Insight

# Understanding the End of the QM Patch

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## Executive Summary

- The Consumer Financial Protection Bureau (CFPB) requires that all mortgage borrowers have a debt-to-income ratio of below 43 percent (the “Qualified Mortgage,” or QM, rule), but it created an exception for mortgages backed by Fannie Mae and Freddie Mac (the QM Patch).
- The QM Patch allows Fannie Mae and Freddie Mac to breach CFPB regulations by backing mortgages to borrowers with a higher ratio of debt to income, but the CFPB has indicated that it will allow the QM Patch to expire in 2021, eliminating this privilege.
- While allowing the QM Patch to expire will likely decrease mortgage availability, particularly for those with low incomes, it also will necessarily decrease the systemic risk implicit in the U.S. housing sector.

## Introduction

Last week the Consumer Financial Protection Bureau (CFPB) announced that it would allow its special treatment of some mortgages backed by Fannie Mae and Freddie Mac, also known as the QM Patch, to expire in 2021. This piece addresses some of the questions around this change in policy:

- What is the QM Patch?
- What made the QM Patch such bad policy?
- What are the consequences of the expiration of the patch?
- How has the housing finance world reacted?
- How should this be viewed in light of the broader ongoing housing reform debate?

## What is the QM Patch?

The CFPB requires lenders to assess the likelihood that their borrowers will be able to repay the loans they take out, a requirement known as the “Qualified Mortgage,” or QM, rule. The assessment that lenders perform is a simple one; a calculation of debt to income (DTI). As an example, if my debts (be they mortgage, auto, or any kind) totaled $1,000 per month, and my income $3,000 per month before tax, my DTI is 33 percent. Alternately, if my monthly income is $2,000 per month, my DTI is 50 percent. Usually, a lower DTI improves your chances of obtaining a loan or a line of credit, as there is a much greater likelihood that the loan will be repaid. Most lenders generally prefer a DTI of 33 to 36 percent, as, again, at this ratio borrowers are statistically more likely to continue to make payments. The CFPB’s requirements prevent lenders from offering loans to borrowers who exceed a 43 percent DTI.

The effect of this rule is to prevent the riskiest borrowers, or those more likely to default, from becoming homeowners. This makes sound economic sense, but the rule makes it harder for some people to reach the

American Dream of homeownership, and as a result one very important exception to the rule exists. Former CFPB Director Richard Cordray introduced the QM "Patch," which allows Fannie Mae and Freddie Mac, the government sponsored enterprises (GSEs), to back loans with a DTI exceeding 43 percent, thereby allowing those risky borrowers to obtain mortgages.

The QM Patch was always intended to be temporary and is due to "sunset," or expire, in 2021. By declining to continue the special treatment for the GSEs, the CFPB has indicated that those with a DTI exceeding 43 percent will no longer be able to take on mortgages.

**What made the QM Patch such bad policy?**

The benefits of the QM rule are wide-ranging: borrowers are less likely to default; lenders are less likely to lose money, as they have performed appropriate risk-management assessments (and they typically wouldn't loan to individuals above that DTI anyway, as noted above); and the economy is slightly less likely to suffer the shock that a large number of defaults within a short period might cause. Anything that allows an exception to this rule, particularly by providing loans to those far less likely to be able to repay, does not make sound policy.

In addition, the QM patch is wildly anti-competitive, as it is an advantage only the GSEs enjoy. The GSEs already enjoy a tremendous advantage over private industry due to their government backing, and this rule only further shuts private mortgage providers out of the secondary mortgage market.

The problems with the QM patch are not merely philosophical, either. The QM patch currently enables almost a third of all GSE-backed loans, a proportion that has only grown in recent years. One analysis finds that in 2018 the QM Patch accounted for 16 percent of all mortgage originations in 2018, comprising $260 billion in loans. To allow for more risk to enter the housing market is contrary to the purpose of Dodd-Frank and reinforces that housing, a risk and inflationary factor in the last recession, is today more risky rather than less.

**What are the consequences of the expiration of the patch?**

The expiration of the QM Patch will necessarily decrease the availability of mortgages, while also increasing their quality and price. While the long-term impacts will be to decrease systemic risk in the housing sector, in the short-term the riskiest population of borrowers (in practice the less well off) will find it more difficult to get on the housing ladder, a key step in building up equity and demonstrating creditworthiness. We can also expect in the short-term to see a relaxation of standards as private mortgage providers lend above their typical DTI (moving upwards from 33 percent, probably) in order to capture some of this market. Although this relaxation introduces more risk into the system, borrowers are still protected by the QM rule as it normally applies.

The expiration of the QM Patch seems likely also to impact adversely the GSEs' market share. The QM Patch has enabled a significant book of business for the GSEs, and while they will lose businesses because of this change, it is probable that announcing the end of the QM Patch so far in advance is intended to manage this problem. The GSEs will of course still enjoy the vast benefits that a decade of taxpayer funding and support has provided, but some of this business will flow to private competition.

It is likely that the transitional period that would mark the end of the QM Patch will involve some degree of grandfathering for the current QM Patch mortgages. There could be legal challenges, however.

An Advance Notice of Proposed Regulation (ANPR) that accompanied Thursday's CFPB press release is

seeking industry input into how to manage the transitional period and minimize these concerns. In particular, the CFPB and the Federal Housing Finance Agency (FHFA) are seeking comment on how to fix the qualified mortgage process itself, as the existence of the patch is indicative that it is not fit for purpose.

**How has the housing finance world reacted?**

Director Calabria of the FHFA, regulator and conservator of the GSEs, accompanied Director Kraninger of the CFPB for the announcement, noting that the QM patch "exacerbates an unlevel playing field" and that "Fannie and Freddie should play by the same rules as everyone else."

Former FHFA Director Ed DeMarco applauded the move and noted the structural problems with the QM rule: "By itself, a borrower's debt-to-income is a poor indicator of a borrower's ability to repay and both the numerator and denominator are very hard to define in regulation."

Others have noted the likely adverse impact on low-income borrowers. Some industry institutions, including the Mortgage Bankers Association, are seeking changes to the QM rule prior to the sunset of the QM Patch in order to achieve a flexibility in DTI restrictions that will still allow some riskier borrowers to be served.

**How should this be viewed in light of the broader ongoing housing reform debate?**

Decreasing the GSEs' market share – and therefore their footprint – will delight proponents of widescale GSE reform, as decreasing the GSEs' market penetration is viewed as a necessary first step in this process. The announcement marks the first, and only, concrete step toward housing reform in the last decade. It is likely that Director Kraninger is making this move knowing that the current administration is at least contemplating significant reform of the GSEs. The release of a combined Treasury-Housing and Urban Development memo on housing reform, anticipated in the next few months, should make the administration's intentions clear.

**Conclusions**

It would be far better to rewrite the rulebook than continue to allow the rules to be broken. Allowing the QM Patch to expire is a painful but necessary step toward decreasing the systemic risk implicit in the U.S. housing market.