What, If Anything, Should Replace the QM GSE Patch?

The Patch Is Set to Expire on January 10, 2021

Karan Kaul and Laurie Goodman

August 2018

One of the most significant accomplishments of the Consumer Financial Protection Bureau (CFPB) was finalizing the qualified mortgage (QM) rule. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires mortgage lenders to make "a reasonable, good faith determination" of each borrower's ability to repay the proposed loan, considering such factors as borrower income, assets, debt, and employment. One way to meet this requirement is by originating a "qualified mortgage," as defined by the QM rule. Introduced in January 2014, the QM rule was designed to prevent borrowers from obtaining loans they could not afford and to protect lenders from borrower litigation. A qualified mortgage can give lenders legal protection from lawsuits that claim the lender failed to verify a borrower's ability to repay. A borrower who obtains a qualified mortgage is presumed to have the ability to repay.

All qualified mortgages should generally meet the following mandatory requirements:

1. The loan cannot have negative amortization, interest-only payments, or balloon payments.

2. Total points and fees cannot exceed 3 percent of the loan amount.[1]

3. The mortgage term must be 30 years or less.

Qualified mortgages must also satisfy at least one of the following three criteria:

1. The borrower's total monthly debt-to-income (DTI) ratio must be 43 percent or less.

2. The loan must be eligible for purchase by Fannie Mae or Freddie Mac (the government-sponsored enterprises, or GSEs) or insured by the Federal Housing Administration (FHA), the US Department of Veterans Affairs (VA), or the US Department of Agriculture Rural Development (USDA), regardless of DTI ratio.[2]

3. The loan must be originated by insured depositories with total assets less than $10 billion[3] but only if the mortgage is held in portfolio.

Mortgages that meet the QM definition are presumed to comply with ability to repay in one of two ways. First-lien mortgages with an annual percentage rate no more than 150 basis points above the Average Prime Offered Rate[4] (APOR) receive an unrebuttable presumption of compliance, a so-called safe harbor. This offers lenders the highest level of legal protection. All other QM loans receive a presumption of compliance that can be rebutted in litigation by showing that the lender failed to verify borrower ability to repay.

The CFPB's QM rule created an exemption from the 43 percent DTI cap for mortgages eligible for purchase by Fannie Mae or Freddie Mac. This exemption is commonly known as the "GSE patch." Loans insured by the FHA, VA, or USDA are governed by separate QM rules developed and implemented by each of these agencies.[5] The QM rules finalized by these three agencies have no maximum DTI requirement. The GSE patch is a temporary measure that is set to expire on January 10, 2021, or on the day the GSEs exit Federal Housing Finance Agency conservatorship, whichever occurs first. The FHA, VA, and USDA QM rules are permanent.

High-DTI Lending under QM

Data show that a considerable share of federally insured or GSE-guaranteed qualified mortgages over the past several years had DTI ratios over 43 percent. Table 1 shows the share of purchase mortgages with DTI ratios over 43 percent by origination year. About one in five GSE-backed mortgages originated in 2017 had a DTI ratio over 43 percent, and one in two FHA or VA mortgages had a DTI ratio over 43 percent. In comparison, the share of these mortgages in bank portfolios, which consists largely of high-quality jumbo loans, averaged about 15 percent from 2013 to 2018 but has risen to about 20 percent.

TABLE 1

Agency Purchase Originations with DTI Ratios over 43 Percent

	Fannie Mae	Freddie Mac	FHA	VA
2013	13.3%	14.1%	42.4%	33.0%
2014	13.6%	15.1%	42.7%	35.1%
2015	13.2%	17.2%	41.8%	36.6%
2016	13.9%	18.6%	44.7%	38.0%
2017	19.3%	21.2%	51.5%	41.9%
2018[a]	29.0%	24.9%	55.3%	45.9%

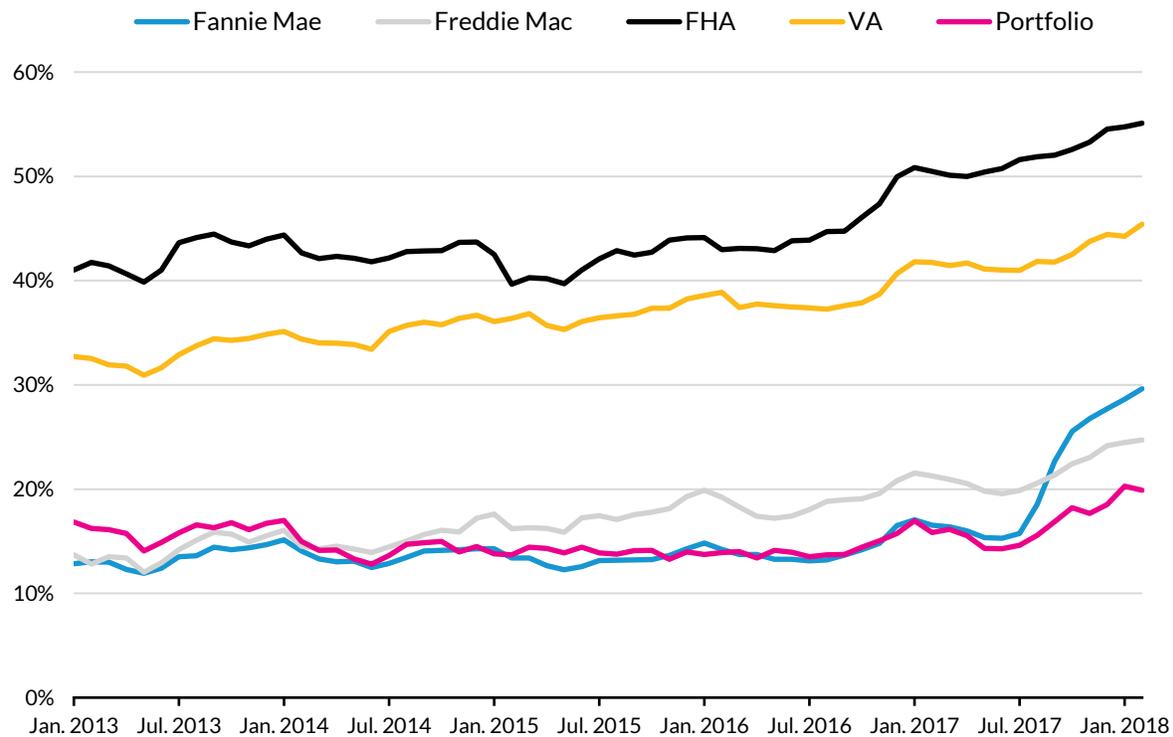**Source:** Urban Institute calculations based on eMBS data.
Note: FHA = Federal Housing Administration; VA = US Department of Veterans Affairs.
[a] 2018 data are through May 2018.

The share of QM loans with DTI ratios over 43 percent has risen because the widening gap between house price appreciation and wage growth has forced homebuyers to borrow more in comparison with incomes. And since 2016, rising interest rates have increased monthly payments, further increasing DTI

ratios. Through May 2018, the share of purchase originations with DTI ratios over 43 percent is about 25 percent for Freddie Mac loans, 29 percent for Fannie Mae loans, 55 percent for FHA loans, and 46 percent for VA loans.

Share of Purchase Originations with DTI Ratios over 43 Percent, by Channel

Source: Urban Institute calculations based on eMBS and CoreLogic data.
Note: FHA = Federal Housing Administration; VA = US Department of Veterans Affairs.

To appreciate how significant these numbers are, it is worth looking at the market for loans that fall outside the QM definition. Although reliable data on "non-QM" lending volumes are difficult to come by, estimates of originations range from $10 to $20 billion a year[6] for 2017, a drop in the bucket compared with the $1.8 trillion in total originations. The non-QM market is small because most lenders are wary of taking on the risk that a borrower in default will sue, citing lender failure to verify ability to repay.

When one combines the small non-QM lending volume with the rise of high-DTI lending, it does not take much imagination to see what would happen to the market—at least in the short run—should the 43 percent DTI ceiling be applied to loans backed by Fannie Mae and Freddie Mac. The GSE patch is nonetheless set to expire on January 10, 2021, setting up an urgent need to determine what, if anything, should replace it. This brief is an effort to kick-start the debate about the future beyond the GSE patch by exploring three options.

Option 1: Preserve the GSE Patch Largely as Is

The CFPB can preserve the GSE patch one of two ways. The first is a simple extension, leaving the rules that govern qualified mortgages as is. The CFPB would essentially extend the patch to a new expiration date or to the GSEs' exit from conservatorship, whichever comes first. Absent GSE reform, this option would force the CFPB to revisit the patch before the new expiration date. Or the CFPB could drop the sunset date and tie patch expiration to the GSEs' exit from conservatorship.

The CFPB could also go further and expand the GSE patch modestly. All elements of QM would remain in place, but the patch would be expanded to cover mortgages within the risk tolerances of the GSEs' automatic underwriting systems (AUS), even if they are GSE-ineligible for other reasons. For instance, a loan that is ineligible because its size exceeds the conventional loan limit but is otherwise within the AUS risk profile would be deemed a qualified mortgage. For the most part, this expansion would award QM status to jumbo loans with DTI ratios over 43 percent held in bank portfolios. Jumbo loans tend to be high-quality mortgages but are agency-ineligible because their size exceeds the conforming limit.

This option's practical benefit is modest, though: there is ample credit available at the jumbo end of the market. Loans to low- and moderate-income borrowers and first-time homebuyers—for whom access to credit remains tight—are less likely to fall within AUS risk tolerances and thus are less likely to be deemed qualified mortgages under this patch expansion.

We believe this option will yield only modest benefits, and most of them will flow to the high end of the market, where credit availability is not constrained. Additionally, the patch, even if extended, is a temporary solution that will eventually need revisiting. Considering this, we recommend the CFPB consider a more permanent alternative. The next approach, option 2, would constitute a major change to QM but would meaningfully improve credit availability.

Option 2: Drop the DTI Cap and GSE Patch from the QM Definition

We recommend a QM safe harbor standard based on a loan's overall riskiness as opposed to the DTI ratio, or who insures or guarantees the mortgage. Under this structure, the 43 percent DTI cap and GSE patch would be dropped from the CFPB's QM rule. Restrictions on risky products, loan terms, and points and fees would remain unchanged, as would the statutory exemption for portfolio lenders with less than $10 billion in assets. With no DTI cap or the patch, this framework would provide safe harbor status to first-lien mortgages as long as their annual percentage rate is no more than 150 basis points over the APOR. The underlying premise is that loans priced under the 150 basis point rate-spread threshold would be less risky than loans priced above this threshold. A rate spread–based QM regime offers several advantages:

Mortgage rates reflect credit risk more holistically than DTI ratios. The DTI ratio is one of several factors affecting borrower creditworthiness and ability to repay. But it is not a good predictor of default because it is often poorly measured.[7] Consider the following examples: Families who could qualify for a mortgage using only one spouse's earnings would not have the incentive to document and report the second income on their loan application. In this case, household income would be understated, and the DTI ratio would be overstated. As another example, debt owed to individuals, family members, or friends (e.g., money borrowed from parents for college or a car purchase) is not recorded, does not show up in a credit report, and is likely underreported. This would tend to understate the borrower's true debt burden and DTI ratio. In both examples, the ability to repay would be inaccurately measured, and there would be no way for a loan officer to know the household's total debt burden or income. Other situations that can distort the DTI ratio include undisclosed income from a second, part-time, or seasonal job; rental or room-share income; and debt taken on shortly after the loan closes.

The annual percentage rate, however, considers a wider set of borrower, property, and loan characteristics, including the DTI ratio, resulting in a more holistic measure. Evidence from default rates on historical GSE originations shows the limitations of DTI ratios in predicting default risk (table 2). For each year since 2011, the 90-day delinquency rate for loans with DTI ratios over 45 percent is less than that for loans with DTI ratios between 30 and 45 percent. This inconsistency is not present in other measures of riskiness, such as FICO scores and LTV ratios.

TABLE 2
90-Day Default Rate for GSE Purchase Originations by DTI Ratio, FICO Score, and LTV Ratio

| | DTI Ratio | | | FICO Score | | | LTV Ratio | | |
	<30%	30–45%	>45%	>750	700–750	<700	<80%	80–95%	>95%
1999	2.68%	3.81%	4.39%	0.77%	1.82%	6.63%	2.59%	5.08%	5.72%
2000	2.51%	3.34%	3.53%	0.63%	1.59%	6.38%	2.26%	4.46%	5.69%
2001	2.53%	3.59%	4.05%	0.78%	1.91%	6.54%	2.38%	5.52%	6.22%
2002	2.87%	4.26%	4.84%	1.07%	2.60%	7.59%	2.84%	7.00%	7.88%
2003	3.70%	6.14%	7.05%	1.76%	4.30%	10.17%	4.27%	9.32%	11.61%
2004	5.73%	8.81%	9.95%	2.78%	6.48%	14.03%	6.81%	12.85%	15.14%
2005	7.83%	13.14%	15.67%	4.73%	11.05%	20.97%	11.00%	18.13%	20.42%
2006	9.43%	15.55%	19.22%	5.78%	13.69%	25.25%	13.62%	21.05%	27.65%
2007	9.91%	16.99%	21.95%	6.27%	14.89%	28.18%	14.27%	23.98%	29.10%
2008	4.91%	9.73%	15.03%	3.84%	10.43%	22.05%	8.33%	15.12%	15.87%
2009	0.94%	2.40%	4.13%	0.95%	3.04%	8.06%	1.94%	3.17%	2.99%
2010	0.72%	1.76%	2.13%	0.60%	2.08%	5.71%	1.29%	1.89%	3.15%
2011	0.56%	1.38%	1.34%	0.43%	1.58%	4.61%	0.99%	1.42%	1.51%
2012	0.33%	0.85%	0.66%	0.26%	0.98%	3.08%	0.54%	0.94%	1.15%
2013	0.36%	0.87%	0.54%	0.24%	0.88%	2.65%	0.54%	0.96%	1.40%
2014	0.39%	0.88%	0.54%	0.22%	0.75%	2.33%	0.58%	0.96%	1.05%
2015	0.20%	0.47%	0.26%	0.11%	0.36%	1.29%	0.29%	0.50%	0.82%
2016	0.06%	0.14%	0.07%	0.04%	0.10%	0.38%	0.09%	0.15%	0.33%

Source: Urban Institute analysis based on Fannie Mae and Freddie Mac loan-level credit data.
Note: DTI = debt-to-income; GSE = government-sponsored enterprise; LTV = loan-to-value.

A rate-spread framework would create a more level playing field. Moving to a regime that takes a holistic view of credit risk would also level the playing field between the private sector and the agencies, potentially encouraging more lending outside federally backed channels. The safe harbor protection lenders currently receive for agency-eligible mortgages substantially reduces litigation risk relative to agency-ineligible loans with similar risk profiles. Assume two loans with the same DTI ratio over 43 percent and same probability of default. One is agency-eligible and is deemed a qualified mortgage, and the other is not agency-eligible and is not deemed a qualified mortgage even though it is no riskier. Because there is no way to get safe harbor protection for the second loan, the lender will either price for the added litigation risk or choose not to originate the loan. Either way, this does not serve the borrower well. Under our recommendation, the lender would be able to get safe harbor for both loans as long as the annual percentage rates are within 150 basis points of the APOR.

The standard would facilitate innovation. Encouraging lenders to originate and hold more high-DTI loans would provide an incentive for them to seek ways to better serve the market, such as by using new innovative methods to verify ability to repay, especially as borrower and household characteristics and work arrangements evolve. Recent technology innovations have automated income and asset verification and reduced the need for paper-based manual entries, which has improved the robustness of loan underwriting and cut down approval times. Such incremental accuracy matters because it can make a difference in a marginal borrower being approved for or denied a loan. The prospect of earning greater profits by holding high-DTI QM loans in portfolio could encourage lenders to make investments that are needed to serve future homebuyers, who are more likely to have nontraditional incomes and heavy student loan burdens than prior generations.

There is ample precedent for a rate-spread test. History shows there is ample precedent for the rate-spread regime. The trigger for restrictions and additional disclosure requirements under the Home Ownership and Equity Protection Act is based on an APOR test. Similarly, the requirement to set up escrows for property taxes and insurance is based on a rate spread.[8] Lastly, certain reporting requirements under the Home Mortgage Disclosure Act are based on the APOR test. Admittedly, the objectives of the QM rule are different. But strong historical precedent for the APOR test merits serious consideration.

There are a couple of downsides to a rate spread–based QM. 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. Finally, a rate spread–based regime could give lenders an incentive to price mortgages just below the threshold to qualify for the safe harbor.

Option 3: Take No Action on the Patch

Here, the CFPB would let the GSE patch expire in 2021, establishing a hard 43 percent DTI cap for mortgages guaranteed by Fannie Mae and Freddie Mac. But this option is not as straightforward because the FHA, VA, and USDA have their own permanent QM rules with no DTI caps. If the CFPB were to let the GSE patch expire, that would send the market for high-DTI GSE loans to the FHA. This would be the only way for lenders to secure a safe harbor for high-DTI loans. Portfolio lenders might hold on to some high-DTI loans as non-QMs, at least during periods of economic growth and strong house price appreciation.

But the non-QM market is small, as noted earlier. Today's non-QM loans are also relatively high quality. Data on recently securitized non-QM loans show pools with mostly full-documentation loans, LTV ratios averaging well under 80 percent, FICO averaging above 700, average DTI ratios ranging well under 43 percent,[9] and very low serious delinquency rates. These loans are often made to highly creditworthy borrowers who cannot qualify for agency-backed loans because they do not meet agency documentation requirements, are self-employed, have nontraditional incomes, or for other reasons. At the very least, this suggests that today's non-QM market would have to undergo a massive multiyear expansion and transformation to adequately serve the void left behind by the GSE patch.

Conclusion

The upcoming GSE patch expiration is an opportunity for the CFPB to modify the patch to make it work better. We believe replacing the current DTI-heavy framework with one that captures risk more holistically (option 2, rate spread) would more effectively expand access while mitigating credit risk. Option 2 would also create a more level playing field between the agency-backed and purely private capital–backed channels, potentially providing incentives for more private lending. Option 1 (preserving the patch) would at best have marginal benefit and would leave unresolved the uncertainty surrounding the patch's future. Option 3 (letting the patch expire) would largely redirect high-DTI lending from one government-backed channel (the GSEs) to another (the FHA).

We recognize there might be other options for addressing patch expiration, and we hope this brief is a useful starting point for a robust debate.

Notes

1   Higher points and fees are allowed for loan amounts below $100,000.

2   The CFPB's QM rule has jurisdiction over private mortgages and those guaranteed by Fannie Mae or Freddie Mac. Mortgages insured by the FHA, VA, or USDA are governed by separate QM rules developed and implemented by these federal agencies.

3   The original 2014 QM rule had established an asset threshold of $2 billion. The recently passed Economic Growth, Regulatory Relief, and Consumer Protection Act increased the threshold to $10 billion.

4   The Average Prime Offered Rate is an annual percentage rate based on average interest rates, fees, and other terms on mortgages offered to highly qualified borrowers. The underlying data source for most fixed and adjustable-rate products is Freddie Mac's Primary Mortgage Market Survey.

5   "Qualified Mortgage Definition for HUD-Insured and Guaranteed Single-Family Mortgages," 78 Fed. Reg., 75215 (December 11, 2013); "Loan Guaranty: Ability-to-Repay Standards and Qualified Mortgage Definition under the Truth in Lending Act," 79 Fed. Reg., 26620 (May 9, 2014); "Single-Family Housing Guaranteed Loan Program," 81 Fed. Reg., 26461 (May 3, 2016).

6   Brad Finkelstein, "How a CFPB Overhaul of the QM Rule Will Remake Mortgages," *National Mortgage News*, June 4, 2018, https://www.nationalmortgagenews.com/news/how-a-cfpb-overhaul-of-the-qualified-mortgage-rule-will-remake-home-loans; "Non-agency MBS Making Big Strides in 2018 but Still Far from Being a Meaningful Market," Inside Mortgage Finance, May 25, 2018, https://www.insidemortgagefinance.com/issues/imfpubs_ima/2018_20/news/Non-Agency-MBS-Making-Big-Strides-in-2018-1000046167-1.html.

7   Richard Green, "The Trouble with DTI as an Underwriting Variable—and as an Overlay," *Richard's Real Estate and Urban Economics Blog*, December 7, 2016, http://real-estate-and-urban.blogspot.com/2016/12/the-trouble-with-dti-as-underwriting.html.

8   Requirements for Higher-Priced Mortgage Loans, 12 C.F.R. 1026.35 (2013).

9   Fitch Ratings, "Fitch Rates Angel Oak Mortgage Trust I, LLC 2018-2," news release, June 25, 2018, https://www.fitchratings.com/site/pr/10035455.

About the Authors

Karan Kaul researches topical housing finance issues to highlight the market impact of ongoing regulatory, industry, and related developments. He is also responsible for monitoring and reporting on mortgage market trends and current events weekly. He brings a deep understanding of key reform issues, political landscape surrounding reform, and pros and cons of different approaches concerning their impact on mortgage rates, credit availability, private capital, and other factors. Kaul came to Urban after five years at Freddie Mac, where he worked on various housing policy issues primarily related to the future of housing finance and the reform of the government-sponsored enterprises. Before Freddie Mac, Kaul worked as a research analyst covering financial institutions. He holds a bachelor's degree in electrical engineering and an MBA from the University of Maryland, College Park.

Laurie Goodman is a vice president at the Urban Institute and codirector of its Housing Finance Policy Center, which provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Goodman spent 30 years as an analyst and research department manager on Wall Street. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held

research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial and Arch Capital Group and is an adviser to Amherst Capital Management, a member of Morningstar Credit Ratings Regulatory Governance Board, and a member of the Federal Reserve Bank of New York's Financial Advisory Roundtable. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

Acknowledgments

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I N S T I T U T E

2100 M Street NW
Washington, DC 20037

www.urban.org

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