Center for Responsible Lending

Leadership Conference on Civil and Human Rights

NAACP

National Association of Hispanic Real Estate Professionals

National Association of Real Estate Brokers

National CAPACD

National Community Reinvestment Coalition

National Housing Conference

Comments to the Consumer Financial Protection Bureau

Notice of Proposed Rulemaking

Qualified Mortgage Definition under the Truth in Lending Act (Regulation Z): General QM Loan Definition

12 CFR Part 1026

Docket No. CFPB-2020-0020

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I. Executive Summary

Thank you for the opportunity to comment on the Consumer Financial Protection Bureau's (CFPB's) qualified mortgage (QM) proposed rule. Given CFPB's decision to end the GSE patch, we believe that a price-based approach is an appropriate and effective method to determine QM status. However, additional safeguards are necessary to ensure that the final rule effectively protects consumers and promotes access to responsible mortgage credit.

In finalizing its rule, CFPB should ensure borrower protections for four key issues: fair lending, pricing caps, short-reset adjustable rate mortgages (ARMs), and "consider and verify." Our comment also addresses CFPB's seasoning proposal and small balance loans.

We recommend that CFPB do the following:

1) Protect against pricing discrimination by ensuring that lenders engaged in price discrimination cannot take advantage of the safe harbor;
2) Adopt a price-based approach to QM rather than a DTI- or hybrid DTI/price-based approach;
3) Raise the safe harbor threshold to 2% over APOR;
4) Raise the overall QM cap for rebuttable presumption loans to 3% over APOR;
5) Ensure that borrowers are protected from excessive payment shock in short-reset ARMs consistent with the QM statute;
6) Clarify the requirement that lenders consider and verify debts and income and consider debt-to-income (DTI) or residual income by ensuring meaningful ability to repay (ATR) analysis under the safe harbor;
7) Refrain from adopting a seasoning approach to turn non-QM or rebuttable presumption loans into safe harbor loans. If CFPB adopts the seasoning approach, ensure that none of the safeguards CFPB included in the proposed rule are weakened; and
8) Engage in further data analysis for small loans, disaggregating chattel and real estate-secured loans.

II. Broad QM is Key to Ensure that the Vast Majority of Borrowers, Including Low- to Moderate-Income Borrowers and Borrowers of Color, Can Access the Safest Mortgage Products and Succeed in Homeownership

The central purpose of QM is to encourage lenders to provide the safest loans to borrowers in order to encourage sustainable homeownership. In exchange for doing so, lenders receive a significant litigation advantage. Thus, QM should be defined broadly to ensure that more borrowers are able to gain access to these protected mortgage products and the consequent wealth-building opportunities of homeownership. A narrow definition of QM would reduce lending dramatically at all income levels, with significant economic consequences, and disproportionately harm lower-income families and borrowers of color.

During the subprime lending boom, lenders sold millions of families abusive loans that were not sustainable. Leading up to the crisis, these dangerous niche products that lenders mass-marketed included interest-only loans, ARM loans that combined "teaser" rates with subsequent large jumps in payments, negative amortization loans, and loans made with limited or no documentation of the borrower's income or assets.[1] Studies have shown that these products in and of themselves caused about half of the increased risk in mortgage lending that led to the Great Recession.[2]

These abusive products were disproportionately targeted to communities of color. Roughly half of all mortgages made to Black and Latino families during the run-up to the crisis were subprime loans, which included patently unsustainable terms.[3] Evidence shows that many of those borrowers were steered into toxic mortgages even when they qualified for safer and more

[1] Financial Crisis Inquiry Commission, *The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, at pp. 104-111 (2011), available at https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[2] Morris A. Davis, William D. Larson, Stephen D. Oliner, and Benjamin R. Smith, *A Quarter Century of Mortgage Risk*, FHFA Staff Working Paper 19-02, at p. 35, October 2019 (revised) January 2019 (original) (finding that "risky product features accounted for more than half of the rise in risk during the boom years", defining "risky product features" as those ineligible for QM status). The definition of "risky product features" is conservative because it does not include many loans that would also be ineligible for QM status. Namely, the definition excludes the 22% of subprime loans that were 30-year ARMs (40% of subprime loans were) and that were fully documented (60% of subprime loans were, and 40% times 56% equals 22%). These loans would not have been QM because they almost certainly were not underwritten at the maximum interest rate for the first five years of the loan and a high percentage had prepayment penalties and did not escrow for taxes and insurance. Prepayment penalties are prohibited and escrows are required for loans over 1.5% over APOR by Dodd-Frank. For characteristics of subprime loans, see Testimony of Eric Stein before the U.S. Senate Committee on Banking, Housing and Urban Affairs, *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis*, Center for Responsible Lending (October 16, 2008) at pp. 11-14, 34-39, available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/senate-testimony-10-16-08-hearing-stein-final.pdf. *See also* Lei Ding, Roberto Quercia, Wei Li, and Janneke Ratcliffe, *Risky Borrowers or Risky Mortgages Disaggregating Effects Using Propensity Score Models*, at pp. 245-277, Journal of Real Estate Research: Vol. 33, No. 2, (2011).

[3] Federal Reserve researchers, using data from 2004 through 2008, have reported that higher-rate conventional mortgages were disproportionately distributed to borrowers of color, including African-American, Latino, American Indians, Alaskan Natives, Native Hawaiians, Pacific Islanders, and Hispanic borrowers. *See* R.B. Avery, K.P. Brevoort, and G.B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, Federal Reserve Bulletin (September 2006), available at http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf. For example, in 2006, among consumers who received conventional mortgages for single-family homes, roughly half of African-American (53.7 percent) and Hispanic borrowers (46.5 percent) received a higher-rate mortgage compared to about one-fifth of non-Hispanic white borrowers (17.7 percent). According to the researchers, "[F]or higher-priced conventional first-lien loans for an owner-occupied site-built home, the mean APR spreads were about 5 percentage points above the yields on comparable Treasury securities both for purchase loans and refinancings". R.B. Avery, K.P. Brevoort, and G.B. Canner, *The 2006 HMDA Data*, at p. A88, Federal Reserve Bulletin (December 2007), available at http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf. For a discussion of the unsustainable subprime lending terms and practices, see Testimony of Eric Stein before the U.S. Senate Committee on Banking, Housing and Urban Affairs, ibid.

responsible loans with cheaper costs.[4] As a consequence of these lending practices, Black and Latino families lost over $1 trillion dollars in wealth during the crisis.[5]

In response to these abuses, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established rules ensuring that borrowers have a reasonable ability to repay their mortgage loans at consummation and requiring full documentation of income and assets. The QM statutory product protections ensured that most borrowers will not be placed in loans with built-in payment shock that they cannot handle or excessive fees: 1) the loan cannot have negative amortization, interest-only payments, or balloon payments; 2) ARMs must be underwritten at the maximum rate in the first five years; 3) the mortgage term must be 30 years or less; and 4) total points and fees generally cannot exceed 3 percent of the loan amount. The product protections are the most important benefit to borrowers obtaining QM loans and are fundamentally why QM should be defined inclusively. In addition, given the litigation advantage that lenders receive, interest rates on QM loans will be lower than for non-QM loans, providing borrowers a further boost in sustainable homeownership.

Today the vast majority of lending is appropriately in the QM space, with most loans meeting the QM safe harbor. The non-QM market remains small in comparison but still available for borrowers for whom such terms are appropriate. Thus, which loans are defined to be qualified mortgages has and will continue to have an enormous impact on access to credit.

An overly restrictive QM definition is likely to recreate the dual market of safe products for some and risky and more expensive loans for others that prevailed during the subprime boom. Under such an approach, creditworthy low-wealth families, including families of color, would be more likely to be excluded from QM product protections, and perhaps excluded from homeownership altogether. This would perpetuate homeownership disparities and exacerbate the racial wealth gap.

Today's racial wealth gap and lending disparities are in large part the result of decades of government policies and practices that enabled the redlining of communities of color for most of the 20th century. In the post-Depression era, federal policies that created housing opportunities for returning veterans and their families explicitly excluded people of color from the benefits of government-supported housing programs. Among these programs were public housing, the Home Owners Loan Corporation, and mortgage insurance through the Federal Housing Administration.[6] Not only did this redlining segregate residential neighborhoods across the

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[4] Rick Brooks and Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy*, Wall Street Journal, December 2007, available at https://www.wsj.com/articles/SB119662974358911035; *see* Debbie Gruenstein Bocian, Keith Ernst and Wei Lee, *Race, Ethnicity and Subprime Loan Pricing*, Center for Responsible Lending, Journal of Economics and Business, at pp. 110-124, Vol. 60, Issues 1-2, January-February 2008.

[5] Debbie Gruenstein Bocian, Peter Smith, and Wei Li, *Collateral Damage: The Spillover Costs of Foreclosures*, Center for Responsible Lending, at p. 2 (Oct. 24, 2012), available at https://www.responsiblelending.org/mortgage-lending/research-analysis/collateral-damage.pdf.

[6] *See, e.g.*, National Community Reinvestment Coalition, *HOLC "Redlining" Maps: The Persistent Structure of Segregation and Economic Inequality* (2018), available at https://ncrc.org/holc/.

United States, but it granted whites the ability to build wealth through homeownership while denying equal opportunities for families of color to build similar home equity over the same period. As a result, whites accrued an economic advantage in the form of home equity that has been passed on to future generations through intergenerational wealth transfers.

Creditworthy borrowers of color continue to be underserved in the mortgage market. For example, research from the Urban Institute showed that over 1.7 million Black millennials are mortgage ready yet remain outside of the system.[7] There continues to be a stark disparity in the homeownership rate between whites and people of color, with the white homeownership rate at 73% while the rate is 44% and 48% for Black and Latino borrowers respectively.[8] As a result of homeownership disparities, discrimination, and lack of fair access, the racial wealth gap continues to grow. The median white family has 10 times the wealth of the median Black family and 8 times the wealth of the median Latino family.[9] The definition of QM must not aggravate these persistent and disturbing disparities.

In addition, the denial of QM status to creditworthy borrowers would cause more potential homebuyers to be forced to continue to rent, causing greater competition for units and leading to further rent increases. And since 53% of the total rental market is comprised of single-family homes (1 to 4-unit properties), this enhanced competition among renters could itself cause a rise in the property values of single-family houses. Rent levels, particularly those at the lower end of

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[7] *See* Alanna McCargo, Jung Hyun Choi, and Edward Golding, *Building Black Homeownership Bridges: A Five-Point Framework for Reducing the Racial Homeownership Gap*, Urban Institute, at p. 8 (May 2019), available at https://www.urban.org/sites/default/files/publication/100204/building_black_ownership_bridges_1.pdf; Laurie Goodman, Alanna McCargo, Edward Golding, Bing Bai, and Sarah Strochak, *Barriers to Accessing Homeownership: Down Payment, Credit, and Affordability*, Urban Institute, at p. 20 (September 2018), available at https://www.urban.org/sites/default/files/publication/99028/barriers_to_accessing_homeownership_2018_4.pdf; Freddie Mac, *Industry Insight: Expanding Homeownership to the Millennial Market* (June 22, 2017), available at https://sf.freddiemac.com/articles/insights/industry-insight-expanding-homeownership-to-the-millennial-market.

[8] *See* Jung Hyun Choi, Alanna McCargo, Michael Neal, Laurie Goodman and Caitlin Young, *Explaining the Black-White Homeownership Gap: A Closer Look at Disparities across Local Markets*, Urban Institute (November 2019), available at https://www.urban.org/sites/default/files/publication/101160/explaining_the_black-white_homeownership_gap_2.pdf; Sarah Strochak, Caitlin Young and Alanna McCargo, *Mapping the Hispanic Homeownership Gap*, Urban Institute (August 2019), available at https://www.urban.org/urban-wire/mapping-hispanic-homeownership-gap.

[9] Asset Building Policy Network, *The Hispanic-White Wealth Gap Infographic* (September 2019), available at https://prosperitynow.org/sites/default/files/resources/ABPN_Hispanic_White_Racial%20Wealth%20Gap%20Infographic_Final.pdf; Nick Noel, Duwain Pinder, Shelley Stewart III, and Jason Wright, *The Economic Impact of Closing the Racial Wealth Gap*, McKinsey & Company, Exhibit 1 at p. 5 (August 2019), available at https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-economic-impact-of-closing-the-racial-wealth-gap. The median Black household with children has 1% of the wealth of the median white household with children. Christine Percheski and Christina Gibson-Davis, *A Penny on the Dollar: Racial Inequalities in Wealth among Households with Children*, Socius (June 1, 2020), available at https://journals.sagepub.com/doi/full/10.1177/2378023120916616. The median net worth of Black households, excluding equity in their own home that first-time home buyers lack, is just $2,725, 5% of white households' median net worth of $51,100. *See* U.S. Census, *Wealth, Asset Ownership, & Debt of Households Detailed Tables*, Survey of Income and Program Participation, 2014 Panel, available at https://www.census.gov/data/tables/2013/demo/wealth/wealth-asset-ownership.html.

the market, are inexorably rising faster than incomes.[10] As a result, many tenants are severely cost-burdened today. A quarter of all renters in the United States pay over half of their incomes just for rent, including more than 30% of Black renters and 28% of Latino renters.[11] A rule that excludes creditworthy families from QM protections would deny them a mortgage loan to buy the house of their choice, as well as the opportunity to build wealth through homeownership.[12]

Thus, a broad definition of QM is necessary to ensure that the lowest cost loans with the safest product features are widely available to homebuyers.

III. The CFPB Should Adopt a Price-Based Approach to QM Rather than a DTI- or Hybrid DTI/Price-based Approach

A. The CFPB Should Reject a DTI-Based Approach to QM

QM should not be defined by DTI-based approaches for several reasons. First, DTI is limited as a predictor of mortgage risk. As we noted in our prior comment and paper, DTI alone is so weakly predictive for near-prime loans that for a thousand borrowers between 45% and 50% DTI, *just two additional borrowers default* compared to loans between 40% and 45% DTI, not nearly enough to warrant denying QM protections to the remaining borrowers.[13] In our paper, we

[10] According to the Joint Center for Housing Studies of Harvard University, "[a]djusting for inflation, the median rent payment rose 61% between 1960 and 2016 while the median renter income grew only 5%." *The State of the Nation's Housing*, at p. 5 (2018), available at http://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_State_of_the_Nations_Housing_2018.pdf.

[11] Joint Center for Housing Studies of Harvard University, *America's Rental Housing*, at p. 30, Table A-2 (2019), available at https://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_State_of_the_Nations_Housing_2019.pdf (finding 10.8 million severely cost-burdened renters out of 43.3 million total); *Renter Cost Burdens By Race and Ethnicity*, available at http://www.jchs.harvard.edu/ARH_2017_cost_burdens_by_race.

[12] See Christopher Herbert, Daniel McCue, and Rocio Sanchez-Moyano, *Update on Homeownership Wealth Trajectories Through the Housing Boom and Bust*, Working Paper: Joint Center on Housing Studies of Harvard University, at p. 6 (February 2016), available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/2013_wealth_update_mccue_02-18-16.pdf (stating that "[e]ven after the precipitous decline in home prices and the wave of foreclosures that began in 2007, homeownership continues to be associated with significant gains in household wealth at the median for families of all races/ethnicities and income levels. Households who are able to sustain homeownership over prolonged periods stand to gain much. Meanwhile, renters experienced little wealth accumulation over this period. And though homeownership is certainly not without risk, the typical renter household who transitioned into and then exited homeownership by 2013 was no worse off financially than the typical household who remained a renter over the whole period.").

[13] Center for Responsible Lending, Comment Letter to the Consumer Financial Protection Bureau, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition (September 16, 2019), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-et-al-anpr-comment-sep2019.pdf; Eric Stein and Michael Calhoun, *A Smarter Qualified Mortgage Can Benefit Borrowers, Taxpayers, and the Economy*, at p. 1, Center for Responsible Lending (July 2019), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-a-smarter-qualified-mortgage-july2019.pdf.

summarized several studies concluding that DTI is limited as a standalone measure of ability to repay.[14]

Additional research identifies the small impact of DTI on default. The Urban Institute analyzed two decades of GSE purchase origination data to assess the relative contributions of DTI, FICO, LTV, and the rate spread to mortgage delinquency. They find that:

> For each year since 2011, the 90-day delinquency rate for loans with DTI ratios over 45% is less than that for loans with DTI ratios between 30% and 45%. This inconsistency is not present for the other measures of riskiness, such as FICO scores and LTV ratios.[15]

In other words, patterns since 2011 show that the highest DTI bucket has a lower delinquency risk than the medium DTI bucket. This finding alone is counterintuitive to the notion that higher DTI ratios are a sound predictor of default. The alternative approaches under consideration by the Bureau would establish higher DTI buckets for QM, yet patterns of default in the data do not support this approach.

Subsequent analysis by Urban provided even more compelling evidence against using DTI to inform QM.[16] Similar conclusions were reached by Richard Green, who also used multivariate models to examine the role of DTI ratios on defaults while controlling for FICO scores, loan-to-value ratios, refinances, and other relevant factors.[17] Data came from a random sample of mortgages purchased by Freddie Mac in 2004 and followed through the financial crisis. Measured as ever 90-day delinquent, the default rate for these loans was 14.3%. Results indicate that an increase in DTI of 10-percentage-points is associated with a 1.3 percent increase the probability of default. In contrast, cash-out and rate/term refinances are associated with a much larger 5.2 and 3.6 percent increase in the probability of default. As Green observes, "while DTI is a predictor of mortgage default, it is a fairly weak predictor."[18]

Thus, an accumulation of evidence indicates that DTI is a weaker predictor of mortgage delinquency than other available measures. Given these patterns, the Bureau should reject a DTI-based approach to QM. Additionally, there are considerable challenges to the measurement of DTI, especially the income component. As we noted in our prior comment, these measurement

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[14] Stein and Calhoun at pp. 9-10.
[15] Karan Kaul and Laurie Goodman, *What if Anything, Should Replace the QM GSE Patch?* The Journal of Structured Finance, at p. 6, 24 (4) 59-67 (Winter 2019), available at https://doi.org/10.3905/jsf.2019.24.4.059.
[16] Karan Kaul, Laurie Goodman, and Jun Zhu, Comment Letter to the Consumer Financial Protection Bureau, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition (September 2019), available at https://www.urban.org/sites/default/files/publication/101048/comment_letter_to_the_consumer_financial_protection_bureau_0.pdf.
[17] 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), available at https://real-estate-and-urban.blogspot.com/2016/12/the-trouble-with-dti-as-underwriting.html.
[18] *Ibid.*

challenges are accentuated for non-traditional and non-salary employees including many entrepreneurs and gig-workers.[19]

Moreover, the Bureau should not incorporate a DTI limit because it would needlessly curtail access to mortgage credit for creditworthy borrowers. Our earlier comment noted that application of a DTI limit would result in exclusion of many borrowers who have demonstrated the ability to handle debt by regularly paying more than their mortgage in rent, or who have compensating factors permitting them to exceed a particular DTI cutoff.[20] We also noted that higher DTI borrowers above the threshold would likely pay substantially higher interest rates on potentially riskier products or be unable to obtain financing. These outcomes for all borrowers would be consistent with CFPB's findings with respect to jumbo applicants who had DTIs over 43% and were therefore ineligible for QM status. CFPB found significantly higher interest rates for those who got loans and "sharp reductions in access to credit" for this group of potential borrowers.[21] Finally, our prior comment details that such exclusion would disproportionally affect low-income and low-wealth families, including families of color.

B. CFPB Should Adopt a Price-based Approach to QM

We agree with the Bureau's proposal to remove the General QM definition's 43 percent DTI limit and to replace it with a price-based threshold. The price of a loan reflects ability to repay more holistically than a DTI ratio since it considers a wider set of borrower and loan characteristics, resulting in a stronger measure. As discussed in section IV.D, to ensure that holistic underwriting occurs, CFPB properly requires lenders to document debts and income and to consider the DTI ratio or residual income before making the loan.

For loans that meet the QM product protections, CFPB demonstrates convincingly in the preamble that the price of the loan is strongly associated with its performance and the borrower's ATR, using the reasonable proxy of 60 days delinquent in the first two years of the loan.[22] The CFPB's data corroborates other findings that show that rate-spread pricing is more predictive of default than DTI.[23] Furthermore, as CFPB noted, there is significant precedent for price as a measure of ATR, including in the concept of the safe harbor itself when, in the 2013 Final Rule, the Bureau found that lower rates are indicative of ability to repay. In addition, the Dodd-Frank Act added a number of protections that begin to take effect only once a specific spread over

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[19] Center for Responsible Lending, Comment Letter to the Consumer Financial Protection Bureau, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition (September 16, 2019), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-et-al-anpr-comment-sep2019.pdf.

[20] *Ibid.*

[21] CFPB, *Ability-to-Repay and Qualified Mortgage Rule Assessment Report*, at pp. 11, 117, 198 (January 2019), available at https://files.consumerfinance.gov/f/documents/cfpb_ability-to-repay-qualified-mortgage_assessment-report.pdf.

[22] 85 Fed. Reg. 41716, 41730-41737, particularly Tables 1-6.

[23] *See* Karan Kaul, Laurie Goodman, and Jun Zhu, Comment Letter to the Consumer Financial Protection Bureau, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition (September 2019), available at https://www.urban.org/sites/default/files/publication/101048/comment_letter_to_the_consumer_financial_protection_bureau_0.pdf.

APOR is reached.[24] In addition, an appropriately-set price-based approach strikes the right balance between ensuring consumers receive mortgage credit that they are able to repay and maintaining access to responsible, affordable mortgage credit.

IV. In Finalizing its Rule, CFPB Should Ensure Borrower Protections for Four Key Issues: Fair Lending, Pricing Caps, Adjustable Rate Mortgages, and "Consider and Verify"

A. CFPB Must Be Vigilant to Ensure that Mortgage Pricing is Based on Legitimate Risk Factors and Protect Against Discriminatory Pricing

Pricing discrimination remains a major concern in the mortgage market and can have a deleterious effect on a borrower's ability to repay a loan.[25] CFPB should be vigilant to ensure that mortgage pricing is based on legitimate risk factors and to protect against discriminatory pricing. The only true protection against overcharging borrowers of color is for lenders to have a robust fair lending compliance program that includes disparate impact protections and analyses. The Bureau should incentivize lenders to self-monitor, self-report, and remediate likely pricing discrimination. Lenders that discover and do not remediate likely pricing discrimination should not receive the benefit of the QM safe harbor. Civil rights and consumer advocacy organizations recommend a proposal designed to ward off potential pricing discrimination (see Appendix 1), as described below.

Fair Lending Proposal:

- **No presumption or inferences relating to fair lending**: The CFPB has a separate, yet equally important, responsibility to ensure that the pricing consumers receive for mortgages does not discriminate against applicants on the basis of characteristics protected by law. By statute, one of the functions of the Office of Fair Lending and Equal Opportunity is to coordinate the fair lending efforts of the Bureau with other Federal agencies and State regulators "to promote consistent, efficient, and effective enforcement of Federal fair lending laws." Accordingly, the CFPB should make clear that the QM safe harbor established by this regulation should not be construed to create an inference or

[24] 78 Fed. Reg. 6408, 6511. Examples in Dodd-Frank included limits on prepayment penalties, requirements to establish escrows for taxes and insurance, and exclusions for bona fide discount points. The Home Ownership and Equity Protection Act also includes protections for "high-cost mortgage loans."

[25] *See, e.g.*, Consent Order in *United States v. National City Bank*, Case No. 2:13-cv-01817-CB (W. D. Penn. Jan. 9, 2014), available at https://www.justice.gov/sites/default/files/crt/legacy/2014/04/08/nationalcitybanksettle.pdf (alleging that compensation and incentive policies resulted in Black and Latino borrowers being charged rates higher than white borrowers with substantially similar or inferior financial qualifications); Consent Order in *United States v. Countrywide*, Case No. 2:11-cv-10540-PSG-AJW (C.D. Cal. Dec. 28, 2011), available at https://www.justice.gov/sites/default/files/crt/legacy/2012/01/27/countrywidesettle.pdf (alleging discrimination against more than 200,000 Latino and Black borrowers by systematically charging higher discretionary fees and markups to those borrowers than to white borrowers). *See also* Robert Bartlett, Adair Morse, Richard Stanton, and Nancy Wallace, *Consumer-Lending Discrimination in the FinTech Era*, Haas School of Business UC Berkeley (May 2019), available at http://faculty.haas.berkeley.edu/morse/research/papers/discrim.pdf.

presumption that a loan satisfying the identified criteria is compliant with the Equal Credit Opportunity Act, the Fair Housing Act, or state or local anti-discrimination laws that pertain to lending. A QM safe harbor loan may still violate the requirements of the Equal Credit Opportunity Act, the Fair Housing Act or state and local anti-discrimination laws, as well as other federal and state laws regulating mortgage lending.

- **Diminishing negative impacts on a borrower's Ability to Repay**: The CFPB has an obligation to mitigate actions, like pricing discrimination, that can negatively impact a borrower's ability to repay their debt obligation. The CFPB should therefore limit the ability of a financial institution to receive the QM safe harbor in instances where pricing discrimination has occurred, as set forth below.

  If a financial institution, or creditor as defined by the Equal Credit Opportunity Act (ECOA), originates a loan that meets the Safe Harbor thresholds outlined in the regulation and discovers a likely violation of the ECOA resulting from pricing discrimination related to the loan, the financial institution shall self-report the likely violation to the CFPB and its prudential regulator within 30 days of the discovery of the likely violation. The financial institution shall have 30 days, from the date of discovery, to remediate the harm resulting from the likely violation.

  Should a financial institution fail to self-report a likely violation and remediate the harm resulting from a likely violation within 30 days of the date of discovery of the likely violation, and a judicial, administrative, or regulatory body, through a final adjudication, determines that pricing discrimination in violation of ECOA has occurred, the Safe Harbor will not apply to the loan(s) related to that violation. Loans related to that violation may still qualify as QM loans, but they are not afforded a conclusive presumption of compliance.

B. Pricing Caps

i. CFPB Should Increase the Safe Harbor to 2% Over APOR

We recommend that CFPB raise the safe harbor cap from 1.5% to 2% over APOR. We base this recommendation on both an empirical analysis of early delinquency rates and the observation that lenders gravitate toward making loans with rate spreads that fall below the safe harbor cutoff, which leaves open the potential for disparate credit access across racial/ethnic groups for those who are priced slightly over this cutoff.

To assess the relationship between delinquency rates and rate spread thresholds, we analyze Fannie Mae's Single-Family Loan Performance data. (Please see the Appendix 2 for more detail on our methodology.) Following CFPB, we define delinquency as ever 60 days delinquent within the first two years of loan origination. We approximate the rate spread as the sum of the

mortgage interest rate and an estimated risk-based Private Mortgage Insurance (MI) premium for loans with mortgage insurance, less the average market interest rate from Freddie Mac's Primary Mortgage Market Survey (PMMS). This methodology is similar to CFPB's approach to calculating the rate spread, except that CFPB's MI premium varies only with the original loan-to-value ratio, as premiums did before the financial crisis. Instead, we use a risk-based MI premium rate sheet from 2018/2019 that varies with additional loan and borrower characteristics and is intended to approximate current MI pricing practices. We selected this approach because including risk-based mortgage insurance premiums in the rate spread calculation more accurately represents the rate spreads that current loans would have. It is therefore important in determining what rate-spread threshold should be selected for today's and tomorrow's market.

Incorporating risk-based MI premiums has the effect of shifting the distribution of loans by rate spread, such that more loans have rate spreads above the proposed QM thresholds. Risk-based MI pricing increases the variance of rate spread estimates for loans with MI, such that low-risk borrowers have lower premiums and high-risk borrowers have higher premiums. In consequence, high-risk borrowers tend to become more concentrated within the higher rate spread buckets, which contributes to a corresponding increase in delinquency rates in those buckets and a reduction in delinquency rates at lower rate spreads.

However, the increases in delinquency rates observed at higher rate spreads are modest. As demonstrated in Table 1, for loans originated during the period of 1999-2019, which reflects all origination years in Fannie Mae's mortgage performance portfolio, we estimate that the rate of delinquency at a rate spread of 1-1.49% is 4.1%. The delinquency rate rises to 6.9% for loans with rate spreads of 1.5-1.99%, which represents incremental risk of 2.8 percentage points.

Table 1: Fannie Mae Portfolio, 1999-2019

Two-Year Delinquency Rates by Rate Spread, Fannie Mae Single-Family Purchase Loans, Vintages 1999 – 2019	N	Column Percent	*Ever 60 Days Delinquent*		
			N	Delinquency Rate	Incremental Risk
Total Loans	15,106,094	100.0%	243,930	1.6%	n/a
Rate Spread: Note Rate + PMI - PMMS Rate					
Less than 0.5 percentage points	10,466,221	69.3%	103,469	1.0%	n/a
0.5 to less than 1.0 percentage points	3,140,911	20.8%	65,118	2.1%	1.1
1.0 to less than 1.5 percentage points	1,092,308	7.2%	45,005	4.1%	2.0
1.5 to less than 2.0 percentage points	321,720	2.1%	22,064	6.9%	2.8
2.0 to less than 2.5 percentage points	71,853	0.5%	6,725	9.4%	2.5
2.5 to less than 3.0 percentage points	11,351	0.1%	1,302	11.5%	2.1
3.0 percentage points or more	1,730	0.0%	247	14.3%	2.8

As shown on Table 2, for loans originated more recently during the period of 2013-2018, we estimate that the rate of delinquency at a rate spread of 1-1.49% points is approximately 2.8%. The delinquency rate rises to 5.3% for loans with rate spreads of 1.5-1.99%, which represents incremental risk of 2.5 percentage points. These modest increases in risk are manageable via the conventional risk management strategies used by lenders and the secondary market.

Table 2: Fannie Mae Select Years, 2013-2018

Two-Year Delinquency Rates by Rate Spread, Fannie Mae Single-Family Purchase Loans, Vintages 2013 – 2018	N	Column Percent	*Ever 60 Days Delinquent*		
			N	Delinquency Rate	Incremental Risk
Total Loans	5,809,268	100.0%	62,498	1.1%	n/a
Rate Spread: Note Rate + PMI - PMMS Rate					
Less than 0.5 percentage points	3,588,135	61.8%	17,313	0.5%	n/a
0.5 to less than 1.0 percentage points	1,519,169	26.2%	20,070	1.3%	0.8
1.0 to less than 1.5 percentage points	519,282	8.9%	14,709	2.8%	1.5
1.5 to less than 2.0 percentage points	150,204	2.6%	7,932	5.3%	2.5
2.0 to less than 2.5 percentage points	28,986	0.5%	2,146	7.4%	2.1
2.5 to less than 3.0 percentage points	3,264	0.1%	304	9.3%	1.9
3.0 percentage points or more	228	0.0%	24	10.5%	1.2

Research conducted by the Federal Reserve Board indicates that lenders responded to the implementation of the initial QM rules by reducing the share of higher priced mortgages that they originated, with the eventual result that only 4.6% of home purchase loans originated in 2019 had a rate spread more than 1.5% above APOR.[26] Moreover, a CFPB analysis of mortgage market trends indicates that 22% of Blacks and 23% of Latinos taking out home purchase loans in 2019 received loans priced over 1.5% over APOR, compared with only 8% of whites.[27] Thus, the fact that lenders appear reluctant to lend at rate spreads above the safe harbor threshold implies that credit access to sustainable mortgages for Black and Latino borrowers could be improved by raising the safe harbor threshold to 2% above APOR.[28] Demographic projections

[26] Neil Bhutta and Daniel Ringo, *Effects of the Ability to Repay and Qualified Mortgage Rules on the Mortgage Market*, FEDS Notes, Board of Governors of the Federal Reserve System (2015), available at https://www.federalreserve.gov/econresdata/notes/feds-notes/2015/effects-of-the-ability-to-repay-and-qualified-mortgage-rules-on-the-mortgage-market-20151229.html; Consumer Financial Protection Bureau, Data Point: 2019 Mortgage Market Activity and Trends, Table 8 (2020), available at https://www.consumerfinance.gov/data-research/research-reports/data-point-2019-mortgage-market-activity-and-trends/.

[27] *Ibid.* at Table 7.

[28] As discussed in section IV.A, it is crucial that pricing be based on legitimate risk factors and not discrimination. While pricing discrimination is real, the disparities reflected in the racial composition of loans between 1.5 and 2% over APOR does significantly reflect differences in ability to repay based on differences in credit histories and wealth. For example, the Urban Institute, citing data and a study from Freddie Mac, finds that 65% of Black Americans have no credit score or a score below 620 versus 34% for whites, and that half the homeownership gap

for the US point to future increases in the population shares of Blacks and Latinos, making the need to serve these groups increasingly important for the health and future growth of the housing market.[29] Over the past decade, Latinos have accounted for over 40% of all household formation growth and for 58% of all population growth.[30]

ii. CFPB Should Raise the Overall QM Cap for Rebuttable Presumption Loans to 3% Over APOR

We also recommend that CFPB raise the overall QM cap from 2% to 3% over APOR, subjecting the loans that fall over CFPB's selected safe harbor level to a rebuttable presumption. This recommendation follows from both an empirical analysis of early delinquency rates and the concern that creditworthy borrowers who do not have access to Qualified Mortgages may find their mortgage choices limited to higher cost products with risky features, which may adversely impact their loan performance, or be denied access to credit at all. Because of our concern that QM product protections should be made broadly available, including through the rebuttable presumption, we believe that increasing the upper cap of QM is more important than increasing the safe harbor level.

Extending our analysis of Fannie Mae's loan performance data described above for loans over 2% over APOR that were originated during 1999-2019 (Table 1), we estimate that the rate of delinquency for loans with rate spreads of 2-2.49% is 9.4%, which represents incremental risk of 2.5 percentage points as compared to loans with rate spreads of 1.5-1.99% basis points (delinquency rate of 6.9%). The delinquency rate rises to 11.5% for loans with rate spreads of 2.5-2.99%, which represents incremental risk of 2.1 percentage points, and to 14.3% at 3%+, which represents incremental risk of 2.8 percentage points.

For loans originated during 2013-2018 (Table 2), we estimate that the rate of delinquency rises from approximately 2.8% at a rate spread of 1-1.49% to 5.3%, 7.4%, 9.3%, and 10.5% for loans

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between Black Americans and whites is due to credit score differences. Jung Hyun Choi, Alanna McCargo, Michael Neal, Laurie Goodman, Caitlin Young, *Explaining the Black-White Homeownership Gap: A Closer Look at Disparities across Local Markets*, at p. 8 (updated November 2019), available at https://www.urban.org/sites/default/files/publication/101160/explaining_the_black-white_homeownership_gap_2.pdf). In addition, as discussed in Section II, footnote 9, wealth differences between Black Americans and whites are stark; the more wealth a family has to draw on, the greater their ability to repay a mortgage, particularly when facing adverse events. See Section II for discussion on historic discrimination causes of wealth disparities.

[29] Jonathan Vespa, Lauren Medina, and David M. Armstrong, *Demographic Turning Points for the United States: Population Projections for 2020 to 2060*, Current Population Reports, U.S. Census Bureau, Table 3 (2020), available at https://www.census.gov/content/dam/Census/library/publications/2020/demo/p25-1144.pdf. *See also*, Joint Center for Housing Studies, *The State of the Nation's Housing*, at p. 3 (2013) (stating that "[m]inorities— and particularly younger adults—will also contribute significantly to household growth in 2013–23, accounting for seven out of ten net new households. An important implication of this trend is that minorities will make up an ever-larger share of potential first-time homebuyers.")

[30] U.S. Census Bureau, PEPALL6N Geography-United States Year-July 1, 2018 Hispanic Origin-Hispanic: Annual Estimates of the Resident Population by Sex, Single Year of Age, Race, and Hispanic Origin for the United States: April 1, 2010 to July 1, 2018 (June 2019).

with rate spreads of 1.5-1.99%, 2-2.49%, 2.5-2.99%, and 3%+ respectively. These increases in the delinquency rates across rate spread buckets respectively represent incremental risk of 2.5 percentage points, 2.1 percentage points, 1.9 percentage points, and 1.2 percentage points.

Therefore, as illustrated in Tables 1 and 2, the overall relationship between the rate spread and delinquency rate tends to be smooth even at higher rate spreads, which suggests the absence of a specific threshold above which loan performance deviates from its trend. In fact, during both time periods, the incremental increase in delinquency rates *falls* with each increase in the rate spread up to the 3% cutoff. The Urban Institute made a similar point in its commentary based on a multivariate regression analysis of Fannie Mae data for the period of 1999-2018, noting that there is "no rapid deterioration in performance" at rate spreads above 2%.[31] It is worth noting that the results of the Urban Institute's regression analysis are very similar to the incremental increases that we found in our analysis. That is not surprising since, by using risk-based MI premiums, our analysis incorporates mortgage insurance companies' algorithms to price for other variables for loans that have MI, which also tend to be the loans with the highest rate spreads.

In the interest of encouraging lenders to offer conventional loan products that meet the QM product protections to creditworthy borrowers who might otherwise face higher fees and risky loan features, we recommend that loans with rate spreads up to 3% above APOR be given rebuttable presumption status.

We do not recommend a threshold over 3%, however. In the longer time period, performance did incrementally deteriorate above this threshold. In addition, the numbers of loans in the samples declined materially. Further, beyond 3% above APOR, there is the concern that higher fees or interest rates may themselves exacerbate disparities in loan performance. It has been well documented that the monthly loan payment represents an important driver of loan default, particularly for borrowers with lower incomes and lower wealth.[32] With this relationship in mind, a cutoff of 3% over APOR strikes a reasonable balance between inclusive access to credit and ensuring a borrower's ability to repay.

The fraction of loans made in the rate spread range of 2-3% will likely increase in the future as a result of the increasing adoption of loan-level risk-based MI pricing.[33] As noted above, those loans with the highest rate spreads tend to be those carrying MI. While private mortgage insurance companies have long used statistical credit scoring models, since the financial crises

[31] Karan Kaul, Laurie Goodman and Jun Zhu, *CFPB's Proposed QM Rule Will Responsibly Ease Credit Availability: Data Show That It Can Go Further*, Urban Institute, at p. 9 (2020), available at https://www.urban.org/research/publication/cfpbs-proposed-qm-rule-will-responsibly-ease-credit-availability.
[32] Andreas Fuster and Paul S. Willen, *Payment Size, Negative Equity, and Mortgage Default*, American Economic Journal: Economic Policy 9(4):167-191 (2017), available at https://www.aeaweb.org/articles?id=10.1257/pol.20150007.
[33] Brad Finkelstein, *Why The PMI Industry Is Finally Ready To Embrace Black Box Pricing*, National Mortgage News (2018), available at https://www.nationalmortgagenews.com/news/why-the-pmi-industry-is-finally-ready-to-embrace-black-box-pricing.

there has been a shift toward more focused calibrations of borrower risk.[34] For example, the number of credit bands used in pricing has increased from four to eight. But over the past five years, even this narrower targeting has given way to ever more finely tuned pricing aimed at the borrower's individual loan.

One of the largest private insurance companies introduced *loan-level* risk-based pricing in October 2015. This marked a change from the company's prior practice of pricing loans within large risk buckets to a highly targeted loan-level approach in which they calculate individual risk factors to derive "a precise premium rate for each loan."[35] Other private mortgage insurers followed suit over the ensuing years. For example, in 2016 one MI company launched a proprietary risk-based calculator, to price mortgages on individual risk factors. Similarly, another "followed the rest of the industry in moving more towards risk-based pricing."[36]

As these examples show, private mortgage insurance companies over the past several years have begun using individual risk factors when pricing mortgages. These trends have since accelerated. Risk-based pricing appears to be the approach that private mortgage insurers will use in the foreseeable future.

In addition, proposed increases in GSE capital requirements will increase guarantee fees, particularly during times of economic stress and particularly for borrower with lower credit scores and higher LTVs. Even if FHFA adopts the 2018 proposed rule, the procyclical effects of the rule will also increase costs for these borrowers; CoreLogic data indicate that mortgage default rates have increased dramatically since the start of the COVID-19 pandemic, which will increase capital requirements.[37] For all of these reasons, as noted by the Urban Institute, incorporating a buffer into the rate spread threshold is important to provide necessary flexibility for the market.[38]

Increasing the rebuttable presumption threshold to 3% over APOR would particularly benefit communities of color. As noted in the previous section, Blacks and Latinos are much more likely than whites to take out higher-priced mortgage loans due to lower wealth levels.[39] For GSE purchase loans, for example, loans with rate spreads over 2% represent 2.2% of originations for

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[34] Adam Levitin and Susan Wachter, *The Great American Housing Bubble: What Went Wrong and How We Can Protect Ourselves in the Future*, at p. 223, Harvard University Press, Cambridge, MA (2020).
[35] Inside Mortgage Finance, *Arch Rolls Out Risk-Based Pricing*, IMF Short Takes (Oct. 20, 2015).
[36] Inside Mortgage Finance, *Private MIs Move Forward with Risk-Adjusted Pricing, Radian Joins Growing List of MIs with New Rate Cards*, Issue 2016:10 (March 10, 2016).
[37] Molly Boesel, *Overall Delinquency Rate Increases to Highest Level in More than Five Years*, Loan Performance Insights Report Highlights (2020), available at https://www.corelogic.com/blog/2020/8/overall-delinquency-rate-increases-to-highest-level-in-more-than-five-years.aspx.
[38] Karan Kaul, Laurie Goodman and Jun Zhu, *CFPB's Proposed QM Rule Will Responsibly Ease Credit Availability: Data Show That It Can Go Further*, Urban Institute, at p. 9 (2020), available at https://www.urban.org/research/publication/cfpbs-proposed-qm-rule-will-responsibly-ease-credit-availability.
[39] As discussed in section IV.A and footnote 28, it is crucial that pricing be based on legitimate risk factors and not discrimination. While pricing discrimination is real, the disparities reflected in the racial composition of loans between 2 and 3% over APOR does significantly reflect differences in ability to repay based on differences in credit histories and wealth.

Blacks and 1.6% for Latinos, but 0.7% for whites. The discrepancy across racial/ethnic groups for other conventional purchase lending is larger, as 2.5% of loans made to whites have rate spreads above 2%, compared with 6.5% for Blacks and 10.2% of Latinos.[40] Without an increase in the level of the QM cap, these borrowers would likely be denied QM protections on their loans, or be denied access to a loan at all. This would further exacerbate homeownership disparities at a time of historically low interest rates.

C. Ensure that Borrowers are Protected from Excessive Payment Shock in Short-Reset ARMs Consistent with the QM Statute

Short-reset ARMs pose inherent dangers to borrowers due to the possibility of generating significant payment shock quickly. CFPB must ensure that protections are in place so that lower-wealth borrowers and borrowers of color are not steered into ARMs with excessive payment shock, as occurred in the lead up to the financial crisis. In our prior comment, we recommended additional borrower protections for these loans. We cited research from the National Survey of Mortgage Originations showing that ARMs are poorly understood: 44% of recent homebuyers do not understand the differences between ARMs and fixed-rate mortgages very well.[41]

As short-reset ARMs adjust to higher interest rates, financially constrained borrowers experience payment shocks that they can find difficult to handle. As a result, they are forced to do one of two things – prepay the loan or default on it. ARMs with a fixed rate of just two or three years experience a spike in prepayments and defaults as interest rates reset. Even in periods of economic growth, the interest rate adjustment is associated with a high rate of mortgage terminations through one of these two outcomes. For example, Ambrose et al. examine ARMs originated in 1995-96 and found a substantial increase in prepayments and defaults following interest rate resets.[42]

Borrowers' ability to prepay a loan – either through refinancing or selling the house – rather than being forced to default on it depends significantly on home equity levels, which typically reflect house price changes in the broader market over which the borrower has no control. It is for this reason that the earlier the interest rates reset in ARMs, the riskier they are since there is not time for sufficient house price appreciation to occur.

To this point, Pennington-Cross and Ho studied loan performance between 1998-2005, comparing terminations for fixed-rate mortgages to the riskiest type of hybrid ARM, the 2/28. Controlling for credit score, loan-to-value, unemployment, and house price changes, the authors

[40] Email communication from Karan Kaul (September 1, 2020).
[41] Center for Responsible Lending, Comment Letter to the Consumer Financial Protection Bureau, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition, at pp. 11-13 (September 16, 2019), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-et-al-anpr-comment-sep2019.pdf.
[42] Ambrose, LaCour-Little, and Huszar, *Prepayment Risk in Adjustable Rate Mortgage Subject to Initial Year Discounts: Some New Evidence*. Real Estate Economics, 29: 305-327 (2005).

use a competing risks framework to predict prepayment versus default.[43] Their findings show that mortgage terminations spike at the two-year interest rate reset. On the question whether termination occurs through prepayment or default, the authors find that incidence of default is three times higher for every one-standard deviation increase in payment shock. Unsurprisingly, low home equity levels amplify this effect. When interest rate resets result in payment shocks that combine with little or no home equity, default probabilities increase six times higher.[44]

While the preceding default patterns occurred during periods of economic expansion, the consequences are far more severe when economic conditions deteriorate. During periods of economic decline, the default patterns for ARMs intensify, as evidenced during the financial and foreclosure crisis over a decade ago. Seventy percent of the private-label security (PLS) mortgages that dominated the market in the run-up to the crisis were ARMs, almost all short-reset ARMs.[45] As is well known, the performance on these mortgages was poor, with loss rates on PLS loans from 2008 of 24% and delinquency rates for subprime ARMs of 40% by 2009.[46]

In sum, short-reset ARMs are inherently riskier than fixed-rate mortgages not merely because of the payment shock that occurs during the interest rate reset, but also because of how ARMs uniquely interact with home equity. In the case of two- and three-year interest rate resets, payment shocks can occur before borrowers have accumulated the home equity that might otherwise buffer depreciating house prices. Pennington-Cross and Ho identify the structural risks of ARMs:

> It is the classic combination of the borrower not having enough equity on the home in conjunction with a trigger event that drastically increases the rate of hybrid loan termination. The only difference for the hybrid, as compared with the [fixed-rate mortgage], is that the trigger event is designed into the contract and is contingent on the path of future interest rates.[47]

The Dodd-Frank Act recognized and solved for this problem by requiring ARMs to be underwritten at, and DTIs calculated by, the monthly payment reflecting the highest possible interest rate for the first five years of the loan. Under the existing QM rules, this solution has been effective since ARMs underwritten in this manner are subject to the 43% limit imposed by the General QM rule or the DTI limits imposed by the GSEs under the Patch. However, under a

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[43] Pennington-Cross and Ho, *The Termination of Subprime Hybrid and Fixed-Rate Mortgages*, Real Estate Economics, 38: 399-426 (2010).
[44] *Ibid*. at 430.
[45] David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 Harv. J. Legis. 437, at p. 482 (2013), available at https://scholarship.law.uci.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1036&context=faculty_scholarship.
[46] Jim Parrott, Bob Ryan and Mark Zandi, *FHFA's Capital Rule is a Step Backward*, at p. 6, Table 4 (July 2020), available at https://www.urban.org/sites/default/files/publication/102595/fhfa-capital-rule-is-a-step-backward_0.pdf; Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report* (2011), available at https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (finding 40% delinquency rate).
[47] Pennington-Cross and Ho at p. 420.

price-based approach, QM would not impose a particular DTI limit for ARMs. As a result, the requirement to underwrite at the maximum rate as a QM protection would become less meaningful.

To address this concern, CFPB's proposed rule requires lenders to run a separate APR calculation on all short-reset ARMs, in addition to the normal APR calculation, that applies the maximum rate for the first five years to the full term of the loan. We appreciate CFPB taking the dangers of short-reset ARMs seriously in the proposed rule and we agree with the intent of the APR proposal. However, we acknowledge the complexity lenders would face in implementing it.

As a result, we suggest an alternative QM eligibility test that would be easier to implement but would similarly protect borrowers from short-reset ARM payment shock. It would cap the amount of payment shock that borrowers of short-reset ARMs can experience based on the interest rate of a published comparable prime loan. Specifically, the test would compare the maximum interest rate on the ARM in the first five years with the Average Initial Interest Rate (AIIR) for a comparable ARM product plus 2.5%. The 2.5% limit would not be adjusted for loan size because borrowers who are only able to afford a small house are likely to be particularly vulnerable to short-reset ARM payment shock.

Under this test, if the maximum possible rate is less than or equal to the AIIR plus 2.5%, the loan would be eligible to be considered a qualified mortgage. If the maximum rate is higher than 2.5%, the loan could not be a QM loan. As with interest-only loans, short-reset ARMs can be helpful for certain borrowers, and the lender could still offer the product to these borrowers, subject to liability under the ability to repay requirement.

As an example, if the loan in question is a five-year ARM, the maximum rate is the initial rate of the loan (say 4%) plus 2%, the normal first adjustment cap, for a maximum rate of 6%. This rate would be compared with the AIIR for a five-year ARM (say 3.75%) plus 2.5%, for a comparison rate of 6.25%. Because 6% is less than 6.25%, the loan is eligible to be considered QM.

If the loan meets the 2.5% test, it would still be subject to the same rate-spread test that all other loans use, where the APR of the mortgage, calculated normally, is compared with APOR. Whether a loan that passes the 2.5% test receives a safe harbor, a rebuttable presumption, or ultimately would be non-QM would depend on the rate spread of the loan and the thresholds that CFPB establishes.

D. CFPB Should Clarify the Requirement to Consider and Verify DTI or Residual Income

We commend the CFPB for establishing a requirement in the QM rule that lenders consider and verify debts and income and consider DTI or residual income. Consider and verify, however, needs more specificity as to what it means in order to ensure that the lenders engage in the meaningful ability to repay consideration for safe harbor loans that is required. Please see Appendix 1 for a description of "consider and verify" provisions that should be included in any modified QM rule, whether by regulation or in the official interpretation.

Additionally, we believe that CFPB should grant a definitional safe harbor to lenders for using a methodology of defining debts and income provided by a GSE or government program. However, if CFPB removes references to the GSEs from this safe harbor, it should remove the safe harbor altogether.

V. CFPB Should Provide Further Data Analysis to Justify Higher Thresholds for Small Balance Loans

We believe that CFPB should do more data analysis before finalizing any unique rate spread rules for small loans, the rates for which appear high in the proposed rule. The data included does not indicate the volume of loans in each rate-spread segment, which is important in interpreting the listed delinquency rates. In addition, the data conflates chattel mortgages and real estate-secured mortgages, including manufactured housing and site-built dwellings. Given the prevalence of chattel loans in the small loan category, we believe that CFPB should analyze the two segments separately.

VI. CFPB Should Not Adopt its Seasoning Proposal

As stated in our response to the ANPR, CRL is opposed to the use of seasoning to turn non-QM loans into QM safe harbor loans.[48] In its seasoning proposed rule, CFPB would permit fixed-rate loans that meet the QM product requirements and are priced above the safe harbor threshold to become safe harbor QM loans if they perform for 36 months with only two 30-day delinquencies, no 60-day delinquencies, and they are held in the lender's portfolio. CFPB stated that it wants to encourage non-QM and rebuttable presumption loans to be made, as well as to promote innovation in underwriting.

Loans with the possibility of claims – non-QM or rebuttable presumption loans – are subject to claims of recoupment in response to a foreclosure at any time during the life of a loan, not limited to three years.[49] Congress intended that these claims should not be cut off with any hard time limit and, therefore, seasoning should not determine QM status. As appropriately stated in the Official Commentary, the longer the period that a rebuttable presumption loan remains current, the less likely the borrower would be able to rebut the lender's presumption of compliance with the ability to repay requirement.[50] However, rebuttable presumption and particularly non-QM ability to repay determinations should remain case-by-case because, with a particular loan, there could be reasons why it defaulted very quickly that do not indicate that the borrower lacked an ability to repay, or reasons why it remained current for a long period that do not indicate that the borrower could reasonably afford it. Examples of the former are a divorce or health emergency that occurs shortly after origination, while an example of the latter is taking

[48] Center for Responsible Lending, Comment Letter to the Consumer Financial Protection Bureau, Advance Notice of Proposed Rulemaking, Qualified Mortgage Definition (September 16, 2019), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-et-al-anpr-comment-sep2019.pdf.
[49] 15 U.S.C. § 1640(k).
[50] *See* Comment 43(e)(1)(ii)-1, available at https://www.federalregister.gov/documents/2013/01/30/2013-00736/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z.

out credit card debt and forgoing medicine and food to keep mortgage payments current for a longer period of time. Although a borrower is unlikely to win or even bring a case where they have paid regularly for three years, it is important for borrowers to have potential recourse as a check on lenders' underwriting of higher-priced mortgages.

However, if CFPB decides to move forward with the seasoning proposal, it is critical that the Bureau maintains the protections it imposed in the proposed rule. First, we concur with the proposal that a seasoning requirement should never be used to convert loans that are non-QM because they lack the QM product protections or are adjustable-rate mortgages into QM loans. Non-QM loans can be interest-only or negatively amortizing. Such loans will have teaser payments for the first few years, with payment shock due to higher future payments built into the structure of the loan when it begins amortizing over a shorter time period. As a result, non-QM loans could easily pass a seasoning test during the teaser payment stage but still have been fundamentally unaffordable for the borrower at the time the loan is consummated. It was just such payment shock that the QM product protections were designed to prevent. Similarly, the fact that a borrower can repay their ARM during an initial teaser rate or low initial economic interest rate period does not mean that they have the ability to repay the loan when their interest rates rise.

In addition, CFPB should maintain its requirement that the seasoning rule only applies to loans that are held on a lender's portfolio for at least three years.

Congress and CFPB have twice provided special flexibilities for creditors to obtain QM and safe harbor status, but both times these flexibilities were only provided if lenders held these loans in portfolio, and were not provided if they are sold. Congress and the Bureau acted in this way because there is a unique alignment of interests between the lender and borrower for loans held in portfolio that is absent when lenders sell loans upon origination. Because lenders holding loans on portfolio bear the risk if the loan defaults, such lenders have an interest in ensuring long-term affordability for the borrower.

First, in the Dodd-Frank Act, Congress permitted small creditors operating primarily in rural or underserved areas to provide balloon loans as qualified mortgages and not to have to maintain escrows.[51] Using its exemption authority, CFPB expanded these exceptions to permit all loans by these lenders, under $2 billion in assets, that meet QM product requirements and are held in portfolio for at least three years to receive the safe harbor (with a 3.5% rather than a 1.5% limit).[52] As CFPB noted in the preamble to the final rule, small portfolio creditors generally engage in "relationship banking" and have strong incentives to work with their customers:

> Where consumers have trouble paying their mortgage obligations, small portfolio creditors have stronger incentives to work with the consumers to get them back on

[51] 15 U.S.C. § 1639c(b)(2)(E); 15 U.S.C. § 1639d.
[52] 12 C.F.R. § 1026.43(e)(5).

> track, to protect both the creditors' balance sheets and their reputations in their local communities. Market-wide data demonstrate that mortgage delinquency and charge-off rates are significantly lower at smaller banks than at larger banks.[53]

The second time Congress provided QM flexibilities to creditors for certain loans, it gave safe harbor status to larger creditors, those under $10 billion in assets, who make loans that comply with the QM product restrictions in the Economic Growth, Regulatory Relief and Consumer Protection Act (EGRRCPA). However, again, this safe harbor was only available if the lenders held the loans in portfolio – and in this case, for the entire life of the loan.[54]

The seasoning proposal would essentially extend CFPB's small creditor three-year portfolio exception to lenders of any size, including the largest bank in the United States, which is over $2.5 trillion in assets – *1,250 times the size that CFPB permitted for the small creditor portfolio exception and 250 times what Congress allowed in EGRRCPA*. If CFPB goes well beyond its and Congress' permissible creditor sizes, it should not go beyond their central policy judgment that flexible provision of a safe harbor should only be provided for lenders holding loans in portfolio, rather than lenders engaging in an originate-to-distribute model.

Further, CFPB should not reduce the three-year seasoning requirement or relax the delinquency standards. The three-year period is consistent with a three-year statute of limitations for borrowers to bring affirmative ATR claims. This period and the delinquency standard, as CFPB noted, is consistent with the GSEs' Representation and Warranty policies against lender put-backs.

Lastly, if seasoning is adopted we would suggest that the rule only permit a loan to go down one level, *i.e.*, from non-QM to rebuttable presumption, or from rebuttable presumption to safe harbor, rather than being able to skip two levels, from non-QM to safe harbor. This would provide borrowers with some recourse for loans originated as non-QM loans, while still providing lenders with a stronger litigation defense for good loan performance through the rebuttable presumption.

Conclusion

We agree with CFPB's approach to eliminate a specific DTI threshold and instead implement a price-based test. However, to ensure an inclusive and sustainable definition of QM that better serves lower-wealth borrowers and communities of color, we urge CFPB to adopt our recommended borrower protections. The Bureau should protect against pricing discrimination by ensuring that lenders engaged in it cannot take advantage of the safe harbor. CFPB should set the safe harbor threshold at 2% over APOR and the overall QM price cap at 3% over APOR. CFPB should also ensure that borrowers are protected from excessive payment shock in short-reset ARMs and clarify the requirement that lenders consider and verify debts and income and

[53] 78 Fed. Reg. 4726, 4735 (January 22, 2013); *see also* 85 Fed. Reg. 59943, 59953 (October 2, 2015).
[54] Pub. L. 115-174, Title I, § 101 (May 24, 2018).

consider DTI or residual income. CFPB should engage in further data analysis for small loans. Finally, CFPB should refrain from adopting a seasoning approach to turn non-QM or rebuttable presumption loans into safe harbor loans. If CFPB adopts the seasoning approach, it should ensure that none of the important safeguards it included in the proposed rule are weakened.

Appendix 1

Needed Fair Lending and Consider and Verify Requirements for QM

September 8, 2020

Fair Lending Proposal:

- **No presumption or inferences relating to fair lending**: The CFPB has a separate, yet equally important, responsibility to ensure that the pricing consumers receive for mortgages does not discriminate against applicants on the basis of characteristics protected by law. By statute, one of the functions of the Office of Fair Lending and Equal Opportunity is to coordinate the fair lending efforts of the Bureau with other Federal agencies and State regulators "to promote consistent, efficient, and effective enforcement of Federal fair lending laws." Accordingly, the CFPB should make clear that the QM safe harbor established by this regulation should not be construed to create an inference or presumption that a loan satisfying the identified criteria is compliant with the Equal Credit Opportunity Act, the Fair Housing Act, or state or local anti-discrimination laws that pertain to lending. A QM safe harbor loan may still violate the requirements of the Equal Credit Opportunity Act, the Fair Housing Act or state and local anti-discrimination laws, as well as other federal and state laws regulating mortgage lending.

- **Diminishing negative impacts on a borrower's Ability to Repay**: The CFPB has an obligation to mitigate actions, like pricing discrimination, that can negatively impact a borrower's ability to repay their debt obligation. The CFPB should therefore limit the ability of a financial institution to receive the QM safe harbor in instances where pricing discrimination has occurred, as set forth below.

  If a financial institution, or creditor as defined by the Equal Credit Opportunity Act (ECOA), originates a loan that meets the Safe Harbor thresholds outlined in the regulation and discovers a likely violation of the ECOA resulting from pricing discrimination related to the loan, the financial institution shall self-report the likely violation to the CFPB and its prudential regulator within 30 days of the discovery of the likely violation. The financial institution shall have 30 days, from the date of discovery, to remediate the harm resulting from the likely violation.

  Should a financial institution fail to self-report a likely violation and remediate the harm resulting from a likely violation within 30 days of the date of discovery of the likely violation, and a judicial, administrative, or regulatory body, through a final adjudication, determines that pricing discrimination in violation of ECOA has occurred, the Safe Harbor will not apply to the loan(s) related to that violation. Loans related to that

violation may still qualify as QM loans, but they are not afforded a conclusive presumption of compliance.

Consider and Verify:

- **Early defaults**: Creditors should be required to track early defaults and maintain records showing this tracking and any responses to increases in early defaults to ensure link between pricing and ATR.
- **Reasonable and good faith determination**: CFPB should affirm that creditors making QM loans must nonetheless comply with the underlying statutory requirement to make a reasonable and good faith determination of ATR.
    - Consistent with CFPB's request for examples of what "not meaningfully consider" means, outer bounds of what could be consider and verify documentation inconsistent with a reasonable and good faith interpretation of ATR:
        - 100% DTI loans, including 100% at maximum loan payment on current income, and including full DTI for all known debts, including simultaneous loans;
        - Zero or negative residual income (after-tax monthly income less debt payments), after accounting for all known debt obligations, including simultaneous loans;
        - Documentation that is falsified or subject of fraud by or with the knowledge and consent of the lender, broker, or their agents;
        - Statements by borrower that they cannot pay projected payments or can only pay the minimum ARM payment, as reflected in the underwriting file;
        - Promises by lender, broker, or their agents that the lender will refinance the loan upon any stated future event (e.g., ARM reset, financial difficulty experienced by borrower, borrower's retirement), as reflected in the underwriting file;
        - If ARMs are not excluded from QM, CFPB should state that consider and verify, like ATR, has to be based on the maximum payment in the first five years;
        - Escrow requirements must, per the statute, reflect all applicable taxes, insurance, and assessments, including any known post-closing upward adjustments reflecting a new assessment/ loss of exemptions, etc.; and
        - Statements by borrower or other documented evidence that the borrower expects a reduction of income soon unless the underwriting is done in accordance with borrower's projected income drop, as reflected in the underwriting file.

- **Record retention**: At a minimum, the creditor's record retention of how it considered and verified income or assets and DTI or residual income must meet the following standards:
    - As CFPB says, the creditor must verify anything it considers;
    - There must be detailed enough record retention that an examiner could review the underwriting to confirm that it was done in accordance with the creditor's procedures, based on verified information, and that DTI or residual income were considered;
    - The considerations for pricing and an explanation for the pricing must be maintained, including any role played by LTV or equity in the home. Examiners should be able to determine and verify from reviewing the retained documentation the basis of the pricing decision, any applicable weight given to various factors in the consideration (including minimally which factors played a role in determining pricing), and, if present, any mathematical relationships. For example, a printout from the underwriting system saying the loan is approved by itself should be inadequate to demonstrate pricing considerations, if the printout only indicates that the loan was approved and not how it was priced.
    - On any individual loan, to the extent discretionary pricing was permitted and occurred, including any deviations from rate sheets, both any rate sheets used and explanations for deviations from those rate sheets or other discretionary pricing must be retained.
    - To combat the risk of discriminatory pricing, any fair lending analysis conducted on pricing or loans originated must be retained and available for supervisory examinations on QM compliance.
    - In order to maintain the safe harbor against a borrower raising the ATR as a defense to foreclosure, documentation must be retained. If the documentation is not maintained, the creditor or assignee loses the presumption that a good faith determination of ATR was conducted.
- **No asset-based lending**: CFPB should affirm prior interagency guidance that lending on LTV/asset value alone is per se predatory and cannot satisfy the requirements of consider and verify.

Appendix 2

QM Methods Summary

Data: We analyze Fannie Mae Single-Family Loan Performance data.[55] These data consist entirely of conventional fixed-rate loans and exclude loans with non-traditional or risky features that would be considered non-QM under the current QM rule. Following the CFPB (2020), we restrict our analytic sample to purchase loans. We analyze loans originated during two time periods: the first spans all of the origination years for which the Fannie Mae data are available (1999-2019), while the second spans the origination years of 2013-2018 and is meant to highlight the performance of recently originated loans.

Delinquency: Following CFPB, we define delinquency as ever 60 days delinquent within the first two years of the loan.

Rate Spread: We calculate the rate spread as follows:

Rate Spread = interest rate + PMI - PMMS rate in percentage points

This approach is similar to that used by CFPB, except that we use a recent rate sheet to approximate risk-based Private Mortgage Insurance (PMI) premiums.[56] Specifically, we approximate annual risk-based PMI premiums using an insurer rate sheet for 2018/2019, which permits the PMI premium to vary with the loan LTV, borrower credit score, percentage of mortgage insurance coverage, loan term, and property type. Following Stein and Calhoun, we then multiply the annual premium by 0.73 to approximate the contribution of the PMI premium to APR.[57] We use these relatively current PMI premiums rather than historical premiums in an effort to assess the likely relationship between similar loans and delinquency rates under current loan pricing practices.

Estimated interest rates for the market come from Freddie Mac's Primary Mortgage Market Survey (PMMS). We apply the 30-year fixed-rate mortgage interest rate for loans with terms

[55] Fannie Mae Single-Family Loan Performance Data, available at https://www.fanniemae.com/portal/funding-the-market/data/loan-performance-data.html.

[56] Genworth Rate Sheet, available at https://new-content.mortgageinsurance.genworth.com/documents/rate-cards/national/monthly_premium_mi/MonthlyBPMIFixedRateCard.06042018.pdf. Note that Kaul, Goodman, and Zhu, Comment Letter to the Consumer Financial Protection Bureau on the Qualified Mortgage Rule, Urban Institute (2019) also use a rate sheet to approximate risk-based PMI premiums in their measure of the rate spread. That methodology differs from the authors' most recent QM commentary (Karan Kaul, Laurie Goodman, and Jun Zhu, *CFPB's Proposed QM Rule Will Responsibly Ease Credit Availability: Data Show That It Can Go Further*, Urban Institute (2020)), in which they adopt methodology more similar to that used by CFPB.

[57] Eric Stein and Michael Calhoun, *A Smarter Qualified Mortgage Can Benefit Borrowers, Taxpayers, and the Economy*, Center for Responsible Lending, at p. 25, n. 53 (July 2019), available at https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-a-smarter-qualified-mortgage-july2019.pdf.

greater than 15 years, and the 15-year fixed-rate mortgage interest rate for loans with terms of 15 years or less.