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The Qualified Mortgage (QM) Rule and the QM Patch

Background

On January 30, 2013, the Consumer Financial Protection Bureau (CFPB) released a final rule implementing the ability-to-repay (ATR) requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203). For residential mortgage originations, the Dodd-Frank Act includes in the ATR requirement that lenders consider and verify with documentation eight underwriting criteria for the borrower: (1) current or reasonably expected income or assets; (2) current employment status; (3) monthly payments of principal and interest on the primary mortgage lien; (4) monthly payment on any junior mortgage lien; (5) monthly payment for mortgage-related obligations (e.g., property taxes, homeowner association fees); (6) any additional debt (e.g., automobile, credit card, education) obligations; (7) monthly debt-to-income ratio or residual income; and (8) credit history. The rule became effective on January 10, 2014.

The final ATR rule provides multiple ways for a loan originator to comply, one of which is by originating a qualified mortgage (QM). A mortgage loan that receives QM status must meet certain product-feature and underwriting requirements:

- The mortgage must fully amortize, meaning that the borrower's payments must be applied toward paying down a portion of the principal loan balance over time. A QM generally cannot have a balloon or large principal payment due at the end of the loan. Furthermore, a QM loan cannot *negatively* amortize, meaning that the principal loan balance may not increase over time.

- The borrower's debt-to-income (DTI) ratio must not exceed 43%. The DTI is defined as total monthly (housing and nonhousing) expenses divided by gross monthly income. Monthly housing expenses include principal, interest, taxes, insurance, and homeowner association fees. Monthly nonhousing expenses include other consumer loan payments and other regularly scheduled obligations (e.g., child care, utility bills). When both housing and nonhousing expenses are included, this computation is specifically referred to as the *back-end* DTI ratio.

- For a QM loan, the difference between the annual percentage rate (APR) and the average prime offer rate (APOR) must be less than 1.5% for a first lien and 3.5% for a junior lien. The APR includes both the annual interest cost and upfront fees spread over the life of the mortgage and expressed as a percentage; the APOR is a weekly average of the market rates and points (upfront fees) found in the Primary Mortgage Market Survey conducted by Freddie Mac.

If a loan satisfies the requirements for QM status, the lender receives a presumption of ATR compliance for legal purposes. Specifically, QM loans provide *safe harbor* legal protection, meaning that a borrower would not be able to assert that the originator (and any subsequent secondary-market purchaser) failed to comply with any of the required underwriting criteria.

QM Exemptions and the QM Patch

If a loan's DTI exceeds 43%, it may still receive QM status if guaranteed by the Federal Housing Administration, U.S. Department of Veterans Affairs, or U.S. Department of Agriculture. Rather than limit DTIs to 43% for the mortgages they guarantee, these federal agencies adopted their own QM definitions that still exclude product features they consider would impede repayment from borrowers they predominantly serve.

The CFPB's *QM patch* created an exemption from the 43% DTI cap for mortgages eligible for purchase by the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac. Hence, the GSEs may purchase loans with DTIs exceeding 43% and still receive QM status. The QM patch was put into effect for seven years (until January 10, 2021) or until the GSEs exit conservatorship, whichever occurs sooner.

Recent Developments

As the private-label securitizations market has declined over several years, the federal agencies that guarantee residential mortgage loans have increased in importance. The GSE's QM patch has also increased in importance, accounting for approximately 16% of 2018 total mortgage originations. One reason might be related to the legal protections linked to QM loan originations. Many originators have limited themselves to making only QM loans to avoid exposure to potential liability and litigation risks. Originators that continue to offer non-QM loans reportedly charge higher rates to offset potential legal and compliance risks.

In January 2019, the CFPB released an assessment report of the ATR and QM rule, which reached conclusions similar to those reported by private-sector researchers. Among numerous findings, the CFPB reported that the approval rates for non-QM high-DTI applicants declined across all credit tiers and income groupings since the QM rule took effect, possibly as a result of lenders' wanting to avoid litigation risks. In addition, the CFPB found that borrowers applying for loans eligible for purchase or guarantee by one of the GSEs or federal agencies were less affected by the QM rule. The CFPB also found that the GSEs may have loosened their underwriting requirements for high-DTI borrowers.

On July 25, 2019, the CFPB issued an Advance Notice of Proposed Rulemaking, proposing to allow the QM patch to expire on January 10, 2021. If the QM patch expires, whether the GSEs would purchase non-QM loans in the future is unclear. Financial institutions historically have been less willing to assume potentially costly legal risks. For example, after the Georgia Anti-Predatory Lending Act of 2002 was passed, the GSEs announced that they would no longer purchase mortgages originated in the State of Georgia to avoid the legal risk of assignee liability. Likewise, the GSEs could limit their purchases to QMs or, alternatively, they could charge higher fees to offset potential legal and compliance risks like the private-sector originators that continue to offer non-QM loans.

Alternative Metrics for Consideration

Generally speaking, a main goal of the Dodd-Frank Act was to promote the financial stability of the United States. Along with capital requirements and other prudential regulations for financial institutions, a DTI requirement can also be viewed as a macroprudential policy tool that may reduce a financial system's vulnerability to payment disruptions and systemic panics.

If a DTI requirement is considered to be a useful macroprudential policy tool, it is possible that the *front-end* DTI could be used rather than the back-end DTI. The front-end DTI consists only of the monthly housing expenses divided by monthly gross income. Thus, it is less restrictive than the back-end DTI and could result in greater credit access for some creditworthy borrowers. For example, suppose renters (using their monthly rents in the calculation) have *back-end* DTIs exceeding 43%, yet they have demonstrated the ability to meet their monthly expenses. In this case, renters who apply for mortgages arguably should not be denied if their total monthly payment obligations with a mortgage would be relatively similar. For this reason, the *front-end* DTI may be a sufficient indicator of housing affordability while also satisfying a macroprudential policy goal. Depending upon borrower circumstances, lenders traditionally consider acceptable front-end DTIs to range from 28% to 41%.

Another alternative to the back-end DTI is the loan-to-value (LTV) ratio, defined as the outstanding mortgage balance divided by the current residential property value. Some academic policy research has found that the back-end DTI ratio may be a less reliable predictor of single-family borrower default than the LTV. If macroprudential stability is the goal, the determination of mortgage eligibility arguably should be linked to a ratio that is a more reliable predictor of default.

If Congress desired to replace the back-end DTI with any alternative metric(s), it may require statutory change. The Dodd-Frank Act requires the regulator to use specific metrics that are informative about the ability to repay, but it may not necessarily provide the CFPB with the flexibility to substitute metrics that may better predict loan default.

Additional Resources

Bureau of Consumer Financial Protection (CFPB), "Ability-to-repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z)," 78 *Federal Register* 6408-6620, January 30, 2013.

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Department of Housing and Urban Development, "Qualified Mortgage Definition for HUD Insured and Guaranteed Single Family Mortgages," 78 *Federal Register* 75215-75238, December 13, 2013.

Department of Veterans Affairs, "Loan Guaranty: Ability-To-Repay Standards and Qualified Mortgage Definition Under the Truth in Lending Act," 79 *Federal Register* 26620-26628, May 9, 2014.

Department of Agriculture, Rural Housing Service, "Single Family Housing Guaranteed Loan Program," 81 *Federal Register* 26461-26465, May 3, 2016.

Mortgage Bankers Association, "ATR/QM Issues," at https://www.mba.org/advocacy-and-policy/residential-policy-issues/cfpb-consumer-laws-and-regulations/atr/qm-issues.

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Pete Carroll, Expiration of the CFPB's Qualified Mortgage "GSE Patch"—Part 1, CoreLogic, at https://www.corelogic.com/blog/2019/07/expiration-of-the-cfpbs-qualified-mortgage-gse-patch-part-1.aspx.

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