Comments to the

Consumer Financial Protection Bureau

Docket No. CFPB-2012-0022
RIN 3170-AA17

Request for Comment on Qualified Mortgage

by

Center for Responsible Lending
Consumer Federation of America
The Leadership Conference on Civil and Human Rights

July 9, 2012

The Center for Responsible Lending (CRL) is a not-for-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, one of the nation's largest nonprofit community development financial institutions.

Consumer Federation of America (CFA) is a non-profit association of some 300 national, state and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

The Leadership Conference on Civil and Human Rights is the nation's oldest and most diverse coalition of more than 200 civil and human rights organizations, representing persons of color, women, children, organized labor, persons with disabilities, the elderly, gays and lesbians, and major religious groups.

I. Introduction

The Center for Responsible Lending, Consumer Federation of America, and The Leadership Conference on Civil and Human Rights welcome this opportunity to comment on the rulemaking now underway at the Consumer Financial Protection Bureau (Bureau) to implement a new ability-to-repay (ATR) requirement for most residential mortgage loans and to define a qualified mortgage (QM), as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

Congress established the ATR standard in Title XIV to correct widely documented failures by mortgage lenders to underwrite mortgages properly. These failures were not the result of inexperience or ignorance, but of a pervasive and persistent erosion of historical underwriting standards in pursuit of business volumes and market share, combined with a failure by regulators to set and enforce reasonable and effective limits to lenders' behavior. It was this failure to respect and use well-understood, time-tested underwriting practices that prompted Congress to act.

The QM concept was included in Title XIV to establish a default standard of mortgage products, features and costs inside the concept of ATR so that vulnerable borrowers would receive the same safe and affordable loans that more affluent families do, a dominant motive for passing Title XIV as a whole. A QM definition that sets a tight standard for DTI or other borrower characteristics would exclude exactly those families that QM was designed to protect, recreating the dual market in place during the subprime boom. These families are more likely to be lower-income, people of color, or living in lower-income communities or communities of color. Congress did not intend for those families hurt the most by the housing crisis to then be kept out of the QM market. That's why eight changes during the legislative process made the QM definition broader, and none narrower.

QM was designed to provide a clear and predictable path through which lenders could reduce their exposure to challenges by investors and borrowers by offering a set of products and features that minimized consumer costs and maximized suitability and sustainability. By providing lenders with a limited form of protection from liability under the broad ATR requirement in return for offering products with such features, Congress meant to steer the vast majority of loans into this space. QM protections are substantial for borrowers: 1) Loans must be fully amortizing – no interest only or negative amortization loans; 2) no balloons; 3) maximum 3 percent fees rather than 5 percent; 4) no teaser ARMs – underwritten at maximum rate for five years; and 5) pricing will be cheaper because of reduced litigation and put-back. Thus, we believe that the definition of QM should apply as broadly as possible to the overall mortgage market so that the sustainable products it defines are offered to the largest number of borrowers.

Loans that do not meet QM standards can and should be available. But lenders should have a much higher degree of accountability when offering them, which will encourage them to carefully assess a borrower's ability to succeed with riskier features and terms. Even with the ATR requirement applying, lending abuses will

likely re-emerge in the non-QM market. The impact of state anti-predatory lending statutes shows that it is difficult to protect a significant numbers of borrowers through general standards – such as an ability to repay requirement – that are enforced through individual borrower actions. (State laws that use specific, measurable standards, however, such as those defining QM protections, have proven effective.) As a result, non-QM loans should be limited to niche products, with lenders taking full responsibility for the underwriting of these loans.

We are concerned that in the wake of the mortgage crisis consumers already are faced with the most restrictive lending environment in decades. The "credit box" that defines eligibility for secondary market access through Fannie Mae and Freddie Mac (GSEs) is very tight. There is no functioning mortgage investment market outside of the FHA/Ginnie Mae or GSE execution. We fully expect that lenders going forward will be unwilling to accept greater liability for mortgage lending and therefore will restrict their activity to what is defined under QM, and we believe that investors will reinforce this behavior by requiring that loans they purchase or guarantee meet the QM standard. To the extent that lenders originate and purchasers buy non-QM loans, we would expect the pricing to be significantly higher. These circumstances dictate that QM be structured in a way that does not further restrict credit than is already the case, that it encompass the entire current constrained market with room for additional lending beyond today's levels, and that it provide a means through which lenders can efficiently apply the standard in a scalable way.

We believe the Bureau should incorporate several key features into the QM definition in order to meet these objectives. One is to apply a "bright-line" standard on which lenders can rely to determine when a loan qualifies under QM. The second is to make this bright-line standard broad and to recognize that no single test can adequately account for the different circumstances borrowers experience or adequately predict their success as a homeowner. Decades of underwriting have confirmed that a failure to meet any one underwriting test can be effectively overcome by considering whether the borrower's financial situation includes compensating factors that strengthen the likelihood of a successful loan.

We have altered our views on this since submitting joint and individual comments on the original rule proposed by the Federal Reserve last year. In those comments on the proposed rulemaking we supported the Fed's approach to rely on generally accepted underwriting standards to determine eligibility for QM, which lenders would apply and for which they would be responsible. However, we have come to believe that the consumers we most care about – low-wealth, low- income and minority consumers – will be at greater risk of being excluded from the QM market unless creditors can apply a bright line standard which is easily measured, understood, and can be applied at scale across underwriting platforms and organizations. The use of a bright line standard should reduce uncertainty about what loans qualify for QM treatment, and facilitate clearer and less contentious determinations of compliance with the QM and ATR requirements, especially in cases where investors would try to put back failed loans to originating creditors.

The definition of QM is not meant to be a substitute for complete and thorough loan underwriting, nor is it meant to substitute regulatory benchmarks for lenders' obligation to act as a responsible creditor. The QM definition's purpose is to define the characteristics of a loan that will qualify it for the limited protection from liability that otherwise applies under Title XIV.

The ATR requirement addresses only one aspect of effective underwriting, the consumer's actual *ability* to repay the loan on the terms offered at origination. Creditors retain the obligation to underwrite the borrower's *propensity, or likelihood* of repaying based on a reasonable assessment of the consumer's credit history. They also must examine and be confident in the adequacy of the collateral to serve as security for the loan. Moreover, the statute and proposed rule provide standards for product types, verifications and documentation that are meant to ensure that lender assessments are made with the fullest possible knowledge of a borrower's circumstances, and that the products offered are as straightforward as possible.

The Bureau must balance the objectives of encouraging inclusion and access to mortgage credit and congressional intent to have QM represent the most sustainable loans in the market. In a joint comment submitted by the Center for Responsible Lending, The Clearing House Association, Consumer Federation of America, and The Leadership Conference on Civil and Human Rights, we recommended that the Bureau adopt a series of successive tests—which we refer to as a "waterfall"—to define when a loan is entitled to the protection of QM. [1] (The joint comment, including a listing of the members of The Clearing House Association, is attached as an Appendix.) This series of successive tests was designed to provide a scalable, predictable test for inclusion in QM while also enabling lenders to apply more than one standard to do so. The proposed "waterfall" in our joint comment started with a proposed bright line of a maximum total debt-to-income ratio of 43 percent.

But because many lower-income and low-wealth families – and others – carry relatively high DTIs *and* have shown successful ability to repay reasonable and non-abusive mortgage debt, DTI should not be the sole way to qualify for a QM loan. The GSEs purchase loans that meet their credit and collateral tests that go up to 50 percent DTI with compensating factors.[2] FHA will go even higher with such factors. There is no social benefit to excluding these loans from QM status, and the current, widespread use of compensating factors speaks to their effectiveness. As the analysis below describes, we believe that defining QM using a "waterfall" approach provides both a reasonable test of a borrower's overall ability to repay, and excludes the smallest reasonable number of borrowers. The waterfall also would permit the

[1] "Ability-to-Repay ("ATR") Analysis and Qualified-Mortgage ("QM") Determination", Joint Recommendations of the Center for Responsible Lending, The Clearing House Association, Consumer Federation of America, The Leadership Conference on Civil and Human Rights, March 7, 2012.
[2] Fannie Mae will purchase non-HARP loans underwritten by Desktop Underwriter with compensating factors if DTI is less than or equal to 50 percent.
https://www.efanniemae.com/sf/guides/duguides/pdf/current/rndodu83.pdf.

application of additional compensating factors, such as a history of regular repayment of similar housing costs, low mortgage costs, liquid reserves, and a residual income test. As the data described below document, these compensating factors are valid and reliable means to judge a consumer's likely ability to repay. They are consistent with long-standing industry practice and well established underwriting procedures and standards.

It is not possible to test empirically precisely where to draw the lines defining each of these waterfall elements. Assessing mortgage lending performance is too complicated an endeavor given the number of factors at play, and data are too limited to do so. But the Bureau should not let the perfect be the enemy of the good. As we show below, each of these waterfall elements defined in a reasonable manner to supplement DTI do a better job assessing ability to repay than relying on DTI alone. It is more important therefore to include each with a reasonable definition than to wait to obtain the perfect level of detail to get the criteria precisely right in the future, because that perfection will never occur. Once the elements are part of the QM rule, the Bureau would have the ability to track performance and tweak rules as needed.

In this Comment, we present evidence from several different sources to help inform the Bureau's rulemaking on QM, including data from a nationally-representative, merged dataset of loans originated between 2000 and 2008, as well as data from more targeted lending programs (the United States Department of Veterans Affairs (VA), the Community Advantage Program (CAP), and State Employees' Credit Union in North Carolina (SECU)). These data point to three important conclusions:

1) **The lower the DTI threshold is set, the more a rule would unnecessarily exclude a large percentage of borrowers from the QM market.** At a DTI threshold of 42 percent, for example, approximately one-quarter of borrowers between 2000 and 2003 would not have qualified for QM. In addition, DTIs in Pacific, Mountain and New England states are significantly higher than elsewhere in the country, so a QM definition based on a relatively low DTI will disproportionately harm borrowers in these states. Further, a lower DTI will also disproportionately exclude low- and moderate-income borrowers as well as communities of color.

2) **DTI is only one element of prudent underwriting, and lenders historically have used other compensating factors and underwriting criteria in qualifying a borrower.** The effect of excluding higher DTI borrowers from QM on reducing the ever 60+ delinquency rate is not very large. While there is a monotonic, increasing relationship between DTI and delinquency, the strongest trend is observed by looking at loan vintages rather than at DTI tranches. During the subprime boom, the deterioration of underwriting coupled with an explosion of loans with risky product features led to the high rates of delinquencies observed after 2003. If lenders follow traditional underwriting standards, the importance of DTI in predicting delinquency is reduced; the greatest impact in reducing delinquency is by eliminating the prohibited product features from QM. Setting a baseline DTI,

without giving lenders the flexibility to go above it by considering other compensating factors that logically bear on the borrower's ability to repay, would unnecessarily exclude creditworthy borrowers from the QM market and its product protections.

3) Available data from the VA and other lending programs show that **compensating factors, such as residual income, liquid cash reserves, past payment history, or low housing payments, are effective at identifying borrowers who have the ability to repay, even at higher DTI ratios** (e.g., between 43 and 50 percent). While data on these factors do not exist for the market as a whole, these measures have been commonly used to analyze a consumer's ability to repay for decades. Moreover, the available evidence supports our recommendation that the Bureau establish an explicit QM cut-off based on a borrower's total debt-to-income (DTI) ratio while at the same time allowing these alternative paths to a QM designation.

In addition, we discuss litigation and put-back risk, concluding that recent experience weighs heavily toward a broad definition of QM.

II. Data Analysis and Evidence

1) Setting a narrow DTI would unnecessarily exclude a large share of borrowers from QM protections.

Historical data on the distribution of loans by reported DTI can be used to approximate the percent of borrowers who would likely qualify for QM mortgages under different DTI thresholds.[3] Although there will undoubtedly be some adjustments at the margin, if the DTI cut-off is relatively low, significant numbers of borrowers will end up with non-QM loans, exposing them to higher costs, reduced access, and fewer built-in protections in the form of product restrictions and limitation on points and fees. However, if the DTI threshold is relatively high, the majority of mortgage lending will likely gravitate towards QM mortgages, with non-QM lending restricted to niche products designed for a limited clientele—for example, wealthy borrowers who might prefer interest-only mortgages as a cash flow strategy.

Based on the FHFA data provided by the Bureau, **Exhibit 1** shows the percent of GSE purchases between 1997 and 2009 that would be excluded from the QM market at different DTI thresholds, excluding product types that are ineligible for a QM designation. These data show that establishing a DTI ratio of below 36 percent would have excluded between one-third and one-half of borrowers from QM protections. At

[3] In general, reported DTIs will tend to overestimate the borrower's actual DTI since the borrower may choose not to report sources of income that are not required to qualify for the loan (e.g., child support). However, particularly during the subprime crisis, borrower incomes may have been over-inflated to qualify for the loan. It is unclear how these two countervailing trends bias data on DTI ratios.

a DTI threshold of 42 percent, approximately one-quarter of borrowers between 2000 and 2003 would not have qualified for QM.

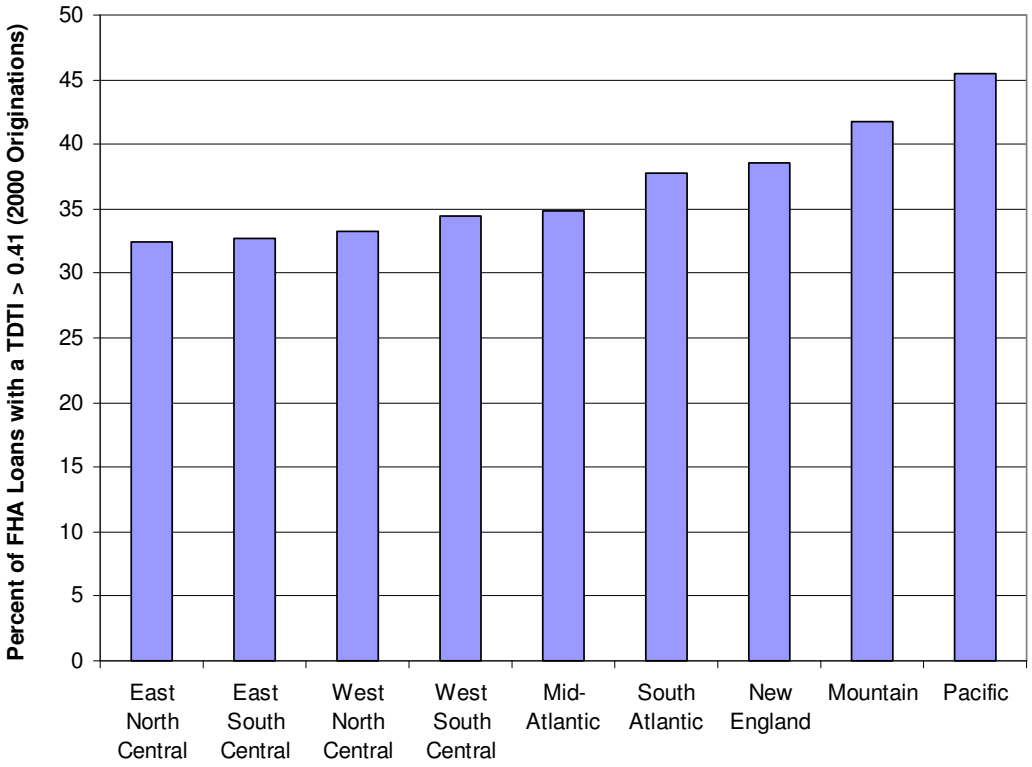
Exhibit 1: Percent of GSE Purchases that would be Excluded from QM by Borrower DTI

	DTI < 32	DTI < 34	DTI < 36	DTI < 38	DTI < 40	DTI < 42	DTI < 44	DTI < 46
1997	51.1	42.7	34.0	25.3	17.6	11.9	8.0	5.5
1998	45.2	38.0	30.9	24.1	18.1	13.4	9.9	7.4
1999	52.0	45.3	38.4	31.9	25.8	20.6	16.3	12.9
2000	61.4	54.8	48.0	41.2	34.6	28.5	23.1	18.4
2001	53.5	47.2	41.0	35.0	29.3	24.2	19.7	15.8
2002	51.6	45.7	39.9	34.4	29.2	24.4	20.2	16.5
2003	49.9	44.3	38.9	33.7	28.7	24.2	20.2	16.6
2004	60.2	54.5	48.7	43.0	37.3	31.9	26.9	22.4
2005	66.2	60.3	54.1	47.8	41.5	35.5	29.9	24.7
2006	70.6	65.0	59.0	52.7	46.3	39.9	33.7	28.0
2007	72.3	67.0	61.4	55.4	49.2	42.9	36.8	31.0
2008	66.1	60.5	54.8	49.1	43.3	37.6	31.9	26.6
2009	50.8	45.0	39.4	34.0	28.8	23.9	19.4	15.4

Source: FHFA data provided by the Bureau, Docket No. CFPB-2012-0022. Excludes loans with prohibited product features.

These data also mask the wide variations in borrower DTIs across the country; setting too narrow a threshold would disproportionately affect borrowers in high-cost markets. For example, Federal Reserve analysis of FHA data suggests that the impact of a narrow DTI will be felt most strongly by borrowers in Pacific, Mountain and New England states, leading to significant geographic variation in the cost of credit and the accessibility of QM mortgages. **Exhibit 2** shows the percent of FHA borrowers with a DTI ratio of above 41 percent, by region. In 2000, even before the housing boom, more than 45 percent of FHA borrowers in Pacific States – such as California and Washington – had DTIs of above 41 percent, compared to less than 35 percent of borrowers in Central (East, North and South) states such as Alabama, Michigan, and Ohio. The variation across regions is quite striking, and should caution the Bureau against setting narrow QM thresholds, which would limit protections for borrowers in coastal states.

Exhibit 2: Percent of FHA Loans with a DTI > 41 Percent, by Region (2000 Originations)



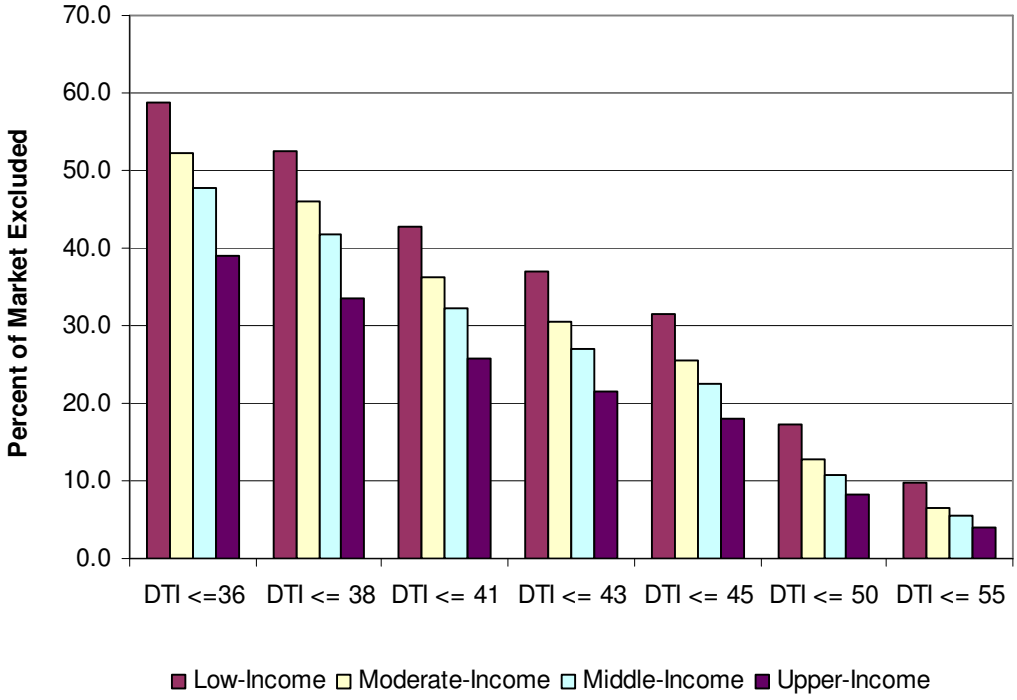
Source: Harriet Newburger (2011). "FHA Lending: Recent Trends and Their Implications for the Future," Federal Reserve Bank of Philadelphia Discussion Paper. Available online at http://www.philadelphiafed.org/community-development/publications/discussion-papers/discussion-paper_fha-lending-trends-and-implications.pdf.

In addition, CRL analysis of a unique dataset[4] that merges data from Lender Processing Services Analytics, Inc. and BlackBox with data from the Home Mortgage Disclosure Act (HMDA) shows that a narrow QM would have a disproportionate

[4] Exhibits 3, 4, 5, 7, 15 and 16 in this comment rely on a CRL-created dataset that merges together loan level information from two national, proprietary sources: Lender Processing Services (LPS) and BlackBox. LPS is collected from loan servicers, while BlackBox is collected from investor pools and is exclusively comprised of loans that are in private-label securities. The advantage of using loan level data from both LPS and BlackBox is that it allows us to analyze a broader segment of the mortgage market than using either one by itself. We limit our analysis to first lien, owner-occupied, single-family mortgage loans originated between 2000 and 2008. We further limit the sample to loans with populated data for all our key fields, and restrict the data to loans with an original value of more than $3,600 and less than $3 million dollars, as well as those with a DTI ratio of at least five percent and less than 98 percent. This results in a sample of approximately 18.2 million loans. In addition, for loans originated between 2004 and 2008, we merged the LPS/BlackBox data with data from the Home Mortgage Disclosure Act (HMDA) using a probabilistic matching technique. This allows us to provide data on borrower income and race/ethnicity. Loans originated prior to 2004 are not matched due to limitations in the number of overlapping fields used for matching. For more details on the matching algorithm, see Appendix A in Bocian, D., et al., Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures. The Center for Responsible Lending, Durham, NC, 2011.

impact on low- and moderate-income families[5] and communities of color.[6] Exhibits 3 and 4 present the percent of loans originated in 2004 and 2005 that would be excluded at each DTI threshold, stratified by borrower income and borrower race/ethnicity. More than 37 percent of low-income and 30 percent of moderate-income borrowers had DTIs above 43 percent, compared to 27 percent of middle-income and 20 percent of upper-income borrowers. A narrow DTI threshold would also disproportionately affect Latino and African-American borrowers.[7]

Exhibit 3: Percent of LPS/BlackBox Sample that Would Be Excluded from QM by Borrower DTI and Borrower Income



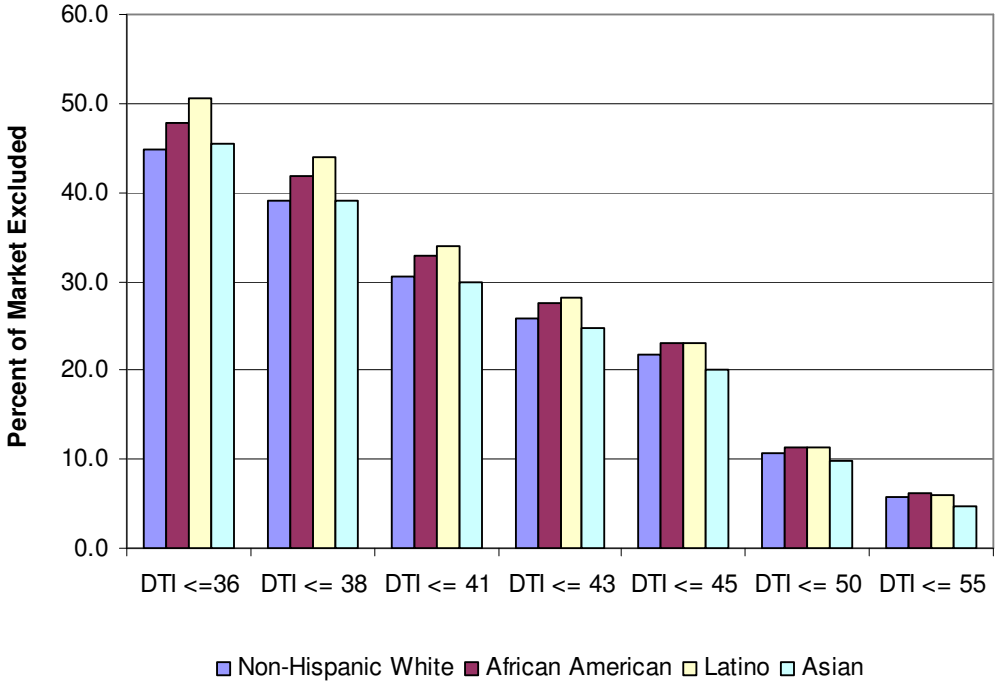
Source: CRL analysis of LPS/BlackBox sample, 2004 and 2005 originations. Performance measured through February 2011.

[5] Borrower income categories are classified as follows: "low-income" - less than 50 percent of the Metropolitan Statistical Area (MSA) median income; "moderate-income" - at least 50 percent and less than 80 percent of the MSA median income; "middle-income" - at least 80 percent and less than 120 percent of the MSA median income; and "higher-income" - at least 120 percent of MSA median income. The mean incomes for each of the categories are $26,000 for low-income, $41,000 for moderate-income, $61,000 for middle-income, and $108,000 for higher-income.

[6] Borrower race and ethnicity are derived from the HMDA data and refer to the race/ethnicity of the primary applicant. African-American borrowers are those who are classified as "Black or African American", and can be of any ethnicity. Asian borrowers are those who are classified as "Asian", and can be of any ethnicity. Latinos are those who are classified as "Hispanic or Latino" as their ethnicity and who indicate "White" as their race.

[7] For more analysis of how different DTI thresholds would affect segments of the market, see Roberto Quercia, Lei Ding, and Carolina Reid (2012). *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages.* University of North Carolina, Center for Community Capital Working Paper. Available online at http://www.ccc.unc.edu/abstracts/QRMunderwriting.php.

Exhibit 4: Percent of LPS/BlackBox Sample that would be Excluded from QM by Borrower DTI and Race/Ethnicity



Source: CRL analysis of LPS/BlackBox sample, 2004 and 2005 originations. Performance measured through February 2011.

2. DTI is only one part of responsible underwriting, and QM product restrictions matter.

Lenders have long relied on DTI, loan-to-value ratios, borrower credit profiles, and other compensating factors as part of their underwriting process. During the subprime crisis, however, these underwriting standards deteriorated at the same time as the market saw an explosion of loans with risky product features, including loans with teaser interest rates, limited or no income and assets documentation, and lack of amortization. The QM provisions contained within Dodd-Frank will offer important consumer protection to those families who qualify for QM by prohibiting the origination of loan terms with these risky features, greatly reducing delinquency rates even for borrowers with higher DTIs.

QM product restrictions alone make a significant difference in ensuring borrower ability to repay.

To demonstrate the importance of QM product protections, we analyzed a national sample of approximately 18 million prime, subprime and Alt-A loans originated between 2000 and 2008 (hereafter referred to as the LPS/BlackBox sample).[8]

[8] See footnote 4 for a description of these data.

Exhibit 5 shows a breakdown of 60+ delinquency rates by year, stratified by loans meeting QM product prohibitions versus those that do not—non-QM loans. As the table shows, the delinquency rate for loans with prohibited features is significantly higher than those that exclude the prohibited product features.[9] In the context of determining the definition of QM, it is important to note that even borrowers with DTIs between 43 and 45 percent who received a product without prohibited features during the boom years (2004 – 2007) had delinquency rates well below that for the borrowers below a 36 DTI who received a loan with risky features prohibited by QM. For example, in 2005, only 9.4 percent of borrowers with a DTI of between 43 and 45 percent who received a safe loan ever experienced a 60+ delinquency, compared to 17 percent of borrowers with a DTI of less than 36 percent who received a loan with these prohibited product features.

In addition, the relationship between DTI and ever 60+ delinquency is not nearly as pronounced as the relationship between prohibited features and delinquency. For instance, moving from a DTI of between 36 and 40 percent to one between 40 and 43 percent raises the delinquency rate by a couple of percentage points. In contrast, loans with prohibited features have a delinquency rate of more than **two times** that of loans without, especially between 2005 and 2007.

Prohibitions on risky loan features are a very important part of QM. Setting a narrow DTI threshold for QM would relegate a large share of the market, especially lower-income families and people of color, to a non-QM market that could include a greater share of loans with risky features, including high equity-stripping fees, negative amortization, balloons, and 2/28 adjustable interest rates. QM was meant to provide a strong incentive for lenders to avoid these products by providing the protection against liability for the ATR determination in the QM market and to re-establish loans with QM features as the market standard for most borrowers. Unnecessarily restricting the loans that would qualify for QM treatment would thwart this clear Congressional intent.

[9] Loans without prohibited features 1) have full documentation, 2) are not interest-only or negative amortizing loans, 3) do not include a balloon payment, 4) do not have adjustable interest rates with fixed terms under five years, 5) do not have a maturity of greater than 30 years, and 6) do not include a prepayment penalty. Dodd-Frank and the QM proposal do not prohibit prepayment penalties entirely, but do pose several significant restrictions on when prepayment penalties can be used. For simplicity, we assume that loans with prepayment penalties are not permitted. The QM proposal includes two other product term restrictions which we cannot identify in our data: 1) the total points and fees cannot exceed 3% of the total loan amount, and 2) the underwriting will take into account any mortgage-related obligations.

Exhibit 5: 60+ Delinquency Rate by DTI and Year of Origination, Stratified by Loans Excluding/Including QM Prohibited Features

	DTI <= 36			36 < DTI <= 40			40 < DTI <= 43		
	All Loans	No Prohibited Features	Prohibited Features	All Loans	No Prohibited Features	Prohibited Features	All Loans	No Prohibited Features	Prohibited Features
2000	11.8	12.2	11.2	13.5	12.3	16.2	14.4	13.1	17.4
2001	5.4	4.8	10.2	8.0	7	15.3	8.4	7.6	12.1
2002	3.5	3.2	5.1	5.4	4.9	8.1	5.7	5.4	6.6
2003	2.8	2.6	3.9	4.3	3.9	5.9	4.5	4.2	11.6
2004	6.1	4.7	8	8.1	6.4	10.4	8.9	7.1	25.5
2005	11.8	7.2	17	16.0	9.8	23.1	18.3	11.1	37.6
2006	16.6	10.2	23.8	24.3	13.5	35.1	27.3	15.9	35.5
2007	14.9	11.1	21.7	20.9	14.8	31.2	24.7	18.1	12.5
2008	6.3	6.1	7.2	10.2	9.9	11.6	11.5	11.3	12.5

	43 < DTI <= 45			45 < DTI <= 50			50 < DTI <= 55		
	All Loans	No Prohibited Features	Prohibited Features	All Loans	No Prohibited Features	Prohibited Features	All Loans	No Prohibited Features	Prohibited Features
2000	19.4	16.3	25.6	14.9	12	23.6	17.7	13.6	26.2
2001	9.7	8.3	18.3	8.2	7	20.6	9.0	6.6	25.4
2002	6.4	5.7	10.8	6.1	5.1	11.8	5.2	4.2	12.7
2003	5.0	4.4	7.9	4.8	4.2	7.6	3.6	3.2	6.9
2004	9.0	6.7	12.5	9.3	6.5	13.3	6.8	5.5	10.3
2005	17.9	9.4	28.6	20.0	10.2	30.7	16.3	10.9	24.3
2006	26.8	14.5	39.9	27.2	14.4	40.1	22.8	15.4	33.6
2007	22.3	15.8	34.9	23.6	18.1	32.3	25.3	20.4	35.2
2008	9.9	9.7	12.0	12.4	12.2	14.5	12.4	12.2	14.2

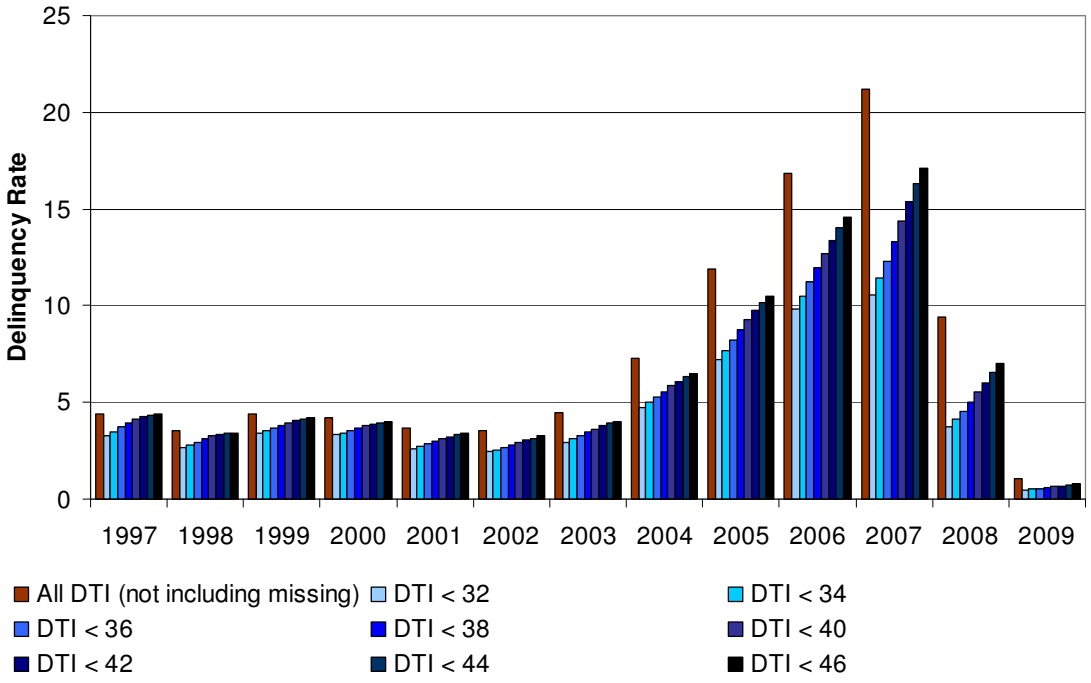
	DTI >= 55		
	All Loans	No Prohibited Features	Prohibited Features
2000	12.5	11.3	14.6
2001	8.2	7.3	14
2002	5.9	5	9.7
2003	5.2	4.4	8.8
2004	8.5	6.4	12.5
2005	11.8	9.1	15.3
2006	16.6	14.4	18.9
2007	19.8	18.3	24.2
2008	10.1	9.9	11.4

Source: CRL analysis of LPS/BlackBox sample, 2000 to 2008 originations. Performance measured through February 2011.

DTI, although important, is just one factor in assessing ability to repay.

The effect of excluding higher DTI borrowers from QM on the ever 60+ delinquency rate is not very large. **(Exhibit 6)** While there is a monotonic, increasing relationship between DTI and delinquency, the strongest trend is observed by looking at loan vintages rather than at DTI tranches. Despite the fact that between a third and a half of all loans were made with DTIs of above 36 percent in the years before the subprime crisis (1997-2003), delinquency rates for the market as a whole were below 4.5 percent. Moreover, the ever 60+ delinquency rate for GSE purchases of loans up to a DTI of 46 percent in 2000 was only 4.02 percent, well below the ever 60+ delinquency rate for loans with a DTI below 32 percent in 2006 (9.84 percent). In other words, during the subprime boom, all the DTI tranches performed at historic lows, making it a mistake to define QM based on the experience of those years. In addition, the most significant driver of high delinquency rates in the FHFA data are loans underwritten with a DTI of over 46. Our Joint Proposal, which suggests a baseline DTI threshold of 43 percent while allowing the lender the flexibility to go higher with compensating factors (see discussion below), balances the policy goal of establishing a safe, bright line for QM that is in line with historical performance data while not excluding a large share of borrowers from QM protections.

Exhibit 6: 60+ Delinquency Rate of GSE Purchases by Year and Borrower DTI



Source: FHFA data provided by the Bureau, Docket No. CFPB-2012-0022. Excludes loans with prohibited product features.

In addition, while DTI is an important underwriting measure that can be used to assess a borrower's ability to repay a loan, it is only one factor that influences loan performance. **Exhibit 7** presents the results of a proportional hazards, competing risks model that shows the relationship between DTI categories and the likelihood of a loan ever becoming 60 days delinquent (with full repayment serving as a competing risk[10]) for the LPS/BlackBox sample of loans originated in 2004 and 2005. The analysis demonstrates that DTI is a reasonable measure that can help lenders establish a borrower's ability to repay, but at the same time, it has only a small effect on delinquency, especially after we take into account the proliferation of loans with risky products originated during the subprime boom.

In Model 1, we include only variables on a borrower's DTI, with borrowers who had a DTI of between 36 and 40 percent serving as the referent (or comparison) category. Model 1 shows that there is an expected relationship between DTI and delinquency. Loans with a DTI of below 36 percent were **less likely** to ever become 60 days delinquent than loans with a DTI of between 36 and 40 percent, while loans with DTIs of between 40 and 50 percent were **more likely** to ever become 60 days delinquent than loans with a DTI of between 36 and 40 percent. Loans with DTIs over 50 percent actually perform slightly better than loans between 36 and 40 percent DTI, likely due to the fact that lenders are more likely to scrutinize loans with DTIs above 50 percent for compensating factors.

However, the models suggest that if lenders are following traditional underwriting standards, the importance of DTI in predicting delinquency is reduced. In Model 2, which includes other underwriting variables such as a borrower's FICO score, LTV, and loan amount, we find no statistical difference in the likelihood of delinquency among loans with a DTI of between 40 and 43 percent and those with a DTI between 36 and 40 percent; loans with a DTI of between 43 and 45 percent were only marginally more likely to become delinquent than loans with a DTI between 36 and 40 percent. This provides evidence that a baseline of 43 percent DTI is a reasonable standard, in that even during the height of the subprime lending boom, these loans performed comparably to loans with a DTI of between 36 and 40 percent.

Model 2 also shows the importance of the product prohibitions laid out by Dodd-Frank, in the form of a dummy variable indicating whether or not the loan met QM product prohibitions. Not surprisingly, this variable has an incredibly strong effect on loan performance. Receiving a loan that did not have any of the features prohibited by QM reduced the likelihood of delinquency by 60 percent, even after controlling for DTI, LTV, FICO, loan amount, and loan purpose. In addition, when we run the model separately for only those loans that meet QM product prohibitions (Model 3),

[10] In constructing our model, we follow a rich literature on mortgage default and estimate a proportional hazards model using a competing risks framework. The competing risks framework is used here due to its ability to account for "terminal" events that remove the loan from the risk of experiencing a separate event; in this case, we cannot observe a 60-day delinquency if the loan has already been prepaid. In the model, we are estimating whether or not a loan becomes 60-days delinquent, contingent upon it not already having been paid in full (e.g., through a refinance).

we find that there is no statistical difference between loans originated at DTIs of 40 to 45 compared with those originated with DTIs of between 36 and 40 percent.

Exhibit 7: Competing Risks Model Estimating the Likelihood of Ever 60+ Delinquency (2004 and 2005 Originations)

	All Loans								QM Loans Only			
	Model 1				Model 2				Model 3			
	Coeff.	SE		Hazard Ratio	Coeff.	SE		Hazard Ratio	Coeff.	SE		Hazard Ratio
Debt to Income (Omitted: 36 < DTI <= 40)												
DTI <= 36	-0.3843	0.0190	***	0.68	-0.430	0.022	***	0.65	-0.3788	0.0348	***	0.69
40 < DTI <= 43	0.1104	0.0257	***	1.12	0.046	0.029		1.05	0.0158	0.0461		1.02
43 < DTI <= 45	0.0767	0.0260	*	1.08	0.097	0.030	*	1.10	0.0621	0.0489		1.06
45 < DTI <= 50	0.2018	0.0251	***	1.22	0.154	0.030	***	1.17	0.0801	0.0490		1.08
50 < DTI <= 55	-0.1706	0.0332	***	0.84	0.084	0.038		1.09	0.1146	0.0567		1.12
DTI >= 55	-0.2093	0.0314	***	0.81	-0.319	0.040	***	0.73	-0.1241	0.0525		0.88
Borrower FICO (Omitted: FICO < 580)												
580 >= FICO < 620					-0.410	0.032	***	0.66	-0.4304	0.0552	***	0.65
620 >= FICO < 680					-0.918	0.028	***	0.40	-0.9851	0.0473	***	0.37
680 >= FICO < 720					-1.434	0.030	***	0.24	-1.5434	0.0498	***	0.21
FICO >= 720					-2.196	0.031	***	0.11	-2.3609	0.0511	***	0.09
LTV at Origination (Omitted LTV > 100)												
LTV= < 50					-1.415	0.050	***	0.24	-1.4365	0.0683	***	0.24
50 > LTV= < 80					-0.501	0.028	***	0.61	-0.6260	0.0409	***	0.54
80 > LTV =< 100					-0.051	0.027	*	0.95	-0.1627	0.0381	***	0.85
80% LTV Dummy					0.360	0.021	***	1.43	0.2831	0.0371	***	1.33
Origination Amount (Omitted $75,000 >= Loan Amt < $427,000)												
Loan Amt < $75,000					0.093	0.028	**	1.10	0.0939	0.0356	*	1.10
Loan Amt >= $427,000					0.137	0.029	***	1.15	0.0462	0.0674		1.05
Purchase					0.092	0.017	***	1.10	-0.0461	0.0278		0.96
Loan Meets QM Product Restrictions					-0.906	0.016	***	0.40				

Source: CRL analysis of LPS/BlackBox sample, 2004 and 2005 originations. Performance measured through February 2011.

This suggests that **as long as the Bureau remains within the boundaries of established underwriting practices, exactly where it chooses to "draw the line" with respect to a DTI cut-off will have a relatively small effect on loan performance and ATR, but a relatively large effect on consumer's access to QM loans.**

Finally, it is important to emphasize that the purpose of the QM definition is not to define "safe" loans or establish new underwriting standards that will replace the multi-variant approach that lenders traditionally have used. Instead, the adoption of a standard is meant **only** to provide guidance to lenders as to when a loan will be presumed to have met the ATR standard, and only for purposes of providing a greater protection against liability for failing to meet it than for non-QM loans. The assessment of DTI is only one suggested factor in this guidance. Lenders remain responsible for carrying out the other critical parts of credit underwriting, including propensity to repay and the quality of the collateral securing the debt, in addition to the documentation, verification and product requirements, to gain QM status.

3. Compensating factors such as residual income, liquid reserves, payment performance and low housing payments are important to consider in assessing ability to repay.

Because reliance on DTI alone inadvertently excludes otherwise qualified borrowers who have the ability to repay the loan, our Joint Proposal recommends that the Bureau allow QM to include loans with higher DTIs with compensating factors. These compensating factors can include the relationship between mortgage debt and total debt (front- and back-end ratios), liquid reserves, residual income, and proven payment history at roughly the same payment level. In this section, we present new data from the U.S. Department of Veterans Affairs (VA), the State Employees' Credit Union (SECU), the Community Advantage Program (CAP) and our LPS/BlackBox sample that show the validity of this type of approach for QM.

The U.S. Department of Veterans Affairs (VA)

Since 1944, the VA has run a loan guarantee program for military veterans.[11] According to current program guidelines, veterans who present a Certificate of Eligibility (COE) and meet credit and income standards can borrow up to 100% of the reasonable value of a home.[12] In the context of ATR, the important thing to note about the VA program is that it explicitly assesses whether borrowers meet the residual income standard shown in **Exhibit 8**. In fact, residual income standards supersede DTI in the VA's underwriting decision tree, in that significantly low residual income can be cause for denial while DTI alone is not. The VA DTI baseline

[11] U.S. Department of Veterans Affairs, "Legislative History of the VA Home Loan Guaranty Program," available online at http://www.benefits.va.gov/homeloans/docs/history.pdf.
[12] The VA provides a guaranty on the mortgage, ranging from a basic entitlement of $36,000 up to a 25% maximum on homes valued up to $417,000 (and higher in some counties.) See http://www.benefits.va.gov/homeloans/loan_limits.asp for more information.

is 41 percent; however, the VA will allow higher DTIs with compensating factors, such as residual income at least 20 percent above the guidelines and/or the presence of nontaxable income such as disability retirement or military allowances. The VA also includes data on liquid reserves. Although the VA does not consider liquid reserves as a primary underwriting criterion, they must be sufficient to cover closing costs and can be used as a compensating factor if residual income and DTI tests aren't met.[13] The VA data are thus a rich source of information on the efficacy of allowing higher DTIs with compensating factors.

Exhibit 8: U.S. Department of Veterans Affairs Residual Income Guidelines

Table of VA Residual Incomes by Region								
For loan amounts of $79,999 and below					For loan amounts of $80,000 and above			
Family Size	Northeast	Midwest	South	West	Northeast	Midwest	South	West
1	$390	$382	$382	$425	$450	$441	$441	$491
2	$654	$641	$641	$713	$755	$738	$738	$823
3	$788	$772	$772	$859	$909	$889	$889	$990
4	$888	$868	$868	$967	$1,025	$1,003	$1,003	$1,117
5	$921	$902	$902	$1,004	$1062	$1,039	$1,039	$1,158
over 5	Add $75 for each additional member up to a family of seven.				Add $80 for each additional member up to a family of seven			

To assess the effectiveness of using residual income and liquid reserves as compensating factors, we analyzed VA purchase, fixed-rate mortgages originated in 2004 and in 2006.[14] The results from this analysis are presented in **Exhibit 9,** and show that both residual income[15] and liquid reserves serve as effective compensating factors that can reasonably predict a borrower's ability to repay, even at higher DTI thresholds. **Importantly, borrowers with DTIs over 43 percent with sufficient residual income and liquid reserves performed better than borrower with DTIs below 43 percent who did not meet the tests.** For example, in 2006, a borrower with a DTI of between 46 and 50 percent who met the 6-month asset test had a default rate of 4.07 percent, compared with a default rate of 6.64 percent for borrowers who had a DTI of below 43 percent but who did not have 6 months of liquid reserves. Similarly, a borrower with a DTI of between 46 and 50 percent who met the residual income test had a default rate of 6.26 percent, compared with a default rate of 9.66 percent for borrowers who had a DTI of below 43 percent but who did not meet the residual income test. In addition, across all DTI categories and

[13] The full underwriting guidelines are provided in the Lender's Handbook (http://www.benefits.va.gov/warms/pam26_7.asp), which also notes a long list of other compensating factors (p. 4-61). In addition, some lenders impose additional credit standards above the VA's requirements.

[14] We selected 2004 and 2006 to demonstrate the efficacy of this approach even during a period of overall poor loan performance.

[15] In this analysis, whether or not a borrower passes the "residual income" test is calculated as whether or not the borrower's residual income exceeds the threshold by 20 percent, even at DTIs of below 41 percent.

years of origination, borrowers who meet either the residual income test, a 6-month liquid reserves test[16], or an 18-month liquid reserves test, are significantly less likely to default than borrowers who do not meet those tests. This seems intuitively sensible, as a household that has been able to amass or maintain a significant amount of savings with these higher DTIs has demonstrated the ability to meet its obligations and has available funds to overcome bumps in the road.

Exhibit 9: VA Default Rates by DTI Category and Compensating Factors, Fixed Rate Purchase Loans

	2004 Originations Number of Loans: 145,443 (Overall Default Rate = 3.72%)		**2006 Originations** Number of Loans: 118,427 (Overall Default Rate = 5.74%)	
DTI Category	**Residual Income Test**		**Residual Income Test**	
	Not Met (7.6%)	*Met (92.4%)*	*Not Met (5.9%)*	*Met (94.1%)*
All	5.57	3.36	8.26	5.58
Under 43	7.00	3.64	9.66	5.16
43-46	6.33	3.86	8.00	6.34
46-50	3.75	3.09	7.55	6.26
50+	3.83	3.10	7.45	5.84
	6-Month Asset Test		**6-Month Asset Test**	
	Not Met (68.1%)	*Met (31.9%)*	*Not Met (68.8%)*	*Met (31.2%)*
All	4.53	1.98	6.88	3.22
Under 43	4.77	1.88	6.64	2.82
43-46	4.71	2.58	7.46	3.70
46-50	3.68	1.80	7.17	4.07
50+	3.67	2.25	6.88	3.82
	18-Month Asset Test		**18-Month Asset Test**	
	Not Met (85.7%)	*Met (14.3%)*	*Not Met (85.4)*	*Met(14.6%)*
All	4.03	1.80	6.23	2.84
Under 43	4.20	1.63	5.94	2.23
43-46	4.35	2.36	6.79	3.95
46-50	3.32	2.00	6.67	3.83
50+	3.34	2.48	6.31	4.04

Source: VA data analysis jointly conducted by Joan Combs Durso, Sullivan University, and CRL. Unfortunately, the VA data do not include information on 60-day delinquencies. Default rates in this table refer to loans that ended in foreclosure sale, as of June 2011.

[16] VA borrowers must pay closing costs from liquid reserves. We assume closing costs equal to 3 percent of the loan amount, which is then subtracted from the borrower's total liquid reserves to calculate whether or not they pass the liquid reserves test. The liquid reserves test refers to whether or not a borrower's remaining liquid assets would be sufficient to cover either 6 or 18 months of mortgage payments. In its underwriting matrix, Fannie Mae identifies 6 months or more as the level of liquid reserves that significantly reduces default risk. See the Fannie Mae Comprehensive Risk Assessment Worksheet for Manual Underwriting (October 2008). Available online at https://www.efanniemae.com/sf/guides/ssg/relatedsellinginfo/riskassessuw/pdf/riskassessworksheet.pdf.

The VA data also support our Joint Proposal's recommendation that the Bureau establish a "waterfall" approach that would allow lenders greater flexibility in underwriting loans with DTIs of above 43 percent. In Scenario 1 below, we first apply 6-month and 18-month liquid reserves tests depending on DTI, and if those both fail, apply the residual income test (this best mimics the waterfall steps in our Joint Proposal). In Scenario 2, we first apply a residual income test, and then if that fails, apply the liquid reserves tests. In both waterfall scenarios, we use the VA's guidelines for determining adequate residual income (plus the extra 20%).

In both scenarios, borrowers with DTIs over 43 percent with **any** of the compensating factors present have performance comparable to or lower than all borrowers with DTIs less than 43 percent without them. **(Exhibit 10)** The one exception is for higher DTI borrowers who have more than 6 months of liquid reserves but who do not pass the VA residual income test; their foreclosure rate of 3.87 percent is slightly higher than those with a DTI of below 43 percent (3.79 percent). However, this difference is not statistically significant. In Scenario 1, we find that passing the 6 months asset test – even without looking at residual income – leads to a foreclosure rate of 2.2 percent, considerably lower than the 3.8 percent for borrowers with a DTI of less than 43 percent. In Scenario 2, looking at residual income (without considering liquid reserves) for loans above 43 percent, leads to a default rate of 3.4 percent, compared to 3.8 percent for borrowers with a DTI of less than 43 percent.

Clearly, there is the potential for an interaction effect among borrowers who pass both the income and liquid reserves tests. **Exhibit 11** shows the default rate for borrowers who have a DTI of above 43 percent, stratified by whether or not they passed the residual income test, the liquid reserves test, or all three. Because of the emphasis that the VA places on residual income, many more loans pass the residual income test rather than the liquid reserves test alone (which is not a standard part of the VA underwriting process except as part of compensating factors). The table demonstrates that accounting for compensating factors can be an effective way of assessing whether a borrower who may have a higher DTI still has a reasonable ability to repay the loan. Borrowers with a DTI of over 43 percent with compensating factors had a foreclosure rate of between 1.96 and 3.93 percent; in contrast, borrowers with a DTI of over 43 percent who did not pass any of the three tests had a significantly higher foreclosure rate, at 4.9 percent.

Exhibit 10: Analysis of Default Rates for 2004 VA Fixed Rate, Purchase Loans

Scenario 1 (Joint Proposal)	Number of Observations	Default Rate	Scenario 2 (VA RI Test first)	Number of Observations	Default Rate
DTI <=43	97,957	3.79	DTI <=43	97,957	3.79
43< DTI <=50 and liquid reserves >= 6 months	9,315	2.20	DTI > 43, VA residual income test has been met	40,982	3.38
DTI > 50 and liquid reserves >= 18+ months	1,691	2.48	43< DTI <=50 and liquid reserves >= 6 months (residual income test not met)	1,084	3.87
DTI > 43 but the VA residual income test has been met (liquid reserves test not met)	31,364	3.80	DTI > 50 and liquid reserves >= 18+ months (residual income test not met)	304	3.33

Source: VA data analysis jointly conducted by Joan Combs Durso, Sullivan University, and CRL. Unfortunately, the VA data do not include information on 60 day delinquencies. Default rates in this table refer to loans that ended in foreclosure sale, as of June 2011.

Exhibit 11: VA Loan Performance of Loans with a DTI of Above 43 Percent, by Compensating Factors, 2004 Originations, Fixed Rate Purchase Loans

Residual Income	6 Month Liquid Reserves	18 Months Liquid Reserves	# Obs	Default Rate
No	No	No	4,688	4.90
No	Yes	No	1,081	3.52
No	Yes	Yes	734	3.81
Yes	No	No	29,474	3.93
Yes	Yes	No	6,733	1.96
Yes	Yes	Yes	4,762	2.04

Source: VA data analysis jointly conducted by Joan Combs Durso, Sullivan University, and CRL. Unfortunately, the VA data do not include information on 60 day delinquencies. Default rates in this table refer to loans that ended in foreclosure sale, as of June 2011.

Using compensating factors as part of its underwriting policies allows the VA to reach more low- and moderate-income borrowers without sacrificing protections that ensure a borrower has the ability to repay the loan.

In **Exhibit 12**, we present the VA data from 2004 alongside data on household income. The VA program predominantly serves moderate- and middle-income families; the median household income in the US was $44,684. What is important to note in this table is that although household income is positively correlated with passing the residual income and liquid reserves tests, even families at and below the median income that pass the liquid reserves test perform well despite being more likely to have a DTI of over 43 percent. For example, families with DTIs over 43 percent who passed the 6-month asset test – with a median income of $42,864 – had a foreclosure rate of 3.5 percent, statistically similar to borrowers with DTI ratios of below 43 percent. For many low- and moderate-income borrowers, particularly in higher cost markets, higher DTIs are necessary to make homeownership possible, and rent levels in these areas increase housing burdens in any case. Defining QM in a way that allows the lenders the flexibility to underwrite to higher DTIs with compensating factors will help promote homeownership for lower-income borrowers and ensure they are covered by the protections that QM affords.

Exhibit 12: VA Loan Performance of Loans with a DTI of Above 43 Percent, by Compensating Factors and Household Income, 2004 Originations

DTI	Residual Income	6 Months Liquid Reserves	18 Months Liquid Reserves	# Obs	Default Rate	25*th* Percentile	50*th* Percentile	75*th* Percentile
=<43	-	-	-	97,875	3.8	$42,120	$58,224	$83,004
>43	No	No	No	4,688	4.9	$33,840	$41,088	$50,000
	No	Yes	No	1,081	3.5	$34,596	$42,864	$52,704
	No	Yes	Yes	734	3.8	$33,204	$41,301	$52,452
	Yes	No	No	29,474	3.9	$42,372	$54,672	$75,000
	Yes	Yes	No	6,733	2.0	$44,316	$57,660	$79,860
	Yes	Yes	Yes	4,762	2.0	$43,308	$57,096	$79,560

Source: VA data analysis jointly conducted by Joan Combs Durso, Sullivan University, and CRL. Unfortunately, the VA data do not include information on 60-day delinquencies. Default rates in this table refer to loans that ended in foreclosure sale, as of June 2011.

The Community Advantage Program (CAP) and State Employees' Credit Union (SECU)

In addition to the VA data, we also identified a couple of other data sources that show a similar relationship among assets, residual income, and loan performance. Data from the Community Advantage Program[17], for example, show that among borrowers with a DTI ratio of above 43 percent, having liquid assets of greater than $3,600 (equivalent to approximately 6 months of housing payment reserves) reduces the share of such loans who ever became 90+ days delinquent from 25 percent to 8 percent. **(Exhibit 13)** The presence of liquid assets also appear to be more important for borrowers at these higher DTIs; for borrowers with a DTI of less than 43 percent, the presence of liquid assets does reduce the serious delinquency rate, but not as dramatically.

Exhibit 13: Liquid Assets and Loan Performance, Community Advantage Program

		Percent Ever Seriously Delinquent
DEBT-TO-INCOME RATIO	**LIQUID ASSETS**	
Debt-to-Income <= 43%	**Liquid Assets <= $3,600**	16
	Liquid Assets > $3,600	13
Debt-to-Income > 43%	**Liquid Assets <= $3,600**	25
	Liquid Assets > $3,600	8

Source: Analysis of a subsample of 800 loans with data on liquid assets from the Community Advantage Program, administered by Self-Help. Seriously delinquent refers to loans that were ever 90 days or more delinquent.

Similarly, data on loans provided by State Employees' Credit Union (SECU) show that high DTI lending can be successful when compensating factors and prudent underwriting are taken into account. SECU is the second largest credit union in the country, serving 1.7 million members with just under $25 billion in assets as of March 2012. SECU uses residual income as a compensating factor for borrowers with higher DTI thresholds. In addition to DTI and residual income, SECU considers other traditional underwriting criteria such as length of employment, the presence of liquid reserves, and credit history. However, SECU does not set any minimum

[17] The CAP program, run by CRL's affiliate organization Self-Help, predominantly serves low- and moderate-income households (those earning 80 percent or below the area median income), with a median annual household income of $30,792. Forty-one percent of CAP households are headed by a woman, and 44 percent have credit scores less than or equal to 660. See Roberto G. Quercia, Allison Freeman, and Janneke Ratcliffe (2011). Regaining the Dream: How to Renew the Promise of Homeownership for America's Working Families. Washington, DC: Brookings Institution Press, pgs. 30-31.

requirements in relation to DTI, residual income or credit scores. The ability and willingness of the borrower to repay the loan is based on all of the factors to ensure the loan request is reviewed in its totality. SECU foreclosure and loss rates have been extremely low; as of December 31, 2011, SECU's net charge-off rate was 0.25%. CRL analyzed SECU's portfolio of approximately 54,000 mortgages originated between 2000 and 2010, and assessed their 60+ and 90+ ever delinquent rates as of May 2012. **(Exhibit 14)** As the table shows, SECU's ever seriously delinquent rates are below 10 percent, despite the fact that the performance period covers the worst years of the subprime crisis and recession. Moreover, there is no significant difference in performance between the 36 – 40 percent DTI tranche and the 40 to 43 percent tranche, nor between the 43 to 45 percent DTI tranche and the 45 to 50 percent DTI tranche.

Exhibit 14: SECU Loan Performance, 2000 – 2008 Originations

	All Loans	DTI <= 36	36 < DTI <= 40	40 < DTI <= 43	43 < DTI <= 45	45 < DTI <= 50	DTI >= 50
Ever 60+ Delinquency	6.5	5.4	8.6	8.7	9.6	9.6	10.0
Ever 90+ Delinquency	3.5	2.9	4.6	4.4	5.9	5.9	5.8

Source: CRL analysis of SECU loan portfolio, 2000 – 2008 originations. Performance for SECU loans measured through May 2012.

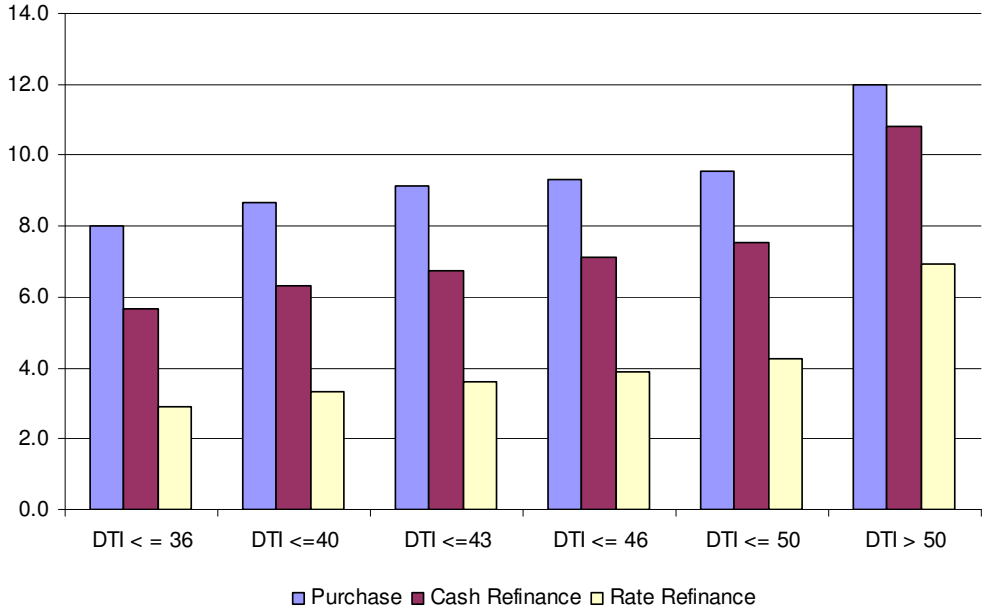
LPS/BlackBox Sample: Past Payment History and Low Front End DTI

Our Joint Proposal also suggests that the Bureau should consider historical rent and/or mortgage payments as a compensating factor for higher DTIs. Because lenders take previous payment history into account when underwriting a refinance loan, looking at the ever 60+ delinquency rates for refinance versus purchase loans can provide some indication that past payment history can help a lender effectively determine whether or not a borrower has the ability to repay a loan, even at higher DTIs. This is the same principle underlying guidance for streamlined refinance mortgages and the Home Affordable Refinance Program.[18]

In **Exhibit 15**, we present analysis of the ever 60+ delinquency rates for our LPS/BlackBox sample of loans without prohibited product features. We find that both cash-out refinance and rate-term refinance loans perform significantly better than purchase loans, with rate-term refinance loans experiencing the lowest delinquency rates. For example, for borrowers with a DTI of less than 50 percent, the 60+ delinquency rate was 4 percent, compared to 9.3 percent for purchase loans. Notably, this is **half** the delinquency rate of purchase loans for loans with a DTI of under 36 percent (8 percent).

[18]Under HARP, the borrower must be current on the mortgage at the time of the refinance, with no 30-day late payment in the past six months and no more than one such late payment in the past 12 months. http://www.fhfa.gov/webfiles/22721/HARP_release_102411_Final.pdf

Exhibit 15: 60+ Delinquency Rate by Loan Purpose, QM Sample
2000 - 2008 Originations, includes 12 million loans



Source: CRL analysis of LPS/BlackBox sample, 2000 to 2008 originations.
Performance measured through February 2011.

We also used the LPS/BlackBox sample to conduct an initial test on whether we could find a relationship between front-end housing-to-income ratios (HTI) and back-end DTI (TDTI). Because we have data on both lender-supplied DTI (which could be either front-end or back-end) and borrower income and monthly housing payments, we can estimate both front- and back-end DTIs from this data and compare the loan performance for loans with low HTI but higher TDTI. If a borrower's monthly HTI ratio (calculated as the ratio of principal and interest payments to income) was at least 20 percent lower than the lender supplied DTI ratio, we assumed that the lender reported TDTI. We then assessed the performance of loans with a TDTI of between 43 and 50 percent, stratifying the sample between loans with a HTI of less than 31 percent and those with a HTI of more than 31 percent. Results of this analysis are presented in **Exhibit 16.** While not conclusive, this analysis does suggest that the combination of a low HTI ratio and a higher TDTI (between 43 and 50) performs significantly better than loans where HTI comprises a larger share of TDTI. This is one area where the Bureau could track performance on these measures and make adjustments as needed going forward.

Exhibit 16: Ever 60+ Delinquency Rate, LPS/BlackBox Sample
(2004-2008 Originations)

Condition	Total Number of Loans	60+ Day Delinquency Rate
HTI < 31 and 43 < TDTI < 50	37,500	9.2
HTI >= 31 and 43 < TDTI < 50	118,680	15.9
Rest of Sample (didn't meet conditions above)	1,891,535	9.5

Source: CRL analysis of LPS/BlackBox sample, 2004 to 2008 originations. Performance measured through February 2011.

III. Litigation and put-back risk weigh heavily toward a broad QM definition.

In general, we do not believe that litigation costs stemming from lawsuits initiated by borrowers will be significant for loans that meet the QM definition. Borrowers facing foreclosure are those most likely to sue alleging inability to repay, and they, by definition, generally lack the resources to obtain counsel and to pay for expert witnesses required to rebut lender defenses. In addition, there is a paucity of lawyers with the specialized expertise to take on these complicated cases for a contingent fee, particularly because the prospects of winning and collecting a fee will be extremely low for a loan that meets QM standards. The major risk to lenders from lawsuits by borrowers is class actions, and since ability to repay cases are focused on individual circumstances, class actions would not be available. Borrower lawsuits will be much more common in the non-QM market where the rebuttable presumption does not apply, and where risks to borrowers from unaffordable loans caused by payment shock[19] and higher fees[20] are substantially greater.

On the other hand, we believe that put-back risk to lenders by purchasers for non-QM loans will be quite substantial. A restrictive QM rule would push more of the market into non-QM status, which would increase this put-back risk for lenders. Potentially any non-QM loan that has a delinquency in the first 3 years – in addition to those loans that reach foreclosure status – could be subject to put-backs. Lenders have

[19] Payment shock caused by expiration of teaser rates and market movements are both significant causes of defaults. See Cristian deRitis, Chionglong Kuo, Yongping Liang, Payment shock and mortgage performance, Journal of Housing Economics, Volume 19, Issue 4, December 2010, Pages 295-314, ISSN 1051-1377, 10.1016/j.jhe.2010.09.003. http://www.sciencedirect.com/science/article/pii/S1051137710000434)

[20] The additional 2% that lenders could charge (5% under revised HOEPA limits rather than 3% under QM) is a substantial cost to many families. For example, 2% of the average home purchase loan amount of $225,000 is $4,500, which is **four times** the median net worth, excluding home equity, of $1,050 for African-American households in 2009. See http://www.mbaa.org/NewsandMedia/PressCenter/80276.htm and http://www.pewsocialtrends.org/files/2011/07/SDT-Wealth-Report_7-26-11_FINAL.pdf at 15

likely faced a hundred times more put-back liability than borrower litigation liability in recent years, which highlights that put-back risk is large and real.

While we appreciate the Bureau's attempts to model litigation risk to help set the QM boundaries, we believe that such an enterprise is fraught with uncertainty. That is because the range of potential outcomes is so large and because there are monumental risks to the already fragile housing market -- restricted access to credit and reduced affordability, which could further reduce housing prices and increase foreclosures -- if the actual impact ends up higher than the predicted one. We simply do not have experience with an ability to repay standard under TILA to assess the likely impact on borrower litigation.

We do know that purchasers, particularly of loans not guaranteed by the government, are skittish and, along with the government and GSEs, have been seeking at unprecedented levels to put the risk of loss back on the originator. Such policies have caused lenders to add often restrictive lender overlays to GSE and FHA loans not required by purchasers or guarantors to reduce exposure to loans that might run into payment difficulties and be subject to put-back in the future. There is no reason to think that lenders would not react similarly to underwrite very conservatively to minimize put-back risk for non-QM loans going forward. Recent experience therefore weighs heavily toward a broad QM definition to reduce the negative impacts on access and affordability that will surely apply with a large non-QM market.

In summary, we believe that QM should be defined broadly to encompass the entire current constrained market with room for additional lending beyond today's levels to avoid unnecessarily excluding creditworthy families from QM protections, particularly vulnerable ones that Title XIV was primarily intended to protect. Even relatively high DTIs would cut off substantial numbers of recent borrowers from accessing QM loans, particularly borrowers from higher-cost housing states and those with lower incomes or who are families of color. DTI is just one element of prudent underwriting, and alone is not that predictive of loan performance; it should be supplemented with proven compensating factors such as reserves, low mortgage payments, stable housing payments and residual income as alternative paths to QM status.

Please feel free to contact us if you have any additional questions about our comments.

Eric Stein, Debbie Bocian, and Carolina Reid, Center for Responsible Lending
Barry Zigas, Consumer Federation of America
Wade Henderson, The Leadership Conference on Civil and Human Rights

Appendix

Ability-to-Repay ("ATR") Analysis and
Qualified-Mortgage ("QM") Determination

DISCUSSION DRAFT

by

Center for Responsible Lending
The Clearing House Association
Consumer Federation of America
Leadership Conference on Civil and Human Rights

For a Meeting With

Consumer Financial Protection Bureau

on

March 7, 2012

This document represents consensus recommendations concerning the ability-to-repay ("**ATR**") and qualified-mortgage ("**QM**") requirements of Dodd-Frank. These recommendations are interrelated and dependent upon each other.

1.0 Qualified Mortgage

Congress intended QMs to comprise the vast bulk of the mortgage market, and they should. QM loans by statute have safer features associated with responsible lending and lower default rates than loans without those features, such as limited fees, full amortization, and limited terms. Congress gave loans with these features a litigation advantage precisely to incent lenders to make QM loans.

If the QM definition is construed narrowly, it will be more difficult for low-income and minority families to qualify for safer loans, and, to the extent that mortgage credit is available to them at all, many of these borrowers will be left to the part of the market where they will be significantly more vulnerable to equity stripping through high fees and bad practices. A large non-QM market would not by its size alone protect consumers, and the broad availability of loan features that experience has shown to entail greater risks for consumers and investors will add to costs without providing commensurate consumer benefits.

By contrast, a broad definition of QM would combine prudent lending with less litigation, benefiting homeowners, investors and lenders alike. It would also support access to credit, since secondary market standards are very likely to require loans to be QM.

2.0 Ability-to-Repay Determination

2.1 General standards

Statutory requirement

The statute states that "no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments." TILA Section 129C(a)(1).

The ability-to-repay analysis should be based on factors that reflect capacity to repay as of the time of consummation, not willingness or propensity to repay.

- The determination of ability to repay is separate and distinct from the underwriting decision, which properly includes factors other than just ability to repay.

- The regulations and accompanying commentary should clarify that:

    - the statutory ATR analysis concerns the borrower's capacity (the statute uses the term "ability") to repay a loan through current income, assets (other than the home), and funds available, not the propensity to make such payments.

    - other factors unrelated to ATR that influence the credit decision (e.g., credit score, LTV, appraisal) should not be used by creditors in establishing the borrower's ATR or in challenging a creditor's determination of ATR.

    - while the statute refers to a consumer's "credit history," this reference was intended to ensure only that a lender obtained a consumer's credit report (which contains the consumer's credit history) to verify the consumer's debts and associated monthly obligations,[1] not that lenders should use the credit history or credit report to otherwise determine the borrower's ability to repay. Otherwise, it would make no sense that QM establishes a rebuttable presumption of ATR when QM does not discuss creditworthiness.

- The CFPB should adopt the portion of proposed commentary Paragraph 43(c)(1)-1, which clarifies that a creditor is required to "determine that a consumer will have a reasonable ability *at the time the loan is consummated* to repay the loan" (emphasis added). A change in a consumer's circumstances after consummation of the loan is not relevant to determining compliance with the rule, unless such events are documented in the consumer's application or by information provided by the consumer reasonably prior to consummation of the loan. For example, the creditor must consider the potential impact of a consumer's impending retirement and the consumer's ability to repay if the consumer's application contains a notation that the consumer plans to retire six months after the loan is made. However, a significant reduction in income due to a job loss that occurs after consummation or a significant obligation arising from a major medical expense arising after

[1] The proposal would require, as part of an ability-to-repay determination, a consumer's credit history. Proposed Regulation section 226.43(c)(2)(vi); Proposed Commentary Paragraph 43(c)(2)(viii). This improperly conflates the full underwriting analysis that all lenders must undertake in order to ensure safe and sound underwriting practices—which includes assessing creditworthiness, loan-to-value ratios, and other factors—with the statute's requirement to consider the borrower's capacity to repay. An analysis of a borrower's ability to repay a debt is simply one important part of a lender's full underwriting analysis.

the loan is consummated would not be relevant to an ability to repay challenge. *See* Paragraph 43(c)(1)-1.

The regulation and commentary should require creditors to verify and document income, assets, and debts using third-party sources.

- **Income or assets:** The final rule should adopt the proposed regulatory provisions and commentary that require verification of income or assets using third-party documentation that provides reasonably reliable evidence of the consumer's income or assets and that permit creditors to consider expected income if it is reasonable and documented. Proposed Rule section 226.43(c)(4); Proposed Commentary Paragraph 43(c)(2)(i)-1; Proposed Commentary Paragraph 43(c)(2)(i)-3. Dodd Frank requires that income and assets be appropriately documented and verified. However, this requirement can pose barriers to obtaining credit for some borrowers who have non-traditional or alternative income sources, such as boarder income and informal self-employment income, which is more difficult to document and verify. Since CFPB will have to confront and resolve these issues in issuing the final regulations, the parties would like to work with the CFPB to develop standards that specifically address how such non-traditional or alternative income sources can be considered by the creditor in the underwriting process and verified, including working through parties that work closely with borrowers, such as HUD-approved housing counselors.

- **Debts:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-1, which provides that creditors may look to widely accepted governmental and nongovernmental underwriting standards to define debts, and a creditor may, for instance, look to credit reports, as well as statements for student loans, auto loans, credit cards, etc., to determine a consumer's outstanding debts. However, see the discussion below regarding expenses not on a credit report or the consumer's application.

- **Reconciling different information:** The CFPB should adopt Proposed Commentary Paragraph 43(c)(2)(vi)-2, which provides that the creditor must consider debts in the credit report that are not listed on the consumer's application. The credit report is deemed a reasonably reliable third-party record under § 226.43(c)(3). "For debts not listed in the credit report, but offered by the borrower through the application process, the creditor need not verify the existence or amount of the obligation through another source. If a creditor nevertheless verifies an obligation, the creditor must consider the obligation based on the information from the verified source."

Ability to repay—when the creditor must consider expenses not listed on the credit report or the borrower's application

- The commentary should clarify that the lender must consider additional information that the borrower provides [in writing] a reasonable time before consummation about regular/recurring expenses that would have a material impact on the borrower's ability to repay the loan. However, the borrower would have the burden of proving that she had offered such information [in writing] reasonably prior to the consummation of the loan and that it would have a material impact on her ability to repay the loan. **[Note to CFPB: The parties disagree about whether this information must be provided in writing.]**

[There is agreement that the borrower needs access to information that describes how the lender conducted the ability-to-repay determination. The parties will attempt to propose a solution at a later date.]

2.2 Payment used to qualify the borrower—treatment of ARMs

For all ARMs, the ATR standard should require the following:

- The contract interest rate and payment *cannot*:
  - adjust more frequently than annually;
  - increase by more than 200 basis points in any annual rate adjustment; or
  - adjust by more than 500 basis points over the life of the loan.

- The borrower must be qualified based on the *maximum* rate and payment that could occur in the first 6 years of the term of the loan (that is, the rule would not allow the creditor to ignore the first rate and payment adjustment on a 5-1 ARM in the ATR analysis).

[**2.3** Potential ATR Carve-Out for Certain Streamlined Refinancings: There is agreement that an exception to the ability-to-repay and qualified-mortgage requirements should be established for certain streamlined refinancings. The parties will attempt to propose such an exception at a later date.]

3.0 QM Definition

All items below must be met in order for the loan to be a designated as a qualified mortgage:

3.1 Loan Terms

A qualified mortgage cannot have terms that provide for:

- an increase of the principal balance as a result of negative amortization based on regular required payments
- interest-only payments
- balloon payments
- a term greater than 30 years
- points and fees that exceed the greater of $3,000 or 3 percent of the total loan amount so long as the loan is not a HOEPA loan
- the contract interest rate and payment to:
  - adjust more frequently than annually;
  - increase by more than 200 basis points in any annual rate adjustment; or
  - adjust by more than 500 basis points over the life of the loan
- In addition, the borrower must be qualified based on the *maximum* rate and payment that could occur in the first 6 years of the term of the loan (that is, the rule would not allow a creditor to ignore the first rate and payment adjustment of a 5-1 ARM in the ATR analysis).

3.2 Documentation Requirements

The following documentation requirements would be required for QM loans:

- Verification of borrower income;
- Verification of employment ("**VOE**") status, if applicable (either written or oral VOE);
- Documentation of current debt obligations (based on credit report and borrower application); and
- Documentation of payments on simultaneous seconds and any other subordinated loans in place at origination.

3.3 Additional QM Underwriting Requirements

In order to be a qualified mortgage, a loan must meet at least one of the "waterfall" tests described below. However, the fact that a mortgage might qualify under one of these tests does not imply an obligation on the creditor's part to make the loan or to otherwise forego the underwriting process. All references to housing debt, housing obligations, and housing payments below would include principal, interest, taxes, insurance, condominium association fees and other housing-related obligations.

- If the borrower's total debt-to-income ratio ("TDTI") is 43 percent or less (with a bona fide error cushion), the loan would meet QM requirements. No other tests would be required.
- If the borrower's TDTI is more than 43 percent, the following tests could be applied:
  - *Front-End Ratio*: Is the borrower's housing debt-to-income ratio 31 percent or less of the borrower's gross monthly income and is TDTI 50 percent or less?
    - If yes, the loan meets QM requirements; no further test required. If no, continue.
  - *Previous Housing Payments*. Has the borrower had stable income for the past six months and made timely mortgage or rental payments over a specified period of time (TBD), and will her new monthly housing obligations be no more than 5 percent higher than her current housing expenses? [Parties are still discussing the appropriate definition and timeframe for establishing a history of "timely" payments.]
    - If yes, the loan meets QM requirements; no further test required. If no, continue.
  - *Reserves.* Does the borrower meet one of the following tests: 1) at least 6 months of liquid financial reserves available to meet mortgage-related obligations and a TDTI of 50% or less; or 2) greater than 18 months in liquid financial reserves (i.e., no TDTI cap required)? (Only 60 percent of any reserves with a withdrawal penalty would be allowed to count.) [Parties agree that some degree of seasoning should be required but do not have a specific recommendation.]
    - If yes, the loan meets QM requirements; no further test required. If no, continue.

– *Residual Income.* Is the borrower's net residual income above the minimum threshold established by the CFPB and/or other government agency (e.g., U.S. Department of Veterans Affairs ("**VA**")?

  - If yes, the loan meets QM requirements; no further test required. If no, the loan will only be made as a non-QM loan unless one of the prior tests in the waterfall is met.

  The residual-income test could be based on tax-adjustment tables and income guidelines prepared by CFPB, VA guidelines, or industry standards.

Even if the loan does not meet any of the QM tests, there is no implication that the loan fails to meet the ability-to-repay test.

4.0 Contesting the Presumption

We propose the following process:

- Borrower rebuts presumption when a borrower demonstrates that the loan fails to meet the basic tests of QM—product type, fee levels, etc.

- If the loan is a QM, the borrower can still assert that the ability-to-repay requirement was not met by demonstrating that the lender failed to take into account information provided to it that, if properly considered, would have prevented a reasonable and good faith finding of a reasonable ability to repay.

  - For example, the borrower shows that she provided information to the creditor before consummation that she owed debt that was not listed on the borrower's credit report. Failure to consider this debt could be grounds for challenging whether the ability-to-repay requirement was met. The lender could still have met the requirement if the existence of the debt did not materially affect a reasonable determination of the borrower's ability to repay.

  - Similarly, if a creditor alters or omits information collected in the course of the application, without reasonable basis, that is relevant to the borrower's ability to repay, the borrower can challenge whether the ability-to-repay standard was met.

  - Absent further information or evidence submitted by the borrower that either contradicts the creditor's records and assertions or documents information that the lender had but did not reasonably consider, the presumption for qualified mortgages should provide a sufficient shield to the lender.

- If the loan is not QM to begin with, the burden of proof that the lender did not appropriately consider the borrower's ability to repay falls on the lender. In this case, the lender will not have the benefit of the presumption of ability to repay when defending borrower claims that the lender failed to consider relevant information provided by the borrower.

- Accordingly, revise proposed Alternative 2 Commentary Paragraph 43(e)(1)-1 as follows [*additions in bold and deletions in strikethrough*]:

In general. Under § 226.43(c)(1), a creditor must make a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability, at the time of consummation, to repay the loan according to its terms, including any mortgage-related obligations. **A borrower raises a claim or defense of violation of sec 226.43(c)(1) by setting forth specific facts that, at the time the loan was consummated, the creditor did not make a reasonable and good faith determination that the borrower had a reasonable ability to repay the loan based upon information provided by the borrower reasonably prior to closing.** Under § 226.43(e)(1), a creditor or assignee of a covered transaction is presumed to have complied with the repayment ability requirement of § 226.43(c)(1) if the terms of the loan comply with § 226.43(e)(2)(i)-(ii) (or, if applicable, § 226.43(f)); the points and fees do not exceed the limit set forth in § 226.43(e)(2)(iii), and the creditor has complied with the underwriting criteria described in § 226.43(e)(2)(iv)–(v) (or, if applicable, § 226.43(f)). If a loan is not a qualified mortgage (for example because the loan provides for negative amortization), then the creditor or assignee must **prove** ~~demonstrate~~ that the loan complies with all of the requirements in § 226.43(c) (or, if applicable, § 226.43(d)). However, even if the loan is a qualified mortgage, the ~~consumer may rebut the presumption of compliance evidence that the loan did not comply with~~ **lender has not necessarily complied with the ability-to-repay requirement** in § 226.43(c)(1). For example, **(1)** evidence of a high debt-to- income ratio with no compensating factors, such as adequate residual income ~~could be sufficient to rebut the presumption~~, **or (2) evidence that the lender did not reasonably consider information provided to it relevant to the borrower's ability to repay could be used by the borrower to establish that the creditor did not meet the ability-to-repay requirement. When a loan is a qualified mortgage, the consumer has the burden of proving that the creditor did not comply with the repayment ability requirement of § 226.43(c)(1).**

The Clearing House Owner Banks
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Bank of America
The Bank of New York Mellon
BB&T
Capital One
Citibank
Comerica
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HSBC
JPMorgan Chase
KeyBank
PNC
RBS Citizens
Regions
UBS
U.S. Bank
Union Bank
Wells Fargo
Payments Company
Shared Board Seat:
City National
Fifth Third Bank
First Citizens
M&T