V.

In support of its position, the coalition argues that DTI ratios are only weakly predictive of mortgage defaults,<sup>14</sup> pointing to mortgage data from the build up to the Great Recession, data, as we describe below, that are tainted by false reporting of incomes.<sup>15</sup> At the same time, the coalition also argues correctly that DTI caps disproportionately restrict access to credit for minority and lower-income applicants.<sup>16</sup> This adverse effect on mortgage availability poses particular concern given the continued depressed homeownership rate post-2008<sup>17</sup> and entrenched wealth disparities in the United States.

We wholeheartedly concur that increased access to mortgage credit for low-income and minority borrowers is of pressing concern. Of particular importance, African-American families continue to suffer from the lingering effects of institutionalized bias in the form of housing discrimination, ballot-box suppression, and extreme disparities in wealth. In the face of rampant inequality, home equity plays an outsized role as the single biggest source of wealth<sup>18</sup> and the most powerful channel of intergenerational wealth transmission for these and other low-income and minority households.

Despite this reality, those seeking to abolish the GSE Patch and lift the DTI cap raise a false dichotomy between risk and access to credit. There are more tailored ways of expanding access to credit to underserved groups than lifting the DTI cap for most or all loan applicants, regardless of income or wealth. Taking a more nuanced approach to access to credit is a matter of urgency because rescinding a general DTI cap would remove an important safeguard to U.S. financial stability while undermining affordable housing.

During incipient housing bubbles, DTI limits should theoretically provide a brake on excessive housing price appreciation. By tying loan applicants' debt obligations to the income they have to service them, a general DTI cap acts as a circuit breaker to an unsustainable spiral in housing prices. Without a government-imposed DTI limit, rising home prices would incentivize mortgage lenders and investors to relax their own internal DTI tests to maintain origination volumes. This phenomenon justifies the DTI cap. Because market discipline will not halt an inflating housing bubble occasioned by deteriorating DTI levels, the

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14. Comment Letter by the Ctr. for Responsible Lending et al. 6–7 (Sept. 16, 2019) [hereinafter CRL Letter] (on file with authors) (citing ERIC STEIN & MICHAEL CALHOUN, CTR. FOR RESPONSIBLE LENDING, A SMARTER QUALIFIED MORTGAGE CAN BENEFIT BORROWERS, TAXPAYERS, AND THE ECONOMY 9–10 (2019), <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-a-smarter-qualified-mortgage-july2019.pdf> [<https://perma.cc/2LBK-K6S8>]); see ABA Letter, *supra* note 11, at 3.

15. See *infra* Part V(A).

16. See *infra* Part VI.

17. In the second quarter of 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*, FED. RES. BANK OF ST. LOUIS, <https://fred.stlouisfed.org/series/RHORUSQ156N> [<https://perma.cc/VB8D-2LQ5>].

18. Christopher E. Herbert, Daniel T. McCue & Rocio Sanchez-Moyano, *Update on Homeownership Wealth Trajectories Through the Housing Boom and Bust 7* (Joint Ctr. for Housing Studies of Harvard Univ. Working Paper, Feb. 2016), [http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/2013\\_wealth\\_update\\_mccue\\_02-18-16.pdf](http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/2013_wealth_update_mccue_02-18-16.pdf) [<https://perma.cc/TLU5-9GMP>].

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.

Our proposal would temper that DTI cap in two important respects. First, the CFPB's research group should examine whether the forty-three 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 goals established by the Federal Housing Finance Agency (FHFA). Providing targeted DTI relief to these loans would expand credit availability to those who really need it without creating a future real estate bubble that would jeopardize financial stability and with it, affordable housing prices.

This Article suggests that three objectives—financial stability, default risk, and access to credit—should guide the CFPB's deliberations when evaluating the future of the GSE Patch. Part II examines the relationship between residential mortgages and financial stability. Part III discusses Dodd-Frank and the DTI limit. Part IV looks at sectoral tools other than the DTI limit that are used to reduce systemic risk. Parts V and VI propose alternative approaches to a DTI cap. Finally, Part VII examines the DTI cap as it relates to access to credit.

## 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.<sup>19</sup> Indeed, the worst financial crises for centuries have been caused by real estate bubbles financed by loose credit.<sup>20</sup> We need only recall the toll from the 2008 financial crisis, after the last housing bubble burst, to appreciate the grave risks of lax mortgage lending.

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19. See, e.g., INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: VULNERABILITIES IN A MATURING CREDIT CYCLE 62 (2019) [hereinafter IMF], <https://www.imf.org/en/Publications/GFSR/Issues/2019/03/27/Global-Financial-Stability-Report-April-2019> [<https://perma.cc/43PB-UEBT>] (“More than two-thirds of the nearly 50 systemic banking crises in recent decades were preceded by boom-bust patterns in house prices.”).

20. See Yuting Huang, Qiang Li, Kim Hiang Liow, & Xiaxia Zhou, *Is Housing the Business Cycle? A Multi-resolution Analysis for OECD Countries 2* (Working Paper, 2018) (citing Edward E. Leamer, *Housing Is the Business Cycle* (Nat'l Bureau Econ. Research, Working Paper No. w13428, 2007)) (suggesting, in important respects, that the housing cycle *is* the business cycle); see also CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY xlii–xlv, 158–62 (2009) (discussing housing price cycles and banking crises); 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) (explaining that lagged credit growth is a predictor of financial crises); MARKUS K. BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION 32 (July 5, 2009), <http://www.princeton.edu/~markus/research/papers/Geneva11.pdf> [<https://perma.cc/XL9U-FJFU>] (explaining that “[m]ost financial crises are preceded by asset price bubbles”); 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) (explaining that real estate cycles and banking crises correlate “in a remarkable number of instances”).

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.<sup>21</sup> When home values are rising, borrowers having trouble making payments can usually steer clear of default by refinancing their mortgages or by selling their homes to pay off their loans.<sup>22</sup> These escape routes keep delinquency rates low during periods of home price appreciation, which emboldens lenders to ease lending standards.<sup>23</sup>

As underwriting standards relax, borrowers flood the housing market, artificially stoking demand for houses and, with it, home prices.<sup>24</sup> At that point, housing values become apt to balloon because creditors and investors cannot gauge the true extent of the credit risk that has mounted in the system.<sup>25</sup> A feedback loop ensues, in which rising prices stimulate looser credit, which further fuels prices.<sup>26</sup> At some point, however, additional easing of credit no longer fans demand at the same rate.<sup>27</sup> As the cycle heads downward, housing prices decelerate, and lenders stop extending mortgages based on the expectation of constant or increasing home values. The housing price boom thus becomes a housing price bust.<sup>28</sup>

There are four reasons why housing bubbles are so dangerous to financial stability.<sup>29</sup> 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 by short-term creditors and thus 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.<sup>30</sup> Third, as credit contracts in the

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21. Ben Bernanke & Mark Gertler, *Agency Costs, Net Worth, and Business Fluctuations*, 79 AM. ECON. REV. 14, 15 (1989); Herring & Wachter, *supra* note 20, at 11–12.

22. JOHNSON & KWAK, *supra* note 3, at 130.

23. The run-up to the 2008 financial crisis was the latest example of this type of deterioration. *See generally* Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, 24 REV. FIN. STUD. 1848 (2011). *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).

24. JOHNSON & KWAK, *supra* note 3, at 130.

25. Adam J. Levitin & Susan M. Wachter, *Explaining the Housing Bubble*, 100 GEO. L.J. 1177, 1184, 1189, 1254 (2012) [hereinafter *Explaining the Housing Bubble*]; *see* Adam J. Levitin & Susan M. Wachter, *Why Housing?*, 23 HOUSING POL'Y DEBATE 5, 18–19 (2013) [hereinafter *Why Housing?*] (“[I]t was not the novelty but the expanded use of niche mortgage and securitization products that marked the bubble. PLS investors theoretically had access to deal-specific information but lacked a marketwide view, which meant they could not analyze borrower and economy interactions.”).

26. *See, e.g.*, CARMEN M. REINHART & KENNETH S. ROGOFF, THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY 217–22 (describing how this feedback loop caused the 2008 subprime mortgage crisis and financial crisis).

27. JOHNSON & KWAK, *supra* note 3, at 157.

28. *Id.*

29. For in-depth discussion, *see* 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*].

30. Herring & Wachter, *supra* note 20. Some investors came up with ways to short mortgage-backed securities and collateralized debt obligations during the years culminating in the 2008 financial crisis.

wake of the housing slump, loans 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 deflates house prices.<sup>31</sup>

In Dodd-Frank, Congress mandated the ATR/QM requirements to stop future deterioration in lending standards that could precipitate another housing crisis. Dodd-Frank designated QMs as loans that would provide a presumption against liability for ability-to-repay violations. In return, General QMs assure safety against borrower and systemic risk, specifically by including a DTI maximum ratio. Removing this DTI limit 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, other lenders may not. Problematically, those other lenders could still claim to funders that their loans are QMs. In tandem with the growth in the share of such lenders and the resulting competitive pressures, this could lead 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 finding compensating factors to underwrite these QM loans. In this originate-to-distribute model, the lenders' jobs are to get the loans done. That is how they are paid.<sup>32</sup> Investors are not able to observe the compensating factors, and compensating factors (soft data) override the safety constraints that DTI (hard data) would provide.<sup>33</sup> Nonbank lenders are not required to retain additional capital under these circumstances and given their scant equity cushion, they are incentivized to take heightened risks. As the current system worsens, so does the potential for destabilization from banks to nonbanks.<sup>34</sup>

When underwriting standards deteriorate, lenders who want to scrap their internal DTI caps could further claim that if renters were already paying in rent what they would pay in mortgages, they have the ability to repay the mortgage.<sup>35</sup>

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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 Explaining the Housing Bubble*, *supra* note 25, at 1243–49. In fact, the risk-adjusted price of the put option continued to fall throughout the bubble. *See id.* at 1203–06.

31. *Why Housing?*, *supra* note 25, at 6, 20.

32. JOHNSON & KWAK, *supra* note 3, at 127–28, 132.

33. One of the ATR rule's strongest benefits lies in imposing objective requirements, including ones that generate hard data that facilitate outside monitoring of risk by investors and regulators. *ATR Rule*, *supra* note 29, at 52–54. If the CFPB permitted QM lenders to override a DTI cap with compensating factors, it would undermine the production and significance of that valuable hard data.

34. *Representations and Warranties*, *supra* note 3, at 303–04; *see generally* You Suk Kim et al., *Liquidity Crises in the Mortgage Market* (Brookings Papers on Econ. Activity, Conference Draft, 2018), <https://www.brookings.edu/bpea-articles/liquidity-crises-in-the-mortgage-market/> [<https://perma.cc/Q5/AY-UXC2>].

35. *Cf.* Peter Linneman & Susan M. Wachter, *The Impacts of Borrowing Constraints on Homeownership*, 17 J. AM. REAL EST. & URB. ECON. ASS'N 389, 399 (1989) (discussing that families with sufficient income but insufficient down payments can rent instead of buying).

Many renters are in fact in this situation. Tenants who are credit constrained<sup>36</sup> rent—even though they would be better off as homeowners—because they do not meet the credit constraint criteria.<sup>37</sup>

These renters may be constrained because credit rationing may be optimal under existing conditions of information asymmetries.<sup>38</sup> Similarly, creditors cannot fully observe who is most likely to go into default.<sup>39</sup> Credit constraints help minimize the impact of these information asymmetries.<sup>40</sup> They protect against overextensions of credit by insulating borrowers and lenders against the chance of underestimating default.<sup>41</sup>

As a result, some credit-constrained tenants pay more in rent than they would for homeownership. In this not uncommon scenario, ability to repay is assured: the lender can simply look at what the household is currently paying, and technically speaking, they can in fact pay that amount. However, many of those households are financially stretched and have few, if any, savings.<sup>42</sup> Unless there are governmentally-mandated credit constraints such as a DTI cap, private lenders can and will extend mortgage credit heedless of sufficient equity or manageable debt service levels during incipient housing bubbles.

This is not hypothetical. Lenders and activists are advocating for the use of rental payments as evidence of ability to repay: renters would qualify for loans as long as they “consistently” pay their rent (whether “consistently” means three months, six months, or a year?).<sup>43</sup> Lenders anxious to get the deal done will push for the minimum, leaving borrowers highly stretched and unable to cover any emergency costs. The deal will get done, but to the long-run detriment of vulnerable households already at their limit in a downturn, in which they lose the savings they put into their home—and their home—in the bargain. This

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36. Here, we use the term “credit constrained” as defined in Linneman & Wachter, *supra* note 35, at 390–93. The two primary credit constraints are income and wealth. *Id.*

37. *Id.*

38. Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393–94 (1981).

39. *Id.*

40. *Id.*

41. *Id.*

42. Two sets of sobering statistics illustrate how stretched those families are. In 2016, the median family in the bottom income quintile only had \$900 in total financial assets and the median family in the second lowest quintile only had \$5000. BD. OF GOVERNORS OF THE FED. RESERVE SYS., 2016 SCF CHARTBOOK 115 (2017). These numbers are 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. Similarly, the Pew Charitable Trusts reported that in 2015, 17% of U.S. renters were severely rent-burdened (that is, they spent 50% of their gross income or more on monthly rent). PEW, AMERICAN FAMILIES FACE A GROWING RENT BURDEN 4 (2018), [https://www.pewtrusts.org/-/media/assets/2018/04/rent-burden\\_report\\_v2.pdf](https://www.pewtrusts.org/-/media/assets/2018/04/rent-burden_report_v2.pdf) [<https://perma.cc/E8JP-ZE4F>]. That same year, 58% of those severely rent-burdened families lacked *any* cash assets. *Id.* at 11, 14–15, tbl.1 & fig. 6 (2018).

43. See, e.g., Letter from the Corp. for Enter. Dev. to Richard Cordray, Dir., Cons. Fin. Prot. Bureau, 3–5 (May 19, 2017), [https://prosperitynow.org/files/PDFs/CFED\\_comment\\_letter\\_on\\_CFPB/\\_request\\_for\\_information\\_regarding\\_use\\_of\\_alternative\\_data\\_and\\_modeling\\_techniques\\_in\\_the\\_credit\\_process.pdf](https://prosperitynow.org/files/PDFs/CFED_comment_letter_on_CFPB/_request_for_information_regarding_use_of_alternative_data_and_modeling_techniques_in_the_credit_process.pdf) [<https://perma.cc/HQ9J-KRSZ>].



undermines the goal of access to credit for first-time homebuyers as the risk eventually gets priced into loans.<sup>44</sup>

The ATR provisions in Dodd-Frank and the DTI cap in the definition of a General QM are designed to prevent this scenario. In the next Part, we describe those provisions and the DTI limit.

### III

#### A SKETCH OF THE ATR AND QM PROVISIONS

In Dodd-Frank, Congress sought to curb the lending excesses that precipitated the 2008 financial crisis by instituting a series of residential mortgage lending reforms. Key among those reforms, Congress conferred a new private right of action against lenders and assignees for home mortgages made without a reasonable determination of the borrowers' ability to repay.<sup>45</sup> As part of that liability scheme, Congress further created a presumption of compliance with the ATR requirement for certain mortgages that meet the definition of a QM and thus are deemed to be safer.

Dodd-Frank's ATR requirement prohibits the extension of residential mortgage credit unless the lender makes a reasonable and good faith determination of the borrower's ability to repay.<sup>46</sup> Dodd-Frank mandates that the creditor base its determination on "verified and documented information"<sup>47</sup> showing that when the loan is consummated, the applicant has a reasonable ability to repay the loan.<sup>48</sup> This ATR requirement applies to all residential mortgages, regardless of their terms.<sup>49</sup>

Injured borrowers may sue lenders who violate the ATR requirement and their assignees and also have a defense to violations of this requirement in foreclosure actions.<sup>50</sup> However, the companion QM provision of Dodd-Frank softens this liability exposure by conferring a presumption of compliance with the ATR rule for home loans that meet the QM requirements.<sup>51</sup> For QM loans that

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44. See Patricia A. McCoy & Susan Wachter, *Why Cyclicity Matters to Access to Mortgage Credit*, 37 B.C. J.L. & SOC. JUSTICE 361, 366 (2017) ("As easy credit expands the pool of prospective borrowers, homebuyers and current homeowners flock to take out or refinance mortgages, adding to the upward push on home prices. The result is over-leveraging, as weaker borrowers incur mortgage debts that they later cannot repay.").

45. Sanford Shatz, *An Overview of the Consumer Financial Protection Bureau's Ability-to-Repay and Qualified Mortgage Rule*, AM. BAR ASS'N (Apr. 30, 2013), [https://www.americanbar.org/groups/business\\_law/publications/blt/2013/04/02\\_shatz/](https://www.americanbar.org/groups/business_law/publications/blt/2013/04/02_shatz/) [<https://perma.cc/U3ZG-2PPT>].

46. 15 U.S.C. § 1639c(a) (2018).

47. *Id.* § 1639c(a)(1).

48. Originally, the Board of Governors of the Federal Reserve System had jurisdiction over the ATR/QM Rule. Dodd-Frank § 1061(b)(1). But that jurisdiction transferred to the CFPB on July 21, 2011.

49. 15 U.S.C. § 1639c(a)(1).

50. *Id.* §§ 1640–1641. Enforcement of the ATR requirement is not limited to private relief. In addition, all mortgage lenders undergo regular federal examinations for compliance with the rule, 12 U.S.C. §§ 5514–5516 (2018) and violations are punishable by agency sanctions, *id.* §§ 1818, 5565. State attorneys general and state regulators also have authority to enforce the ATR requirement. *Id.* § 5552.

51. 15 U.S.C. § 1639c(b)(1).

are not higher-priced, this presumption is conclusive and amounts to a safe harbor against liability for ATR violations.<sup>52</sup> Higher-priced QM loans,<sup>53</sup> in contrast, are only afforded a rebuttable presumption.<sup>54</sup> In addition, all QM mortgages are deemed to be Qualified Residential Mortgages (QRMs) and thus escape Dodd-Frank's risk retention requirements.<sup>55</sup>

Both QM loans and non-QM loans must satisfy the ATR requirement.<sup>56</sup> In addition, QMs are limited to loans with safer features and reduced default risk. In Dodd-Frank, Congress prescribed many of the core requirements of QM loans. For instance, Congress decreed that QM loans must be fully amortizing and have terms not exceeding thirty years.<sup>57</sup> QMs also restrict prepayment penalties<sup>58</sup> and cap total points and fees at three percent.<sup>59</sup>

Home mortgages that do not satisfy the QM requirements automatically are deemed to be non-QMs. The decision to allow lenders to offer non-QM loans with nontraditional loan terms, including negative amortization, interest-only payments or balloon clauses, reflects Congress' judgment to preserve consumer choice.<sup>60</sup> But as the quid pro quo for the higher default risk that non-QM loans pose, those loans offer no presumption of compliance with the ATR requirements in private legal proceedings for violation of the ATR rule.<sup>61</sup> Non-QM loans must also meet the risk retention requirements.<sup>62</sup>

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52. 12 C.F.R. § 1026.43(e)(1)(i) (2019); CONSUMER FIN. PROT. BUREAU, ABILITY-TO-REPAY AND QUALIFIED MORTGAGE RULE ASSESSMENT REPORT 6 (Jan. 2019) [hereinafter CFPB ATR ASSESSMENT], [https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/cfpb\\_ability-to-repay-qualified-mortgage\\_assessment-report.pdf](https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf) [<https://perma.cc/6ECV-F4D7>].

53. Most higher-priced QM loans are defined as having an APR that exceeds the average prime offer rate (APOR) for a comparable loan by 1.5 or more percentage points for a first-lien loan or by 3.5 or more percentage points for a subordinate-lien loan. 12 C.F.R. § 1026.43(b)(4). However, for the small creditor portfolio QM and rural/underserved small creditor balloon payment QM alternatives, a higher-priced loan is defined as one whose APR exceeds the APOR for a comparable loan by 3.5 percentage points or more. *Id.*

54. *Id.* § 1026.43(e)(1)(ii). Borrowers with higher-priced QM loans can rebut the presumption by showing that the originator failed to make a reasonable, good faith determination that the borrower would have had sufficient residual income or assets to meet living expenses after taking the household's monthly obligations into account. *Id.* § 1026.43(e)(1)(ii)(B).

55. Risk Retention Rule, 12 C.F.R. pt. 373, subpt. A (2014). The risk retention rule requires sponsors of securitizations to retain a five percent equity interest in the aggregate credit risk of the assets they securitize. *Id.* §§ 373.3(a), 373.4(a). Securitizations backed solely by QRMs, however, are free from this risk retention requirement. *Id.* §§ 373.13(a)–(b).

56. However, some types of QM loans allow alternative ways of satisfying the documentation and verification part of this requirement. *ATR Rule, supra* note 29, at 32, 34–36.

57. 15 U.S.C. § 1639c(b)(2)(A) (2018); CFPB ATR ASSESSMENT, *supra* note 52, at 45. The one exception is for rural/underserved small creditor balloon payment QM loans. *See* 15 U.S.C. § 1639c(b)(2)(E); 12 C.F.R. § 1026 (2019); Operations in Rural Areas Under the Truth in Lending Act (Regulation Z) Interim Final Rule, 81 Fed. Reg. 16074 (Mar. 25, 2016) (codified at 12 C.F.R. pt. 1026).

58. 15 U.S.C. § 1639c(c).

59. *Id.* § 1639c(b)(2)(A).

60. CFPB ATR ASSESSMENT, *supra* note 52, at 44.

61. 15 U.S.C. § 1639c(b)(1).

62. *Id.*

In addition to the features that are statutorily prescribed, Congress gave the CFPB discretion to require other underwriting safeguards and features for QM loans, including a DTI ceiling.<sup>63</sup> The CFPB exercised that discretion in its final rule defining a QM in January 2013.<sup>64</sup> The CFPB's QM Rule applies to mortgages purchased by the GSEs, home loans held in portfolio, and private-label securitized mortgages. Single-family home mortgages guaranteed or insured by the Federal Housing Administration (FHA), the U.S. Department of Veterans Affairs (VA), and the Rural Housing Service (RHS) can also gain QM status under separate QM rules by their respective agencies.<sup>65</sup>

Putting aside the special QM rules for FHA, VA, and RHS loans, today there are five ways to obtain QM status. The CFPB created four of those categories in its 2013 regulation implementing the ATR/QM Rule. Specifically, the CFPB created a default definition in the form of the General QM,<sup>66</sup> and then created three alternatives to the General QM definition: one for mortgages securitized by Fannie Mae or Freddie Mac (the GSE Patch),<sup>67</sup> one for rural balloon portfolio loans by small creditors,<sup>68</sup> and one for mortgages held in portfolio by small creditors.<sup>69</sup> Later, in the 2018 regulatory relief legislation, Congress authorized a fifth path to QM protection for portfolio loans by small banks, thrifts, and credit unions.<sup>70</sup>

While the General QM and the four QM alternatives have important differences, they all have the same core provisions regarding loan terms.<sup>71</sup> All five options ban negative amortization and interest-only terms,<sup>72</sup> restrict prepayment penalties, and limit loan terms to thirty years. In addition, all QMs must satisfy the cap on points and fees at three percent. As part of a reasonable determination

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63. *Id.* §§ 1639c(b)(2)(A)(vi), (b)(3).

64. Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 12 C.F.R. pt. 1026 (Jan. 30, 2013).

65. See 12 C.F.R. §§ 1026.43(e)(4)(ii)(B)–(E) (2019); 24 C.F.R. §§ 201.7, 203.19, 1005.120, 1007.80 (2019); 7 C.F.R. § 3555.109 (2019); Veterans Affairs Dep't., Loan Guaranty: Ability-to-Repay Standards and Qualified Mortgage Definition Under the Truth in Lending Act: Interim final rule, 79 Fed. Reg. 26620 (May 9, 2014) (codified in parts at 38 C.F.R. pt. 36); Veterans Affairs Dep't., Loan Guaranty: Ability-to-Repay Standards and Qualified Mortgage Definition Under the Truth-in-Lending Act: Agency determination; status of interim final rule, 83 Fed. Reg. 50506 (Oct. 9, 2018) (announcing plans for a future QM rulemaking); CFPB ATR ASSESSMENT, *supra* note 52, at 46–47.

66. 12 C.F.R. § 1026.43(e)(2). For a fuller description of the requirements for General QMs, see *ATR Rule*, *supra* note 29, at 31–32.

67. 12 C.F.R. § 1026.43(e)(4)(ii)(A). Jumbo loans exceed the GSEs' loan limit requirements and therefore do not satisfy the prerequisites for the GSE Patch. Laurence E. Platt, Jon D. Van Gorp & Steven M. Kaplan, *The State of Play of Qualified and Non-Qualified Mortgages*, BLOOMBERG LAW (May 7, 2018), <https://news.bloomberglaw.com/banking-law/the-state-of-play-of-qualified-and-non-qualified-mortgages> [<https://perma.cc/QSE4-J2TA>].

68. 12 C.F.R. § 1026.43(f); see *ATR Rule*, *supra* note 29, at 34–35.

69. 12 C.F.R. § 1026.43(e)(5); see *ATR Rule*, *supra* note 29, at 35–36.

70. Economic Growth, Regulatory Relief, and Consumer Protection Act § 101, Pub. L. No. 115-174, 132 Stat. 1296 (2018) (codified at 15 U.S.C. § 1639c(b)(2)(F)); see *ATR Rule*, *supra* note 29, at 36–37.

71. See *ATR Rule*, *supra* note 29, at 31–36 (discussing types of QMs).

72. The General QM, the GSE Patch, and the small creditor portfolio QM also prohibit balloon payment terms. 12 C.F.R. § 1026.43(e)(2)(i).

of an applicant's ability to repay, all QMs must further document and verify income and assets<sup>73</sup> and take payment shock into account.

Two main differences separate General QMs from the other four QM options. First, General QMs cap the DTI ratio at forty-three percent,<sup>74</sup> while the other four QMs have no DTI cap.<sup>75</sup> Second, when evaluating and verifying applicants' ability to repay, lenders only need to comply with the exacting requirements in the CFPB's Appendix Q for General QM loans.<sup>76</sup> Creditors making other types of QM loans are exempt from Appendix Q and thus are free to document and verify applicants' income, assets, and other financial resources in other, more flexible ways.<sup>77</sup>

#### IV

##### 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.<sup>78</sup> 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 (LTV)) limits, DTI caps, provisioning rules, and capital adequacy risk weights to help avoid housing booms and busts.<sup>79</sup> These tools are part of larger toolkit that provides multiple, needed safeguards against systemic risk.

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.<sup>80</sup> But the United States firmly rejected mandatory LTV limits<sup>81</sup> for

73. 15 U.S.C. § 1639c(a)(1) (2018).

74. 12 C.F.R. § 1026.43(e)(2)(vi).

75. See, e.g., *id.* §§ 1026.43(e)(4)(i), (e)(5), (f)(1) (2019). This does not mean that the DTI ratio is irrelevant. Under these four alternatives, creditors must still evaluate the applicant's monthly DTI ratio or residual income at or before consummation and verify the debt obligations and income used to determine that ratio. See, e.g., *id.* §§ 1026.43(e)(5)(i)(B), (f)(1)(iii).

76. *Id.* § 1026.43(e)(2)(v); 12 C.F.R., App'x Q pt. 1026; CONSUMER FIN. PROT. BUREAU, GENERAL COMPARISON OF ABILITY-TO-REPAY REQUIREMENTS WITH QUALIFIED MORTGAGES (Mar. 2016), [https://files.consumerfinance.gov/f/201603\\_cfpb\\_atr-and-qm-comparison-chart.pdf](https://files.consumerfinance.gov/f/201603_cfpb_atr-and-qm-comparison-chart.pdf) [<https://perma.cc/4ECB-9R6H>]; CFPB ATR ASSESSMENT, *supra* note 52, at 45–46. Appendix Q also sets forth how to determine “income” and “debt” for purposes of complying with the forty-three percent DTI cap.

77. See *ATR Rule*, *supra* note 29, at 32–36.

78. Patricia A. McCoy, *Countercyclical Regulation and Its Challenges*, 47 ARIZ. ST. L.J. 1181, 1208–13 (2015) [hereinafter *Countercyclical Regulation*].

79. See OFFICE OF FIN. RESEARCH, 2013 OFR ANNUAL REPORT 35–38, fig. 27 (2013), <http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2013.pdf> [<https://perma.cc/75T4-CCTM>] (cataloguing sectoral tools used in the United States); *Countercyclical Regulation*, *supra* note 78, at 1208–13 (discussing sectoral regulatory tools).

80. Under the Basel regime, the risk-weighted capital standards for depository institutions include risk weights for residential mortgages. *Countercyclical Regulation*, *supra* note 78, at 1199–1205, 1209.

81. 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 ninety-seven percent. 97% LTV Options, FANNIE MAE, <https://www.fanniemae.com/singlefamily/97-ltv-options> [<https://perma.cc/7WTL-PLDS>]; *Home*

residential mortgages due to access to credit 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.<sup>82</sup> 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 LTV ratios exceeding seventy percent to hold risk retention of five percent.<sup>83</sup>

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.<sup>84</sup> According to an influential 2012 study, seventy-five percent of African-American borrowers and seventy percent of Latino borrowers with performing loans could not have afforded a twenty percent down payment requirement when they first obtained their mortgages.<sup>85</sup> In the end, federal regulators eliminated the seventy percent leverage limit from the final risk retention rule and replaced it with a risk retention exemption for securitizations backed solely by QMs.<sup>86</sup>

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 ATR 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.

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*Possible Mortgage*, FREDDIE MAC, <http://www.freddiemac.com/homepossible/> [<https://perma.cc/W3VZ-MUGT>]. Meanwhile, FHA insures home mortgages with LTVs of 90% to 96.5%, depending on the borrower's credit score. Brandon Cornett, *FHA Down Payment Requirements 2019: The Definitive Guide*, FHA HANDBOOK (2019), <http://www.fhahandbook.com/blog/fha-down-payments-definitive-guide/> [<https://perma.cc/JCN2-UWB6>].

82. Ability to Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 12 C.F.R. pt. 1026 (Jan. 30, 2013).

83. Credit Risk Retention, 78 Fed. Reg. 57927, 57928 (proposed Sept. 20, 2013).

84. See DARRYL E. GETTER, CONG. RESEARCH SERV., R7-5700 ABILITY TO REPAY, RISK-RETENTION STANDARDS, AND MORTGAGE CREDIT ACCESS 13–15 (2012), <http://www.fas.org/sgp/crs/misc/R42056.pdf> [<https://perma.cc/DK2F-QUZN>] (explaining that risk-retention measures might lead to increased type two lending errors, which could result in “less credit availability for qualified borrowers”); ROBERTO G. QUERCIA ET AL., CTR. FOR RESPONSIBLE LENDING, 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> [<https://perma.cc/7UYM-3ENL>]; *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> [<https://perma.cc/8FYZ-3WD3>].

85. BALANCING RISK, *supra* note 84, at 10–11, 27–28.

86. Credit Risk Retention, 79 Fed. Reg. 77601, 77607, 77685, 77688–89 (Dec. 24, 2014). Mortgages that qualify for this exemption are defined as QRM.

## V

## WHY DTI 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 forty-three percent DTI cap maintain that there is no justification for mandating a maximum DTI ratio for QMs, arguing that DTI ratios are weakly correlated with mortgage default risk. However, 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 Part reviews that evidence.

Even more importantly, and lost in the debate, DTI ratios are significant in constraining systemic risk from incipient housing bubbles. For justifiable reasons of distributive justice, the United States previously nixed another important sectoral technique—mandatory LTV caps—to curb the systemic risk from home loans in the QRM debate. Federal financial regulators made that decision even though combined LTV ratios are strongly correlated with mortgage defaults<sup>87</sup> and even though global regulators strongly advise LTV caps to constrain systemic risk.<sup>88</sup> Now that the United States has jettisoned leverage caps as a brake on housing bubbles, it is critical for the CFPB to recognize the systemic risk implications of scrapping a DTI cap as well. As this Part discusses, there are strong financial stability reasons to retain a DTI cap in the QM definition. First, however, Subpart A re-examines the relationship between DTI ratios and default propensities on home mortgages.

## A. Debt-to-Income Ratios and Mortgage Default Rates

Under the double trigger theory of mortgage default, negative equity alone is not the leading reason why households default on their home mortgages.<sup>89</sup> Instead, underwater borrowers default when they no longer have the income to make timely mortgage payments.<sup>90</sup> Accordingly, one might think that keeping mortgage payments reasonable through DTI caps could help reduce defaults.

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87. See, e.g., U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-805, NONPRIME MORTGAGES: ANALYSIS OF LOAN PERFORMANCE, FACTORS ASSOCIATED WITH DEFAULTS, AND DATA SOURCES 22 (2010); JOHNSON & KWAK, *supra* note 3, at 127; Christopher Mayer, Karen Pence & Shane M. Sherlund, *The Rise in Mortgage Defaults*, 23 J. ECON. PERSP., no. 1, Winter 2009, at 27, 42–43; Anthony Pennington-Cross & Giang Ho, *The Termination of Subprime Hybrid and Fixed Rate Mortgages*, 38 REAL EST. ECON. 399, 413–16 (2010).

88. See, e.g., *Countercyclical Regulation*, *supra* note 78, at 1210 & n.139, 1212 & n.148; IMF, *supra* note 19, at 44.

89. See Luigi Guiso, Paola Sapienza & Luigi Zingales, *The Determinant of Attitudes Toward Strategic Default on Mortgages*, LXVIII J. FIN. 1473, 1474, 1483, 1490–92 (2013) (noting myriad reasons for mortgage default).

90. In the aftermath of the 2008 financial crisis, almost seventy-five percent of homeowners with negative equity continued paying their mortgages. See *id.* Strikingly, strategic defaults were relatively uncommon following 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. Reserve Bd. Fin. & Econ.

The bulk of studies on DTI ratios conclude that those ratios are not strongly predictive of defaults when compared to leverage ratios and loan documentation standards.<sup>91</sup> However, most of these studies examined mortgage originations before 2008, when no- and low-documentation mortgages were prevalent.<sup>92</sup> Indeed, there was such a large surge in these reduced-documentation mortgages that by 2006, such loans accounted for about two-thirds of prime adjustable-rate mortgages (ARMs), four-fifths of Alt-A ARMs,<sup>93</sup> and virtually half of subprime ARMs.<sup>94</sup> 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.<sup>95</sup>

Since the ATR was instituted in 2014, reported incomes have become significantly more accurate.<sup>96</sup> In view of today's improved reliability of reported income and thus DTI, it is time to reassess the predictive value of DTI ratios. In 2019, six new empirical studies found that DTI levels were significantly probative of default. For example, the 2019 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

Discussion Series, Working Paper 2010–35, May 2010), <https://www.federalreserve.gov/pubs/feds/2010/201035/201035pap.pdf> [https://perma.cc/TPA7-JD2Z].

91. See, e.g., YONGHENG DENG & STUART GABRIEL, U.S. DEPT. OF HOUSING AND URBAN DEV., MODELING THE PERFORMANCE OF FHA-INSURED LOANS: BORROWER HETEROGENEITY AND THE EXERCISE OF MORTGAGE DEFAULT AND PREPAYMENT OPTIONS 13 (2002); KARAN KAUL & LAURIE GOODMAN, URBAN INST., UPDATED: WHAT, IF ANYTHING, SHOULD REPLACE THE QM GSE PATCH? 6–10 (Oct. 2018), [https://www.urban.org/sites/default/files/publication/99268/2018\\_10\\_30\\_qualified\\_mortgage\\_rule\\_update\\_finalized\\_4.pdf](https://www.urban.org/sites/default/files/publication/99268/2018_10_30_qualified_mortgage_rule_update_finalized_4.pdf) [https://perma.cc/D3WP-58S8]; Marsha Courchane, Leonard C. Kiefer, & Peter M. Zorn, *Underwriting Standards, Loan Products and Performance: What Have We Learned?* 6 (Working Paper, 2013), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2341818](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2341818) [https://perma.cc/FH3D-RFVP]; Yuliya Demyanyk & Otto Van Hemert, *Understanding the Subprime Mortgage Crisis* 2, 19 (Fed. Reserve Bank of St. Louis, Working Paper, 2008), <http://ssrn.com/abstract=1020396> [https://perma.cc/UR8Q-BWBX].

92. Morris A. Davis, William D. Larson, Stephen D. Oliner & Benjamin R. Smith, *A Quarter Century of Mortgage Risk* 45 fig. 7 (Fed. Housing Fin. Agency Staff Working Paper 19-02, Oct. 2019), <https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/wp1902.pdf> [https://perma.cc/6GM5-WKKQ]; cf. *id.* at 15 (noting also that one influential study "only tracked loan performance through the end of 2008, thus omitting about half of the total jump in the unemployment rate during the financial crisis" and thus "mute[d] the estimated effect on households with heavy payment burdens").

93. The term "Alt-A" 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 CHI. FED. LETTER 1, 2 (Aug. 2007).

94. 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).

95. Wei Jiang, Ashlyn Aiko Nelson & Edward Vytlačil, *Liar's Loans? Effects of Loan Origination Channel and Loan Sale on Delinquency*, 96 REV. ECON. & STAT. 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 RES. 507 (2013), [http://pages.jh.edu/jrer/papers/pdf/past/vol35n04/05.507\\_554.pdf](http://pages.jh.edu/jrer/papers/pdf/past/vol35n04/05.507_554.pdf) [https://perma.cc/79YV-UVK5].

96. FED. HOUSING FIN. AGENCY OFFICE OF INSPECTOR GENERAL, AN OVERVIEW OF ENTERPRISE DEBT-TO-INCOME RATIOS (WPR-2019-002, Mar. 27, 2019) [hereinafter IG REPORT], <https://www.fhfaoig.gov/sites/default/files/WPR-2019-002.pdf> [https://perma.cc/M72N-CETX].

factors.”<sup>97</sup> A 2019 analysis by FHFA researchers of virtually the entire home purchase loan market from 1990 to 2018 concluded that “rising DTIs were a significant factor behind the wave of mortgage defaults during the housing bust.”<sup>98</sup> In separate findings, Goldhaber and Parrent concurred, concluding that DTI “is a critical predictor of future [mortgage] defaults” after controlling for other risk factors.<sup>99</sup> Another 2019 study found a similar but smaller positive relationship between DTI levels and likelihood of default.<sup>100</sup> Separately, 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.”<sup>101</sup> The Bank of England finally concluded that mortgage arrears of at least two months rose sharply in the United Kingdom when debt servicing ratios exceeded forty percent.<sup>102</sup>

At a minimum, these newer studies upend any definitive conclusion that DTI ratios have little or no effect on default risk. Research findings now point both ways. Furthermore, the latest studies increasingly find DTI an important predictor of default, particularly and importantly in times of economic stress. Thus, scrapping a DTI cap for QM loans will increase default risk for a wide swath of residential mortgage loans. When one adds to that the fact that the United States has no LTV cap or credit score cutoff, the added danger of layering one risk on another<sup>103</sup> during a time of rising home prices in the form of high DTIs, high LTVs, and lower credit scores poses serious concern.<sup>104</sup> In sum, there

97. CFPB ATR ASSESSMENT, *supra* note 52, at 104–05; *id.* at 100–05, 112–15; accord IG REPORT, *supra* note 96, at 7.

98. Davis et al., *supra* note 92, at 15; *see also* IG REPORT, *supra* note 96 at 14, 35, 38 tbl.3.

99. Letter from Mark Goldhaber & Thomas Parrent to Hon. Kathleen L. Kraninger 1–7, 12 (Sept. 16, 2019) (on file with authors) [hereinafter Goldhaber & Parrent Letter].

100. Anthony DeFusco, Stephanie Johnson & John Mondragon, *Regulating Household Leverage 5* (Working Paper, May 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3046564](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3046564) [<https://perma.cc/AJ9P-P2PD>].

101. IG REPORT, *supra* note 96, at 16.

102. BANK OF ENG., FINANCIAL STABILITY REPORT 4, 4 chart A.6 (June 2019), <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2017/june2017.pdf?la=en&hash=EB9E61B5ABA0E05889E903AF041B855D79652644> [<https://perma.cc/Y3XB-K8BN>]. The U.K. debt servicing ratio includes an interest rate variable.

103. Mortgage loans that feature two or more predictors of default risk pose a higher chance of delinquency. *See* SHIRISH CHINCHALKAR & ROGER M. STEIN, COMPARING LOAN-LEVEL AND POOL-LEVEL MORTGAGE PORTFOLIO ANALYSIS 20 (2010) (“In 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 . . . .”); Goldhaber & Parrent Letter, *supra* note 99, at 12 (concluding that the “combination of multiple high-risk factors such as high DTI, high LTV and low credit score . . . dramatically increased the risk of default”).

104. Those who would eliminate the DTI cap on grounds that LTV and credit scores are more predictive of default than DTI do not reckon with the fact that LTV and credit scores are deregulated in the United States. *See* STEIN & CALHOUN, *supra* note 14, at 10 (arguing for elimination of the DTI cap for near-prime loans).

Scrapping the DTI cap poses another related concern. Under the QM definition in Dodd-Frank, creditors must underwrite adjustable-rate QMs to the maximum interest rate applicable during the first five years of the loan. Dodd-Frank § 1412. If there was no DTI cap, this safeguard “would become less meaningful” because there would be no outer limit on the debt burden shouldered by the borrower. CRL



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 we discuss in Subpart B, is a crucial independent reason for defining QMs to include 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 in the extreme to eliminate a DTI cap from the definition of a QM loan because doing so would remove an important brake on runaway housing price appreciation. Such run-ups in price jeopardize financial stability and homeownership attainment for underserved households.

DTI limits provide an important constraint on housing bubbles in a rising price environment. As values on individual homes continue to rise, the monthly loan payments on those homes will exceed 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 loans to purchase the homes regardless how much the homes are worth.<sup>105</sup> Without financing, these customers are unlikely to bid on those homes, reducing demand and with it the price pressures that fuel a housing bubble.<sup>106</sup> With a binding DTI cap, aspiring homebuyers will respond by increasing their down payments, buying cheaper homes, or waiting until later to embark on homeownership.<sup>107</sup> Without that cap, demand for houses would automatically rise,<sup>108</sup> continuing a vicious cycle of inflating home prices in the face of inelastic supply.<sup>109</sup> The inflating home prices come not only from previously closed-out renters who aspire to homeownership, but also from those who wish to buy a larger home or a trade-up home. Relaxation of a binding DTI limit undesirably enables the increase in indebtedness pro-cyclically across the income distribution, rich and poor.<sup>110</sup>

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Letter, *supra* note 14, at 13. Retaining the DTI cap thus avoids undermining this statutory provision in Dodd-Frank.

105. Daniel L. Greenwald, *The Mortgage Credit Channel of Macroeconomic Transmission* 8, 8 fig. 1 (Working Paper, Nov. 2017), [https://bcf.princeton.edu/wp-content/uploads/2017/11/DG-Paper-mortgage\\_credit\\_channel\\_nov\\_2017.pdf](https://bcf.princeton.edu/wp-content/uploads/2017/11/DG-Paper-mortgage_credit_channel_nov_2017.pdf) [<https://perma.cc/UX9D-LZFC>].

106. David Aikman, Jonathan Bridges, Anil Kashyap & Caspar Siebert, *Would Macroprudential Regulation Have Prevented the Last Crisis?*, 33 J. ECON. PERSP., no. 1, Winter 2019, at 107, 120–21.

107. Linneman & Wachter, *supra* note 35, at 399.

108. Edward J. Pinto, Tobias Peter & Neil Filosa, *The QM patch: The Seen, Unseen, and Foreseeable*, AM. ENTER. INST. (Aug. 22, 2019), <https://www.aei.org/articles/the-qm-patch-the-seen-unseen-and-foreseeable/> [<https://perma.cc/T4GU-J84C>]; Stiglitz & Weiss, *supra* note 38, at 2.

109. See Goldhaber & Parrent Letter, *supra* note 99, at 9 (remarking that “house price appreciation and increasing DTI are part of a feedback loop”).

110. See 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

A new study has specifically examined this effect for QM loans. In a recent landmark paper, Daniel Greenwald simulated the effect of the CFPB's forty-three percent DTI cap for General QMs on the housing bubble that culminated in the 2008 financial crisis. Greenwald concluded that the forty-three percent cap could have reduced the bubble by over one-third—and thus its severity—had it been in place at the time.<sup>111</sup>

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.<sup>112</sup> However, the United States has no mandatory LTV limit for residential mortgages. Even if it did, LTV ratios are misleading during bubbles because they disguise housing price inflation.<sup>113</sup>

The misleading nature of LTV ratios during housing bubbles arises from the fact that LTV 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 economic fundamentals.<sup>114</sup> This was apparent from LTV ratios at the height of the last bubble in 2006: LTV ratios were almost the same as in 2014, and credit standards generally had tightened.<sup>115</sup>

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.<sup>116</sup> As property prices increase, appraisers use these market prices

populations). Conversely, “a limit on DTI serves as a counter-cyclical measure to avoid overheating of house price appreciation.” Goldhaber & Parrent Letter, *supra* note 99, at 9.

111. Greenwald, *supra* note 105, at 4. Similarly, Pinto 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.” Pinto et al., *supra* note 108.

112. See Linneman & Wachter, *supra* note 35, at 396–97 (reporting that during the periods studied, “a substantially greater number of families faced a highly binding wealth constraint than faced a highly binding Income constraint”); see also Arthur Acolin, Jesse Bricker, Paul Calem & Susan Wachter, *Borrowing Constraints and Homeownership*, 106 AM. ECON. REV. 625, 625 (2016) (stating that LTV caps “limit access to mortgages”); Irina Barakova, Paul S. Calem & Susan Wachter, *Borrowing constraints during the housing bubble*, 24 J. HOUSING ECON. 4 (2014) (“Wealth is most likely to restrict homeownership followed by credit and income.”).

113. 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](https://www.barcelonagse.eu/sites/default/files/working_paper_pdfs/1008.pdf) [<https://perma.cc/TH6M-HQRJ>].

114. 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.

115. Greenwald, *supra* note 105, at 9–12.

116. GEORGE A. AKERLOF & ROBERT J. SHILLER, *ANIMAL SPIRITS* 154 (2009); Charles Himmelberg, Christopher Mayer & Todd Sinai, *Assessing High House Prices: Bubbles, Fundamentals and Misperceptions*, 19 J. ECON. PERSP., no. 4, Fall 2005, at 67, 72, 74.

as comparables when conducting appraisals. Appraisers further face pressure to inflate their appraisals to satisfy lenders' goals of closing loans and thus secure repeat business from lenders.<sup>117</sup> 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.<sup>118</sup>

Greenwald's findings have powerful implications for the debate over the GSE Patch. Right now, the 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, 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.<sup>119</sup> 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 the fourth quarter of 2018, twenty-six percent of mortgage purchases by Fannie Mae and eighteen percent of those by Freddie Mac had DTI ratios of over forty-five percent.<sup>120</sup> In Fannie Mae's case, this represented a *three-fold* increase from mid-2017.<sup>121</sup> From mid-2017 to the end of 2018, the proportion of GSE loans with maximum allowable DTI ratios and LTV ratios of over ninety-five percent (or a credit score under 680) also increased.<sup>122</sup> Because the GSEs' home purchase

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117. See Leonard Nakamura, *How Much is that Home Really Worth? Appraisal Bias and House-Price Uncertainty*, BUS. REV. 11, 16 (2010) ("What appears to be occurring is that the parties directly involved in the transaction have a mutual interest in a somewhat upwardly biased appraisal."); Montalvo & Raya, *supra* note 113, at 6 (reviewing literature) (explaining that "appraisers had incentives to inflate transaction prices in order to accommodate the financial needs of their clients").

118. Greenwald, *supra* note 105, at 45; accord Aikman et al. *supra* note 106, at 119–20.

119. IG REPORT, *supra* note 96, at 11; see Damian Paletta, *Federal Government Has Dramatically Expanded Exposure to Risky Mortgages*, WASH. POST (Oct. 2, 2019) (describing the FHFA decision). The directive also forbade the GSEs from imposing overlays related to DTI ratios for mortgages with DTI ratios of up to fifty percent. Over ninety percent of the mortgages bought by the GSEs go through one or the other of their automated underwriting programs (Desktop Underwriter for Fannie Mae and Loan Product Advisor for Freddie Mac). *Id.* at 6–7.

120. *Id.* at 12–13.

121. *Id.*; see also Archana Pradhan, *DTI Has Risen for Conventional Conforming Loans*, CORELOGIC INSIGHTS BLOG (Mar. 20, 2019), <https://www.corelogic.com/blog/2019/03/dti-has-risen-for-conventional-conforming-loans.aspx> [<https://perma.cc/RH3L-YAAT>].

122. IG REPORT, *supra* note 96, at 13–14, fig. 3.

mortgages have generally higher DTIs than their refinance loans,<sup>123</sup> 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:

[H]ome-sale price 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<sup>124</sup>

The FHFA's Inspector General reached the same conclusion.<sup>125</sup> Thus, what we are seeing is the classic dynamic of a potential bubble where lenders respond to rising home prices by cutting lending standards in order to maintain the same volume of borrowers.

Mandatory DTI caps serve another crucial macroeconomic purpose by increasing borrowers' resilience. When family debt service ratios at origination are stretched to the maximum, borrowers have no cash-flow cushion if a recession or other economic shock hits. If those borrowers later have trouble making their mortgage payments, they will cut other spending, amplifying economic downturns.<sup>126</sup>

Significant segments of the mortgage sector are urging the CFPB to lift DTI caps across the board, irrespective of applicants' income or wealth.<sup>127</sup> In our view, 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.

## VI

### NOW IS NOT THE TIME TO REMOVE A DTI CAP

The upcoming decision about the fate of the GSE Patch comes at a particularly perilous moment in this country's economic cycle. The current ten-year expansion eclipsed the U.S. record in July<sup>128</sup> and is long in the tooth. Fears

123. *Id.* at 15.

124. Pradhan, *supra* note 121 (footnote omitted).

125. See IG REPORT, *supra* note 96, at 15 (according to the 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").

126. BANK OF ENG., *supra* note 102, at 3; see Anil K. Kashyap & Caspar Siegert, *Financial Stability Considerations and Monetary Policy*, 16 INT'L J. CENT. BANKING 231, 235 (2020) ("[F]or 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.").

127. See CFPB ATR ASSESSMENT, *supra* note 52, at 257–59.

128. 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> [<https://perma.cc/RS6C-HWEX>].

are circulating about an upcoming recession. The growth in GDP “has been the most anemic on record” and “[w]age growth also has been slow.”<sup>129</sup>

Inflated home prices pose a particular concern. U.S. housing prices have steadily trended upward for thirty-two straight quarters and are starting to soften, according to a 2019 FHFA report.<sup>130</sup> This trend is particularly pronounced in major U.S. urban areas.<sup>131</sup> 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<sup>132</sup> and the median combined LTV ratio at origination is “relatively high,”<sup>133</sup> partly due to “credit-loosening policies” by the GSEs.<sup>134</sup> 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 DTI levels become unmoored from the CFPB’s standard setting, market competition will eliminate meaningful internal DTI caps altogether. The danger is a disaster in the making when asset prices are already high relative to rents.

In the following pages, we make recommendations for what to do about the GSE Patch. Before proceeding to that discussion, a short digression is in order to establish the CFPB’s authority to address systemic risk from residential mortgages.

## VII

### THE CFPB HAS THE JURISDICTION AND RESPONSIBILITY TO CONSIDER SYSTEMIC RISK IN ITS RULEMAKING DECISIONS

So far, we have argued that the forty-three percent DTI cap in the General QM definition serves two important roles: one, it reduces default risk; and two, it constrains potential housing bubbles and the systemic risk they pose. That DTI limit takes on added importance in view of the fact that the United States has rejected safeguards against systemic risk in the form of LTV caps. Furthermore,

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129. 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> [<https://perma.cc/B99Y-2TAX>].

130. FED. HOUSING FIN. 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/Report/Documents/HPI\\_2019Q2.pdf](https://www.fhfa.gov/AboutUs/Reports/Report/Documents/HPI_2019Q2.pdf) [<https://perma.cc/9M4Z-7GE6>].

131. JONATHAN GRUBER & SIMON JOHNSON, JUMP-STARTING AMERICA 142–45 (2019).

132. See Davis et al., *supra* note 92, at 21–22, 43 fig. 5, 51 fig. 13; Goldhaber & Parrent Letter, *supra* note 99, at 1 (noting that the “loosening” of the DTI standard “over the last eight years has increased systemic risk”); Pradhan, *supra* note 121.

133. URBAN INST., HOUSING POL. FIN. CTR., HOUSING FINANCE AT A GLANCE: A MONTHLY CHARTBOOK 15 (Aug. 2019) [hereinafter CHARTBOOK], [https://www.urban.org/sites/default/files/publication/100866/august\\_chartbook\\_2019\\_0.pdf](https://www.urban.org/sites/default/files/publication/100866/august_chartbook_2019_0.pdf) [<https://perma.cc/HJ2M-C5UP>].

134. Paletta, *supra* note 119; Pradhan, *supra* note 121.

the General QM DTI limit serves a third role: it prevents lenders' internal DTI caps from unraveling under competitive pressure.

Naturally, our discussion raises the question of 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 also that the Bureau in fact has a statutory responsibility to do so.

The CFPB's responsibility to safeguard financial stability is grounded in three provisions of Dodd-Frank. First, the Director of the Bureau by law is a voting member of the Financial Stability Oversight Council (FSOC),<sup>135</sup> which is the body ordained by Congress to oversee financial stability and respond to emerging systemic risks.<sup>136</sup> 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."<sup>137</sup> By implication, this provision not only means that the CFPB can take systemic risk into account when promulgating rules such as the QM Rule but that Congress *expected it to do so*, on pain of potential FSOC reversal.

Finally, Congress emphasized the systemic risk dimension of the QM Rule by expressly linking the financial stability safeguards in the risk retention provisions of Dodd-Frank to the definition of a QM. In Section 941(b) of Dodd-Frank, Congress required the federal prudential banking regulators, the Securities and Exchange Commission, the Secretary of Housing and Urban Development, and the FHFA to promulgate joint rules requiring securitizers to retain an economic interest in a portion of the credit risk in residential mortgage-backed securities (RMBS).<sup>138</sup> Companion provisions in Dodd-Frank made clear that Congress enacted the risk retention provisions to ensure financial stability.<sup>139</sup>

However, Congress relieved securitizers from this "skin in the game" requirement for RMBS backed solely by QRMs.<sup>140</sup> Congress then stated that the definition of a QRM could be "no broader than the definition [of a] 'qualified mortgage,'" per Dodd-Frank and the CFPB's interpretation.<sup>141</sup> Thus, the QM

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135. 12 U.S.C. § 5321(b)(1)(D) (2018).

136. *Id.* § 5322(a)(1).

137. *Id.* § 5513(a).

138. 15 U.S.C. § 78o-11(b)(2) (2018).

139. *Id.* § 78o-11(h) (requiring the Chair of FSOC to coordinate the joint risk retention rulemaking); Dodd-Frank § 946 (codified at 15 U.S.C. § 78o-11) (requiring the chair of FSOC to conduct a study on the macroeconomic effects of the risk retention rule, including the effect on real estate bubbles).

140. 15 U.S.C. §§ 78o-11(c)(1)(B), (e)(4).

141. *Id.* § 78o-11(e)(4)(C). See FIN. STABILITY OVERSIGHT COUNCIL, MACROECONOMIC EFFECTS OF RISK RETENTION REQUIREMENTS 2 (2011), [https://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20\(FINAL\).pdf](https://www.treasury.gov/initiatives/wsr/Documents/Section%20946%20Risk%20Retention%20Study%20%20(FINAL).pdf) [<https://perma.cc/Y7U4-839Q>]

definition is an integral part of the financial stability scheme embodied in the risk retention requirement.

Especially in view of these provisions, it is important for the CFPB to seriously discharge its role to safeguard the nation's 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.<sup>142</sup> The FHFA can mandate investor standards, but only for the GSEs. The FSOC has no power to mandate mortgage lending standards.<sup>143</sup> 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.<sup>144</sup> This gap in systemic risk oversight is worrisome, given that nonbank lenders account for two-thirds of home mortgage originations and eighty-five percent of FHA mortgage originations today,<sup>145</sup> but are free from another important sectoral tool in the form of minimum capital requirements.<sup>146</sup>

In the face of this fragmentation in systemic risk oversight, the CFPB is the only federal agency that has rulemaking authority over the entire residential mortgage market. It oversees the whole market and is able to mandate consumer-facing regulations that also further the nation's financial stability. This is another reason why it is important to take systemic risk concerns seriously.

Moreover, this is not a hypothetical concern. A stable financial system is critical to the financial health of every American consumer. Mortgages are 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, contractions in credit, and lost wealth. Indeed, the 2008 financial crisis inflicted the largest wealth losses on younger, minority, and less-educated households.<sup>147</sup> 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 QMs, 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

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(reporting that risk retention has “macroeconomic implications” and can help address “macroeconomic instability”).

142. At the federal level, mortgage regulation is shared among the three federal prudential banking regulators, the FHFA, the Federal Housing Administration, 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 S. CAL. L. REV. 1455, 1514-15 (2019).

143. *Id.* at 1506.

144. 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 nonbank lenders are so designated today. Kress, McCoy & Schwarcz, *supra* note 142, at 1479–80.

145. CHARTBOOK, *supra* note 133, at 11.

146. *Id.*

147. William R. Emmons & Bryan J. Noeth, *Household Financial Stability: Who Suffered the Most From the Crisis?*, FED. RESERVE BANK OF ST. LOUIS REGIONAL ECONOMIST (2012), <https://www.stlouisfed.org/publications/regional-economist/july-2012/household-financial-stability—who-suffered-the-most-from-the-crisis> [https://perma.cc/FM47-3Q2V].

household budgets. As we now discuss, it is possible to achieve this longer-term objective while still providing underserved households greater access to credit.

## VIII.

### HOW TO BALANCE THE DTI CAP WITH ACCESS TO CREDIT

As discussed in this Part, three objectives—default risk, financial stability, and access to mortgage credit—should be foremost in the CFPB’s deliberations when evaluating the future of the GSE Patch. It is eminently feasible to reformulate the QM definition going forward to achieve all three goals. In this Part, we describe our proposal for doing so.

#### A. A Better Way to Protect the Financial System While Enhancing Access to Credit

As our previous discussion indicates, it would be a serious mistake to scrap the DTI cap. To the contrary, 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 to both to mortgage decisions underwritten manually and to loans that undergo automated underwriting.<sup>148</sup> Furthermore, originators would not be allowed to deviate from that cap based on compensating factors.<sup>149</sup>

Importantly, there are other ways of building flexibility into this system without posing a systemic threat. Specifically, we would modify the DTI limit in one and perhaps two important respects. First, the Bureau’s economic researchers should reexamine the effect of the DTI on two key outcomes—default rates and housing price appreciation—to decide whether to keep the cap at forty-three percent or raise it slightly. If research shows that the cap could be modestly relaxed without an unacceptable uptick in risk, raising the cap would expand credit access for all borrowers.<sup>150</sup>

Second, and apart from any slight loosening of the general forty-three percent cap, the CFPB should liberalize that cap for mortgages to creditworthy borrowers

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148. A somewhat different approach, also animated by systemic risk concerns, would replace the 43% DTI cap for General QM loans with a stressed Mortgage Default Rate (MDR) limit. The MDR limit would counteract risk layering and become more binding as housing prices inflate, thus acting countercyclically. Letter from Edward J. Pinto & Tobias Peter, Am. Ent. Inst., and Norbert Michel, The Heritage Found., to the Consumer Fin. Prot. Bureau 2, 19–23 (Sept. 2019), <https://www.aei.org/research-products/report/comment-letter-on-the-qualified-mortgage-definition/> [<https://perma.cc/ACQ9-Z7JE>]. In contrast with that proposal, our proposal is expressly responsive to the need for access to credit for underserved borrowers.

Another 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. STEIN & CALHOUN, *supra* note 14, at 17–18. This proposal would include both the GSEs’ automated underwriting (AU) systems and proprietary AU 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 later manipulated unilaterally by lenders.

149. See *supra* notes 33–34 and accompanying text.

150. Doing so would also forestall any inadvertent downward pressure on local housing prices exerted by supply constraints.



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.<sup>151</sup> 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, binding 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 are creditworthy and that meet the FHFA's affordable housing goals.<sup>152</sup> There are two important reasons for this limitation. First, the 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.<sup>153</sup>

Second, unlike GSE loans, which the FHFA oversees for solvency, non-GSE QM loans lack federal prudential supervision.<sup>154</sup> 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.

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151. This could be accomplished by retaining but amending the GSE Patch or by abolishing the Patch but amending the General QM definition. The FHFA defines "low-income" families as those with annual incomes of eighty percent or less of the area median income (AMI). The Agency defines "very-low-income" families as ones with annual incomes of fifty percent or less of AMI. 12 C.F.R. § 1282.1(b) (2019).

152. 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) (2018). The FHFA sets and enforces annual affordable housing goals. 12 U.S.C. §§ 4561, 4566 (2018).

In its latest affordable housing goals, the 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, the FHFA set a separate annual goal of 21% for refinancing mortgages for low-income families. 12 C.F.R. § 1282.12 (2019); Fed. Housing Fin. Agency, 2018–2020 Enterprise Housing Goals, 83 Fed. Reg. 5878, 5882-91 (Feb. 12, 2018) (codified at 12 C.F.R. § 1282).

153. We saw that type of judgment in 2018, after the 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 responded by announcing that they would not insure mortgages with maximum allowable DTIs and credit scores below 700. IG REPORT, *supra* note 96, at 13–14.

154. Mortgages by independent nonbank lenders that are not federally guaranteed or insured have no federal prudential oversight. 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.

Naturally, the Treasury Department's and other proposals for housing finance reform<sup>155</sup> 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 the FHFA's future mandate and jurisdiction, and the future of the affordable housing goals. Given that uncertainty, we recommend adopting our proposal for today's housing finance market and revisiting the QM definition if housing finance reform becomes law.<sup>156</sup>

Finally, the CFPB should maintain its documentation and verification standards and require adherence to Appendix Q for loans that are currently defined as General QMs as well as for GSE loans. The ATR rule and a DTI cap mean 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 and retirees,<sup>157</sup> consistent with safe and sustainable loans.

#### B. Other Proposals for Revising the QM Definition are Overbroad and Would Pose Heightened Risk

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.<sup>158</sup> The coalition would also eliminate Appendix Q, with no replacement.<sup>159</sup>

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 actually restrict pathways to homeownership 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.<sup>160</sup> Expanding

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155. See, e.g., U.S. DEP'T OF THE TREASURY, HOUSING REFORM PLAN (Sept. 2019), <https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf> [<https://perma.cc/V423-C3YS>].

156. In that connection, if future housing finance reform leads to substantial growth in private-label mortgage securitization, nonbank 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 QMs that includes a DTI cap.

157. Kate Berry, *New Villain in CFPB Mortgage Rule: Appendix Q*, AM. BANKER (Aug. 12, 2019), <https://www.americanbanker.com/news/new-villain-in-battle-over-cfpb-mortgage-rule-appendix-q> [<https://perma.cc/CT9B-9KCY>].

158. Berry, *supra* note 11; ABA Letter, *supra* note 11, at 1.

159. Berry, *supra* note 11; ABA Letter, *supra* note 11, at 1.

160. Berry, *supra* note 11; ABA Letter, *supra* note 11, at 1.

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 for low-income families.<sup>161</sup> Our proposal 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 guardrail against systemic risk by governmentally mandating a ceiling on DTI levels. Lifting that cap and leaving DTI limits to lenders' or guarantors' discretion, as the coalition's proposal would do, would open the door to another destructive race to cut lending standards, free from ATR liability.<sup>162</sup> 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).<sup>163</sup> Loans priced under that rate spread could qualify for QM status free from a mandatory DTI cap. This rate spread option keys off of a 2018 proposal advanced by Laurie Goodman and Karan Kaul at the Urban Institute.<sup>164</sup>

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 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 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

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161. Pinto et al., *supra* note 108, report that under the GSE Patch, housing prices rose more quickly for entry-level homes, compared to higher-priced homes.

162. The fact that most QMs with APRs exceeding the Average Prime Offer Rate 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. 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. Originators similarly gamed the high-cost loan thresholds under the Home Ownership and Equity Protection Act in the lead-up to the last financial crisis. EDWARD M. GRAMLICH, *SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST* 28 (2007).

163. Berry, *supra* note 11; ABA Letter, *supra* note 11, at 1 n.1; STEIN & CALHOUN, *supra* note 14, at 15–16.

164. KAUL & GOODMAN, *supra* note 91, at 6–10.

could give lenders an incentive to price mortgages just below the threshold to qualify for the safe harbor.<sup>165</sup>

To get some sense of the magnitude of this threat, the 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.<sup>166</sup> 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 ninety-seven percent of all GSE loans* could gain 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 forty-three 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.

## VIII

### CONCLUSION

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. Our proposal to institute 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.

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165. *See id.* at 10.

166. FED. HOUSING FIN. AGENCY, ANNUAL HOUSING REPORT—2018, at 25, 36 (2018), <https://www.fhfa.gov/AboutUs/Reports/Pages/Annual-Housing-Report-2018.aspx> [<https://perma.cc/377Z-L98W>].