MILKEN INSTITUTE
CENTER FOR FINANCIAL MARKETS

September 16, 2019

The Honorable Kathleen L. Kraninger
Director
Consumer Financial Protection Bureau
1700 G Street, NW
Washington, DC 20552

**Re: Docket No. CFPB-2019-0039; RIN 3170-AA98; Advance Notice of Proposed Rulemaking on the Qualified Mortgage Definition under the Truth in Lending Act (Regulation Z)**

Dear Director Kraninger:

The Milken Institute appreciates the opportunity to submit our response to the Advance Notice of Proposed Rulemaking (ANPR) on the Qualified Mortgage Definition under the Truth in Lending Act (Regulation Z).[1] The ability-to-repay (ATR) and qualified mortgage (QM) rule (ATR/QM rule) is a centerpiece of post-financial crisis consumer protections and mortgage reform, instilling safety and soundness into the housing finance landscape for the benefit of borrowers, industry, and the national economy. We appreciate the opportunity to share our thoughts with the Consumer Financial Protection Bureau (CFPB or the Bureau) on how to evolve the ATR/QM rule at this critical juncture.

With the QM Patch set to expire in January 2021, it is imperative that the CFPB address deficiencies in the ATR/QM rule. We support the QM Patch expiration, with a short-term extension if necessary to avoid material market disruption. The CFPB must improve Appendix Q or implement an alternative path to QM safe harbor status in connection with the QM Patch expiration.

As a general matter, we suggest the following overall goals for revising the ATR/QM rule:

- Facilitate access to mortgage credit at sustainable levels for all consumers who possess an ability to repay the credit.
- Discourage lenders from extending unsustainable mortgage credit through heightened liability exposure and disclosure requirements.
- Create the largest possible QM safe harbor space without weakening its intended purpose by establishing rigorous tests designed to approve **only those borrowers who demonstrate a clear presumptive ability to repay**.

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[1] The Milken Institute is a nonprofit, nonpartisan think tank that helps people build meaningful lives, in which they can experience health and well-being, pursue effective education and gainful employment, and access the resources required to create ever-expanding opportunities for themselves and their broader communities. The Milken Institute Center for Financial Markets (CFM) conducts research and constructs programs designed to facilitate the smooth and efficient operation of financial markets—to help ensure that they are fair and available to those who need them when they need them. CFM's housing finance program develops tangible solutions to the housing finance issues facing the US by addressing the substantive implications of existing, new, and proposed policies and market practices.

- Maintain current statutory QM product restrictions that prohibit risky loan features.
- Expand Appendix Q's documentation and verification criteria for added flexibility and clarity.
- Retain the eight general ability to repay underwriting criteria.
- Minimize additional regulatory compliance costs associated with terminating the Patch, without sacrificing existing consumer protections.

Adhering to these goals in developing revisions will help the CFPB stay true to its mission of expanding access to sustainable credit. With these goals in mind, we address the following questions from the ANPR in our response.

1) **Assuming without deciding that, in addition to the statutory factors, the Bureau retains as part of the General QM loan definition a criterion that directly measures a consumer's personal finances, should the Bureau continue to include only a DTI limit, or should the Bureau replace or supplement the DTI limit with another method (e.g., residual income or another method)?**[2]

2) **If the Bureau retains a DTI limit as part of the general QM loan definition, should the limit remain 43% or should the Bureau increase or decrease the DTI limit to some other percentage?**

    - **Summary Response to (1) and (2):** The Bureau should increase the QM debt-to-income ratio (DTI) limit to 50 percent and include compensating factors that directly relate to ability to repay, and not to default risk, willingness to repay, or loss severity. Notably, we recommend residual income requirements at certain DTIs, with limited exceptions for specified compensating factors. We also recommend consideration of alternatives other than DTI, but not without instituting appropriate guardrails.

*3)* **Assuming without deciding that the Bureau retains a criterion that directly measures a consumer's personal finances—DTI ratio, residual income, or some other measure—should creditors be required to continue using Appendix Q to calculate and verify debt and income? Should the Bureau replace Appendix Q? If the Bureau retains Appendix Q, how should it be changed or supplemented?**

    - **Summary Response to (3):** Until the CFPB task force can complete an evaluation of residual income as we describe in our response, we recommend the retention of some form of bright-line, standardized underwriting rules to achieve QM status. These rules could come in the form of a revised and more robust and nimble Appendix Q or a standardized underwriting model.

4) **If the Bureau does not retain Appendix Q or permits use of an alternative, what standard should the Bureau require or permit creditors to use to calculate and verify debt and income? Should the Bureau specify in Regulation Z an existing version of a widely used method of calculating and verifying debt and income that creditors would be required to use? Alternatively, to provide flexibility to creditors, should the Bureau combine a general requirement to use a "reasonable method" with the option to use, as a safe harbor, a**

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[2] The stated questions are taken directly from the ANPR. See https://files.consumerfinance.gov/f/documents/cfpb_anpr_qualified-mortgage-definition-truth-in-lending-act-reg-z.pdf.

**specified, existing version of a widely used method for calculating and verifying debt and income? If the Bureau were to specify an existing version of a widely used method for calculating and verifying debt and income under either of the approaches described in this paragraph, which method (or methods) should be allowed? Should Appendix Q be one of them?**

- **Summary Response to (4):** The CFPB should reserve QM status to those loans that demonstrate a presumptive, clear ability to repay. Prescriptive QM rules that afford certainty to the market are critical. The eight ability to repay underwriting factors reflect reasonable "common-sense" underwriting criteria but allow too much variation to provide the required certainty.[3] We recommend improvements to QM standards in our response.

We begin with a longer-term recommendation that the CFPB establish a task force to investigate the feasibility of developing and testing a robust, standardized measure of residual income, which we believe should lie at the heart of determining a consumer's ability to repay. We then discuss the adoption of near-term interim proxies.

<u>**True residual income: can the borrower make the loan work?**</u>

The CFPB should establish a task force in collaboration with housing finance stakeholders, including consumer representatives, to evaluate the importance of residual income, and the technological advances that can help measure residual income with greater accuracy than has been possible to date.

We believe that a robust, technology-driven residual income analysis would provide a much "higher resolution" snapshot of a consumer's true residual income. By "true residual income," we mean the amount that a borrower has left out of *actual income* to pay housing costs net of *actual taxes* and *all other debts and living expenses that are not currently captured in DTI*. A true residual income analysis would provide an accurate, customized picture of a consumer's household budget and cash flow, answering the question: **"Does this individual have the dollars to sustain this mortgage loan, taking account of this borrower's unique income, debt, and spending profile?"** We believe that a better understanding of true residual income would enable the CFPB to develop a residual income test for use as a compensating factor that is far more effective than any residual income test currently in use.

The more informed we are about true residual income dynamics, the better we can shape the ability to repay test to achieve its goals. Furthermore, HUD, Ginnie Mae, FHA, VA, and USDA, along with FHFA and the GSEs, could collaborate with CFPB using the information gleaned from

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[3] QM currently includes only seven of the eight underwriting factors. It does not require a consideration of credit history. See [https://files.consumerfinance.gov/f/201603_cfpb_atr-qm_small-entity-compliance-guide.pdf](https://files.consumerfinance.gov/f/201603_cfpb_atr-qm_small-entity-compliance-guide.pdf) (page 36): "Although consideration and verification of a consumer's credit history is not specifically incorporated into the General QM definition, [lenders] must verify a consumer's debt obligations using reasonably reliable third party records, which may include use of a credit report or records that evidence nontraditional credit references." As a practical matter, lenders do consider credit history, and we recommend the CFPB review the inclusion of credit history as a factor in QM underwriting. Lower credit quality borrowers are often financially vulnerable, and enhanced ability to repay consumer protections are important for such borrowers. Adequate compensating factors should be present in the event a QM loan is extended to a borrower with an impaired credit history.

the task force to create a consistent residual income test across agency, non-agency, and government mortgage channels.[4]

The CFPB should request comprehensive loan-level data sets from the GSEs, FHA, and VA (or from FHFA and HUD) for purposes of the task force. Advances in artificial intelligence, big data analytics, and other financial technologies, applied to these data sets, can inform the CFPB's efforts far more effectively than any other data sets (including those currently available to the public).

***The importance of true residual income***

In our January 2019 Milken Institute paper, "A Blueprint for Administrative Reform of the Housing Finance System," (Milken Blueprint) we noted the importance of residual income as a factor in determining the sustainability of mortgage credit:

> "[W]e believe residual income, net of taxes, is an important factor to consider for higher DTI loans. Residual income tests help lenders evaluate the amount of income a borrower would have left after paying monthly housing and other costs that factor into the DTI calculation. The higher the DTI the greater the risk that the borrower will be cost-burdened and less able to handle an adverse life event or economic downturn. Ensuring adequate residual income affords a measure of protection against the extension of unsustainable credit, which benefits both borrowers and the housing finance system. The CFPB recognized the importance of residual income by providing in the ATR/QM rule that for higher priced QM loans, a borrower could challenge a QM presumption by claiming the lender left the borrower with insufficient residual income with which to meet his or her living expenses."[5]

True residual income is different from the traditional mortgage underwriting definition of residual income. Under traditional underwriting, residual income is merely the inverse of a borrower's DTI. But traditional DTI calculations, even if reasonable, are incomplete in that they leave out potentially large debts and expenses, possibly making it seem like a borrower has lower debt obligations and more residual income than is actually the case.[6] True residual income is a

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[4] HUD: Department of Housing and Urban Development. Ginnie Mae: Government National Mortgage Association. FHA: Federal Housing Administration. VA: United States Department of Veterans Affairs. USDA: United States Department of Agriculture. FHFA: Federal Housing Finance Agency. GSEs: Fannie Mae and Freddie Mac.

[5] See https://www.milkeninstitute.org/sites/default/files/reports-pdf/Blueprint-Admin-Reform-HF-System-1.7.2019-v2.pdf (Kaplan, Stegman, Swagel, Tozer) (Milken Blueprint), at page 18. See also Footnote 18 on page 18: "The Department of Housing and Urban Development (HUD) defines 'cost-burdened' as paying more than 30 percent of [gross] income for housing: see https://www.hud.gov/program_offices/comm_planning/affordablehousing/. See also https://www.census.gov/housing/census/publications/who-can-afford.pdf and https://nlihc.org/issues/hacb." Severely cost-burdened borrowers are defined as spending more than 50 percent of gross income for housing.

[6] Some have argued that DTI can be higher than is actually the case because some lenders stop requiring the documentation of additional income once the borrower's verified income is sufficient to qualify for a loan. While this may be true for borrowers with strong incomes, it would not apply to the most financially

comprehensive look at a borrower's actual household cash flow that would incorporate these traditionally disregarded debts and expenses.[7]

We note here some key components of traditional DTI underwriting and their widely recognized limitations:

- **Underwritten income** – may not reflect actual income to the extent the underwriting guidelines give outsized, partial, or no credit to variable or non-traditional forms of income, such as commission and bonuses, seasonal income, inconsistent income, "gig economy" income, and other less predictable or formulaic earnings.

- **Underwritten debt** – can include inaccurate estimates of certain kinds of debt service, while leaving out important expenditures such as child care, health insurance, elderly care, health care and medications, and "lifestyle" costs.[8] Depending upon borrower-specific details, these unaccounted-for costs could reflect a 30 percent DTI borrower's *inability* to repay or a 50 percent DTI borrower's *strong ability* to repay.

While DTI is an incomplete proxy for true residual income, it is still a useful underwriting data point. DTI accounts for many of the more substantial expenses a household incurs, leaving a cushion for amounts not included in the definition, and has an enormous store of performance data behind it. However, we reiterate that DTI can misrepresent a borrower's true residual income picture and make the difference between lenders extending sustainable or unsustainable mortgage credit.[9]

Additionally, true residual income should be calculated net of actual taxes. Some residual income methods now in use in the non-agency market use gross income before taxes, effectively quantifying residual income as the simple inverse of DTI. Borrower tax status and payments can be significant. Since any dollar lost to taxes is a dollar the borrower does not have to repay the mortgage loan, tax status could mean the difference between sustainability and unsustainability of

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vulnerable borrowers who struggle to identify every dollar of income to qualify for a loan, and for whom consumer protections are most urgent.

[7] Servicers and housing counselors working with distressed borrowers employ a process that attempts to discern a borrower's true residual income. The servicer works with the borrower to document and evaluate the borrower's comprehensive cash flow to determine whether the proposed modification is sustainable. The purpose of this sustainability analysis is no different than the purpose of the sustainability analysis for a newly originated loan. Pre-purchase and distressed homeowner counseling and even the Chapter 13 bankruptcy process are similar in this regard. The more comprehensive and precise the information, the better informed the sustainability analysis will be, as actual income and costs replace estimates and variables in evaluating a consumer's household cash flow.

[8] Lifestyle costs include everything from utilities, cell phone/cable/internet costs, groceries, dining out, gym memberships, gasoline, clothing expenditures, haircuts, vacations, dance lessons, and all other individual or family living expenses. This element is currently baked into the ATR/QM rule for QM rebuttable presumption loans, under which a borrower can assert an ATR claim on the grounds that the lender ***"did not leave the consumer with sufficient residual income/assets left to live on."*** See https://files.consumerfinance.gov/f/201603_cfpb_atr-qm_small-entity-compliance-guide.pdf (page 9).

[9] As we will discuss later in our response, this is one of the reasons why a QM loan's presumptive ability to repay requires standardized guidelines. Allowing variations in QM criteria through which lenders could employ weaker practices would undermine the purpose of QM status and irresponsibly weaken consumer protection on the applicable loans.

mortgage credit. Importantly, using after-tax status in underwriting also means giving lower-income borrowers underwriting credit for various tax credits, including the child-care credit and the earned income tax credit, among others.

**Near-term recommendations in response to the ANPR**

We now turn to a discussion of more accessible near-term proposed rule revisions in response to the questions the ANPR poses.

1) **Assuming without deciding that, in addition to the statutory factors, the Bureau retains as part of the General QM loan definition a criterion that directly measures a consumer's personal finances, should the Bureau continue to include only a DTI limit, or should the Bureau replace or supplement the DTI limit with another method (e.g., residual income or another method)?**

2) **If the Bureau retains a DTI limit as part of the general QM loan definition, should the limit remain 43% or should the Bureau increase or decrease the DTI limit to some other percentage?**

   - **Summary Response to (1) and (2):** The Bureau should increase the QM DTI limit to 50 percent and include compensating factors that directly relate to ability to repay, and not to default risk, willingness to repay, or loss severity. Notably, we recommend residual income requirements at certain DTIs, with limited exceptions for specified compensating factors. We also recommend consideration of alternatives other than DTI, but not without instituting appropriate guardrails.

***Residual income as a compensating factor***

The Bureau should increase the QM DTI safe harbor limit to 50 percent but implement a consistent interim traditional net residual income test (Interim Residual Income Test) for borrowers that exceed 45 percent DTI (high DTI QM borrowers).[10] The Bureau should include an exemption from this test for high DTI QM borrowers who, in applying for a mortgage loan: (i) provide evidence of 12 months of housing history (rental or mortgage) with no 30-day or worse delinquency over such period; (ii) would experience no or negative payment shock under the proposed loan; and (iii) evidence no material decline in income over the prior 12-month period.[11]

We recommend the same 50 percent DTI limit for QM rebuttable presumption loans. However, we counsel the CFPB to implement the Interim Residual Income Test for QM rebuttable

[10]The Bureau would later replace the interim test with a true residual income test (or at least a stronger version of a residual income test using information derived from the task force). Note that in the Milken Blueprint, we recommended increasing the QM DTI threshold to 45 percent but implementing a net residual income test for all loans above 43 percent. We referenced the positive performance of GSE loans above 43 percent in the post-crisis market as a basis for this proposal and thought that residual income would serve as an effective compensating factor that would provide additional protection under stress scenarios. In support of increasing the baseline for a residual income test to 45 percent DTI, see https://www.urban.org/sites/default/files/publication/98949/2018_10_30_qualified_mortgage_rule_finalizedv2_0.pdf.

[11] We recommend that the Bureau work with credit, underwriting, and due diligence experts to determine an appropriate bright-line test for material income decline for purposes of this exception.

presumption loans at all DTIs and replace the current ambiguous language regarding insufficient residual income with this more bright-line test.[12]

We noted in the Milken Blueprint that, "In practice, non-agency higher priced QM and expanded credit non-QM lenders include residual income tests in their guidelines. Among agency and government mortgage programs, only the VA employs a residual income test, although some lenders choose to place residual income overlays on originations in these channels."[13] A cursory review of different tests currently in use shows significant disparity among them.

Some lenders track the VA test, pointing to data evidencing the test as a credit positive.[14] A VA-based test may also provide some protection in an ability to repay challenge given its long-standing industry usage. At the same time, many lenders set their own requirements, ranging from much higher than the VA to much lower. And among other factors, some employ family size and geographical parameters like the VA, and some do not.

While this type of underwriting discretion is appropriate under Non-QM lending, the QM underwriting process is supposed to represent a well-defined set of responsible, bright-line standards that yield a legally-presumptive ability to repay. Inconsistency undermines this clarity and also opens the door to detrimental "forum shopping." A consumer who is denied credit due to insufficient residual income may be able to shop for a lender with lax residual income requirements and obtain an unsustainable loan.

We recommend that the CFPB base its Interim Residual Income Test on the VA test, and eventually leverage the fruits of the Bureau's task force's analysis of relevant income, debt, cost of living, default, fair lending, loan balance, performance, and other data to enhance the baseline. We

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[12] See https://files.consumerfinance.gov/f/documents/cfpb_anpr_qualified-mortgage-definition-truth-in-lending-act-reg-z.pdf (page 28), referencing 12 CFR 1026.43(e)(1)(ii)(B). With respect to QM rebuttable presumption loans, "The [ATR/QM rule] currently provides that a consumer may rebut the presumption of compliance only by proving that, based on the information available to the creditor at the time of consummation, the consumer lacked sufficient residual income to meet living expenses, including any recurring and material non-debt obligations of which the creditor was aware." Note that we recommend substituting a bright-line residual income test in place of the existing insufficient residual income standard only for QM rebuttable presumption loans that comply with revised Appendix Q, as we describe later in our response.

[13] Milken Blueprint (page 18, including Footnote 21), referencing https://www.benefits.va.gov/WARMS/docs/admin26/pamphlet/pam26_7/ch04.doc: "'Note that the VA minimum residual incomes "[…]are a guide. They should not automatically trigger approval or rejection of a loan. Instead…residual income [should be considered] in conjunction with all other credit factors.' The FHA used a residual income test in the past, but now only considers residual income as an elective compensating factor at DTIs that exceed DTI limits. See https://www.hud.gov/sites/documents/FY16_SFHB_MOD4_UNDER.PDF. As a general matter, all residual income tests remain subject to lender-permitted exceptions as the tests are not currently prescribed by law."

[14] See, e.g., https://www.urban.org/urban-wire/residual-income-key-superior-performance-va-loans: "While adding a residual income test may cause some families to rethink or delay a home purchase or purchase a less expensive house, it also appears to be an effective way to reduce default rates and ensure borrowers take out mortgages they can afford. FHA and conventional programs should consider adding residual income to their underwriting. Moreover, lenders making higher cost Qualified Mortgages may want to consider using a residual income screen to provide more certainty that their borrowers can truly repay the loan."

also recommend a more granular geographical component than the VA employs (which divides the country into quadrants), and an analysis of other residual income tests currently in use.

A consistent CFPB-established Interim Residual Income Test would also benefit lenders by imparting clarity to the phrase "sufficient residual income" as it relates to QM rebuttable presumption loans. The CFPB provides lenders and judges no bright-line as to how to interpret this phrase, and this ambiguity creates uncertainty for lenders and potentially exposes them to liability. These uncertainties translate into higher borrowing costs.[15]

***Other compensating factors? Only if they relate to ability to repay***

Some market participants have suggested relaxing or eliminating the QM loan DTI threshold based on documented and, in some proposals, prescribed compensating factors other than residual income. Some of these proposed factors include credit score, loan-to-value ratio, reserves, employment history, housing history, payment shock, and loan price. Assigning some value to any of these compensating factors is a standard component of "common sense" underwriting and even "ability to repay" underwriting. Appendix Q is silent on certain compensating factors and prohibits or qualifies others. We would encourage the CFPB to consider the ability to document, verify, and prescribe different compensating factors that lenders can employ in originating QM loans.

We caution, however, that not all compensating factors are "created equal." Compensating factors help to alleviate the risk of a loan by addressing one or more of the following features:

- Ability to repay
- Default risk
- Willingness to repay
- Loss severity

As we have repeatedly made clear, the ATR/QM rule concerns only ability to repay, and compensating factors relating to a borrower's ability to repay are the only appropriate ones in respect of presumptive QM status.

Conversely, compensating factors that relate to default risk, willingness to repay, or loss severity should not factor into QM criteria but will undoubtedly affect loan pricing or even borrower eligibility.[16] Given the QM Annual Percentage Rate (APR) threshold of Average Prime Offered Rate (APOR)+150 basis points (APOR+150) as the line of demarcation between QM safe harbor and rebuttable presumption status, these additional factors could play a role in shifting loans from QM rebuttable presumption to QM safe harbor status under the right pricing scenario.[17]

**3) Assuming without deciding that the Bureau retains a criterion that directly measures a consumer's personal finances—DTI ratio, residual income, or some other measure—should creditors be required to continue using Appendix Q to calculate and verify debt and income?**

[15]We recommend that the CFPB clarify that courts are only to consider the new test prospectively to avoid prejudicing challenges to loans originated under current tests that are less stringent.
[16] Lenders are free to set their own underwriting provisions and eligibility criteria as long as they comply with applicable law.
[17] See generally https://files.consumerfinance.gov/f/201308_cfpb_atr-qm-implementation-guide_final.pdf.

**Should the Bureau replace Appendix Q? If the Bureau retains Appendix Q, how should it be changed or supplemented?**

- **Summary Response to (3):** Until the CFPB task force can complete an evaluation of residual income as we describe in our response, we recommend the retention of some form of bright-line, standardized underwriting rules to achieve QM status. These rules could come in the form of a revised and more robust and nimble Appendix Q or a standardized underwriting model.

***Despite the consistency it provides, allow the QM Patch to expire…***

QM underwriting requires adherence to bright-line rules to evidence a borrower's presumptive ability to repay. The QM Patch, like Appendix Q, provides such rules.

The expiration of the QM Patch presents an opportunity to bring greater consistency to the ATR/QM rule by requiring agency and non-agency loans to adhere to the same standards. This requirement will help solve for what the CFPB perceived as a lack of guardrails on GSE credit standards and underwriting. Per the ANPR:

> "The Bureau also is concerned about presuming indefinitely that loans eligible to be purchased or guaranteed by the GSEs—whether or not the GSEs are under conservatorship—have been originated with appropriate consideration of consumers' ability to repay. Indeed, one GSE loosened its underwriting standards in ways that proved unsustainable." [18]

An assertive FHFA director could exercise control over the GSEs' standards and practices while the GSEs are in conservatorship, but the GSEs will presumably not always be in conservatorship, and there is no guarantee that the FHFA director will always be assertive in carrying out his or her statutory prudential obligations.

***…but only if Appendix Q is improved or replaced***

While we support expiration of the QM Patch, we do so only if the CFPB concurrently implements a solution to improve or replace current Appendix Q. We are concerned about the ability of the government and non-agency channels to absorb up to one-third of the GSE volume that will fall outside the GSE footprint when the Patch expires. Many of these loans that would otherwise have received QM safe harbor treatment will move to (i) FHA at higher costs to the borrower and greater risk to the government, (ii) fall into Non-QM or, to a lesser extent, QM rebuttable presumption status under current Appendix Q, also at a higher cost to the borrower, or (iii) not get made. Perhaps, more importantly, lenders to date have shown little appetite for making QM rebuttable presumption loans.

Over the last several years, many stakeholders have petitioned the CFPB regarding weaknesses, ambiguities, and unintended consequences of Appendix Q. These stakeholders routinely cite the rule's internal inconsistencies, a lack of guidance around ambiguous language, and rigid exclusions on important areas of underwriting including self-employment, non-traditional income and

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[18] See ANPR page 19, citing Bureau of Consumer Fin. Prot., Ability-to-Repay and Qualified Mortgage Rule Assessment Report (Jan. 2019), https://www.consumerfinance.gov/documents/7165/cfpb_ability-to-repay-qualifiedmortgage_assessment-report.pdf (page 194-95).

employment, and creditworthy borrowers in underserved markets. This is because Appendix Q is based on outdated FHA guidelines that do not reflect America's diverse, sociodemographic profile.

Stakeholders have delivered to the CFPB a wealth of proposed Appendix Q improvements that would help transform it into a more dynamic, nimble, and forward-looking tool that better defines QM safe harbor loans.[19] We recommend that the Bureau convene a working group of industry experts (including those with credit, underwriting, due diligence, compliance, and consumer expertise) to evaluate these proposals and collaborate with the CFPB on reforming Appendix Q.

***Extension of the QM Patch to non-agency loans?***

Some have suggested that, in place of Appendix Q, the CFPB should maintain the QM Patch and extend it to non-agency loans, even for loans with non-conforming loan balances. Supporters maintain that this would help level the playing field between the GSEs and the private sector.

We agree conceptually with this position because it supports our belief that QM status should be channel-agnostic, but we do not favor this proposal. It would solidify GSE duopolistic market power that would continue to control QM eligibility criteria. Furthermore, Fannie and Freddie control their respective automated underwriting systems (AUS) through which most GSE loans are underwritten. The GSEs maintain these tools as "black boxes," with no transparency into the embedded programming and algorithms. Once the GSEs exit conservatorship, this market penetration and opacity would help cement inappropriate authority over lending standards in the housing finance landscape to profit-maximizing shareholder-owned firms, unlike FHA and VA.

It is worth noting that Senators Warner and Rounds introduced a bill in the 115th Congress with a similar intent, incorporating by reference any methods or tools to verify income, assets, or employment used or permitted in government channel originations.[20] We supported this proposal in the Milken Blueprint, but with a caveat:

> "The CFPB should make certain that the selection of any such method or tool does not enable, constitute, or result in "cherry-picking," or selecting a favorable method or tool that only works properly in combination with other unselected methods or tools. Such cherry-picking could result in deficient underwriting that increases the

[19] For example, see https://structuredfinance.org/wp-content/uploads/2019/06/FINAL_SFIG_Comments_on_CFPB_ATR-QM.pdf, which co-author Eric Kaplan participated in formulating as part of a Structured Finance Association (f/k/a Structured Finance Industry Group) task force. We proposed revisions in the Milken Blueprint, as well: "The CFPB should also evaluate and implement a number of technical fixes that industry stakeholders have proposed since the ATR/QM rule development. Many suggestions would not adversely impact borrowers and, in fact, may actually help borrowers who were shut out from access to affordable, sustainable credit by the rule's initial formulation. These include proposed adjustments to documentation for self-employed borrowers, seasonal employment, non-traditional sources of income and assets, and numerous other topics." Milken Blueprint (page 16).
[20] See Sens. Warner and Round's Senate Bill 3401 in the 115th Congress. Note that the ATR/QM rule provides that, "When [A]ppendix Q does not resolve how a specific type of debt or income should be treated, creditors may rely on guidelines of the GSEs or certain federal agencies to resolve the issue. However, a creditor may not rely on GSE or agency guidelines where such guidelines are in conflict with [A]ppendix Q standards." See https://files.consumerfinance.gov/f/201603_cfpb_atr-qm_small-entity-compliance-guide.pdf (page 36).

> danger to systemic safety and soundness. Any applicable regulatory or legislative action should be drafted in a manner that prevents this unsound practice."

This provision would increase the flexibility of Appendix Q and help create more consistency across channels. We encourage the CFPB to consider this proposal but to investigate and, if necessary, establish guardrails around the potential for cherry-picking.

***We prefer a market utility or SRO***

In contrast to the stagnant Appendix Q, the GSEs continually update their QM criteria and underwriting engines updated as their credit policies, processes, and technologies evolve, and the housing finance landscape changes. To achieve this versatility, we would support an alternative longer-term solution by establishing a nonprofit utility or self-regulatory organization (SRO), reporting to the CFPB, that would be responsible for maintaining, evaluating, and revising QM standards and evaluation tools for agency and non-agency loans and acting in the best interest of the housing finance system as a whole.[21]

A consortium with a rotating, independent board drawn from diverse representative stakeholder groups (including industry and consumer representatives) would govern the utility or SRO. The bylaws would make governance and transparency paramount and reflect a public mission to maintain and evolve QM standards in the public interest and on behalf of the CFPB. A *de minimis* "toll" per mortgage loan in the agency and non-agency channels would fund the utility or SRO, and such toll would not count towards points and fees for purposes of QM calculations.

***The utility or SRO could also leverage DU***

We would support the development of an AUS within the utility or SRO that lenders could license to underwrite loans to QM criteria (similar to using DU or LP currently for GSE loans). As a practical matter, DU enjoys (i) strong penetration into the industry, (ii) first-class technology, and (iii) solid loan performance results over time.[22] We recommend that the CFPB and FHFA together explore what it would take to establish a DU-centric credit and technical infrastructure to maintain the tool as a "living, breathing" system going forward.[23]

We would also be open to maintaining a market QM underwriting facility within the Common Securitization Platform (CSP) run by Common Securitization Solutions (CSS), but only if the FHFA directs the removal of CSS from GSE control and the evolution of the CSP into a market utility. We would still insist on full transparency, independence, and a public purpose.

***Creating an SRO or market utility are very big lifts; it is much easier to fix Appendix Q or replace it with an alternative rule***

While not the living, breathing solution of a continually maintained market utility AUS, revising or

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[21] We note that Andrew Davidson & Co., Inc, among others, has recommended a similar proposal ([https://www.ad-co.com/analytics_docs/QM-Patch.pdf](https://www.ad-co.com/analytics_docs/QM-Patch.pdf)). We would envision that the CFPB would have approval power over any new QM rule and revisions going forward.
[22] For example, approximately one-third of annual loan originations are Fannie Mae loans, most of which are underwritten using DU.
[23] This arrangement might prove challenging as Fannie Mae is a privately-owned going concern and DU its intellectual property. However, it would be worth the discussion to help the CFPB understand its options.

substituting a different method for Appendix Q is likely more of a near-term solution than a market utility or SRO. We, therefore, encourage the CFPB to focus on the revision or replacement of Appendix Q and concurrently explore the forward-looking development of a market utility AUS and true residual income test.

4) **If the Bureau does not retain Appendix Q or permits use of an alternative, what standard should the Bureau require or permit creditors to use to calculate and verify debt and income? Should the Bureau specify in Regulation Z an existing version of a widely used method of calculating and verifying debt and income that creditors would be required to use? Alternatively, to provide flexibility to creditors, should the Bureau combine a general requirement to use a "reasonable method" with the option to use, as a safe harbor, a specified, existing version of a widely used method for calculating and verifying debt and income? If the Bureau were to specify an existing version of a widely used method for calculating and verifying debt and income under either of the approaches described in this paragraph, which method (or methods) should be allowed? Should Appendix Q be one of them?**

    - **Summary Response to (4):** The CFPB should reserve QM status to those loans that demonstrate a presumptive, clear ability to repay. Prescriptive QM rules that afford certainty to the market are critical. The eight ability to repay underwriting factors reflect reasonable "common-sense" underwriting criteria, but allow too much variation to provide the required certainty. We recommend improvements to QM standards below.

***Potential Appendix Q replacement: APOR+150***

We applaud the efforts of diverse coalitions that have come together to brainstorm on ATR/QM rule revisions and responses to the ANPR. At least one such well-represented proposal would eliminate the DTI threshold for prime and near-prime loans, defined as falling within the current QM safe harbor-pricing threshold of APOR+150. The proposal would also eliminate Appendix Q but maintain the current safe product restrictions and the eight statutory underwriting factors required to demonstrate an ability to repay.[24]

We agree that the CFPB should maintain the safe product restrictions and the eight underwriting factors. These sound policies address notable ills that factored into the financial crisis and wreaked havoc on consumers, industry, and the economy. However, we are concerned about eliminating Appendix Q without replacing it with alternative standardized QM criteria and eliminating DTI requirements outright.

[24] See https://www.regulations.gov/document?D=CFPB-2019-0039-0017, submitted by a coalition of 23 industry, consumer advocacy, and civil rights organizations.

*Eliminating Appendix Q and DTI for loans that meet the QM safe harbor threshold*

We are concerned that the APOR+150 proposal could convert what would currently constitute Non-QM loans into QM safe harbor loans as long as the APRs fell within the APOR+150 basis point threshold (and QM rebuttable presumption loans if the APRs fell within APOR plus a higher margin of, say, 250 or 300 basis points).

On the positive side, this approach would enhance flexibility in lending standards and allow lenders to utilize their expertise in expanding access to mortgage credit. There would be no need to evolve Appendix Q. And the eight ATR underwriting factors reflect standard common sense underwriting that affords some protection against past underwriting abuses. The CFPB also provides some guidance around the eight underwriting factors, although this guidance is not comprehensive and leaves room for lenders to exercise their credit and underwriting judgments.[25]

On top of that, the pricing threshold would serve as a guardrail against riskier loans obtaining the QM stamp, because riskier loans should carry higher prices that at some point would fall outside the threshold. The approach posits that the pricing threshold would weed out riskier loans and underwriting practices and filter in safer loans and underwriting practices.

We do believe that this approach would result in a larger QM safe harbor bucket that allows for flexible and innovative underwriting and the potential inclusion of borrowers with non-traditional credit and financial profiles who do not currently meet rigid QM criteria.

However, there are caveats to this approach.

*Inconsistency of underwriting guidelines*

This approach would effectively allow every lender to create its own QM Patch, as long as the lender met the eight ability to repay underwriting factors when originating a loan and priced the loan within the applicable QM threshold. As much as the ATR underwriting factors reflect common sense underwriting, we must point out the wide variances in underwriting guidelines the eight factors allow. The inconsistent methods by which non-agency lenders attempt to satisfy the eight ATR factors would replace the consistency and standardization of Appendix Q (and for that matter, the QM Patch). In addition, many industry participants believe certain underwriting practices currently in use reflect materially weaker underwriting standards – certainly not deserving of QM presumption.

Practically speaking, current Non-QM underwriting cannot be said to produce ATR-compliant loans unless and until a borrower raises a challenge and a court rules in the lender's favor. Lenders may believe their methods and decisions are ATR-compliant, and the more thorough and conservative their standards, the safer they likely are in their assumption. Even due diligence firms merely confirm that lenders met the eight underwriting factors without opining on ATR compliance.[26]

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[25] See https://files.consumerfinance.gov/f/201603_cfpb_atr-qm_small-entity-compliance-guide.pdf (generally).

[26] To the extent it has not done so, we encourage the CFPB to obtain and review Non-QM underwriting guidelines or speak with due diligence firms and rating agencies who have done so to understand the extensive variance among these guidelines.

Non-QM borrowers currently enjoy enhanced consumer protections and can challenge lenders' ability to repay decisions. The burden is on the lender to prove that they adhered to the eight factors and made a good faith, reasonable determination of the borrower's ability to repay. The proposed change would complicate judicial review and dilute consumer protections. The QM safe harbor legal protection would likely prevent judges from considering the *quality* of the lender's methods and ATR determination. Doing otherwise would negate the safe harbor and inject uncertainty into QM safe harbor lending—uncertainty from which such lending is designed to be free.

Under this construct, application of the safe harbor or even the rebuttable presumption to what currently constitutes Non-QM underwriting would shift the burden to the borrower of proving a lender failed to consider the eight underwriting factors and that the lender's ATR determination was reasonable and in good faith. Under the safe harbor, it would also eliminate the risk to a shoddy lender that its underwriting would fail judicial ability to repay review. While this protects lenders, we fear it could facilitate a significant weakening of underwriting standards without adequate consumer protections, which runs counter to the heart of the ATR/QM rule.

Thus, substituting Non-QM underwriting criteria in place of current QM criteria would either bestow safe harbor or rebuttable presumption protection even on weak underwriting practices, or vitiate these protections by allowing a judge to rule against the ATR presumption that adherence to the QM criteria is supposed to convey. Neither alternative is acceptable.

***Does the APOR+150 threshold truly mitigate risk?***

The existing safe harbor-pricing threshold does instill guardrails on lending standards through primary and secondary market dynamics. The secondary market demands a higher yield for risk, and lax underwriting standards or greater loan-level risk could drive a loan's price above the safe harbor threshold.

However, certain elements factor into loan pricing or borrowers' cost of credit that have nothing to do with the borrower's ability to repay, and the CFPB should eliminate these from a borrower's APR calculation for purposes of determining whether a loan is a QM safe harbor or rebuttable presumption loan.

There is also a risk of "bunching" just under the threshold. This dynamic would push loans that fall just outside the QM safe harbor border into the safe harbor bucket. Non-agency pricing, particularly in the context of loans slated for private-label securitization, will factor in the cost of risk retention and increased credit enhancement for expanded credit Non-QM or QM rebuttable presumption loans, as applicable. The additional costs imposed on loans that fall into these categories could drive lenders or issuers to discount their pricing up to the amount of these extra costs.[27] Loans that should fall outside the QM safe harbor could price within the QM threshold, reducing the borrower's consumer protections and underpricing the risk of the loan.

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[27] For further discussion, see http://www.redwoodtrust.com/Cache/1001256393.PDF?O=PDF&T=&Y=&D=&FID=1001256393&iid=103579 (page 7).

***What about QM rebuttable presumption loans?***

Some supporters of the APOR+150 approach recommend setting a higher threshold of APOR plus 250 or 300 basis points for QM rebuttable presumption loans and keeping the DTI threshold for QM rebuttable presumption loans at 43 percent. The CFPB should look carefully at this DTI level to ensure that it does not prevent qualified borrowers who merit QM loans—in particular, low-to-moderate income borrowers—from accessing QM loans. The pricing dynamics that would cause an APR to exceed the safe harbor threshold reflect a riskier loan that merits stronger consumer protections. Under any scenario that retains a DTI test, we urge the CFPB to maintain standardized DTI calculations to avoid inconsistencies that could weaken these consumer protections and underprice risk. As we discussed earlier, using different DTI definitions destroys the integrity of the metric. For example, one lender can calculate a 35 percent DTI and a second lender a 45 percent DTI using the same information but different definitions. The potential for significant inconsistency undermines the consistency and confidence necessary to support presumptive ATR treatment for QM loans.

**<u>A potential compromise</u>**

We recognize that any policy other than our ideal, long-term true residual income test must reflect CFPB's judgment. We also acknowledge that setting workable policies often requires compromise. In that light, should the CFPB be inclined to eliminate Appendix Q and DTI limits in favor of the APOR+150 or a similar test, we propose the following hybrid solution as a compromise.

***Hybrid Compromise Revised ATR/QM Rule (see Figure 1 below)***

We recommend granting:

- **QM safe harbor** status to any loan that (i) prices within the APOR+150 threshold, (ii) complies with revised Appendix Q (including a maximum 50 percent DTI), and (iii) for borrowers that exceed a 45 percent DTI, passes the Interim Residual Income Test, unless the borrower qualifies under the payment shock, housing history, and stable income exceptions.[28]
- **QM rebuttable presumption** status to any loan that (i) prices above the APOR+150 threshold, (ii) complies with revised Appendix Q (including a maximum 50 percent DTI), and (iii) passes the Interim Residual Income Test at all DTIs and with no exceptions.
- **QM rebuttable presumption** status to any loan that (i) prices within the APOR+150 threshold, and (ii) does not comply with revised Appendix Q but does meet the eight ATR underwriting factors.
    - Lenders would remain subject to the current non-bright-line "insufficient residual income" challenge applicable to QM rebuttable presumption loans because DTI and residual income calculations could be inconsistent with the corresponding tests in revised Appendix Q, and courts would have to evaluate each case on its own merits.[29]

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[28] We would consider a further increase of the DTI ceiling for QM loans of up to 55 percent DTI. However, the CFPB should evaluate performance data and strongly consider requiring additional compensating factors to support any such increase. Perhaps a loan of this nature could fall within the QM rebuttable presumption category.

[29] The CFPB's Interim Residual Income Test could be a useful reference point for loans subject to the non-bright-line "insufficient residual income" challenge.

- **Non-QM** status to any loan that (i) prices above the APOR+150 threshold, and (ii) does not comply with revised Appendix Q but does meet the eight ATR underwriting factors.
    - We also recommend that Non-QM loans be subject to the same non-bright-line "insufficient residual income" challenge as QM rebuttable presumption loans that do not comply with revised Appendix Q, as this ability to repay factor is just as critical for Non-QM borrowers as it is for QM rebuttable presumption borrowers.

*(Figure 1)*

**PROPOSED HYBRID COMPROMISE REVISED ATR/QM RULE**

| | QM Safe Harbor Loans | QM Rebuttable Presumption Loans | QM Rebuttable Presumption Loans | Non-QM Loans |
|---|---|---|---|---|
| Pricing Threshold | APR ≤ APOR+150 | APR > APOR+150 | APR ≤ APOR+150 | APR > APOR+150 |
| Revised Appendix Q Compliance | Yes | Yes | No | No |
| DTI Limit (%) | 50 | 50 | No prescribed limit | No prescribed limit |
| Interim Residual Income Test | Yes – DTI > 45 | Yes – all DTIs | No | No |
| Exemptions from Interim Residual Income Test (based on specified compensating factors) | Yes, if:<br>1) 12 months clean housing history;<br>2) No or negative payment shock; and<br>3) No material income decline over prior 12 months | None | N/A | N/A |
| Subject to Existing (Ambiguous) "Insufficient Residual Income" Challenge | No | No | Yes | Yes |
| Must Meet 8 ATR Underwriting Factors | Yes (lender has safe harbor presumption) | Yes (lender has rebuttable presumption) | Yes (lender has rebuttable presumption) | Yes (lender has burden of proof) |

***Revised ATR/QM Rule Performance-Based Relief Test (see Figure 2 below)***

We would also implement a performance-based rest test that would allow a transition for loans from one category to a higher category. This feature would help alleviate lender exposure without sacrificing consumer protections. Currently, the ATR/QM rule commentary provides that loan performance is evidence but not proof of a borrower's ability to repay the loan.[30] We recommend that the CFPB revise the rule to provide that, after a certain period of performance:

- A Non-QM loan becomes a QM rebuttable presumption loan;
- A QM rebuttable presumption loan becomes a QM safe harbor loan; and
- A QM safe harbor loan is granted relief from the ATR/QM test, and the borrower deemed conclusively to display an ability to repay.

We recommend the following as the revised ATR/QM rule performance-based relief test:

1) For Non-QM loans: the loan becomes a QM rebuttable presumption loan if the borrower makes timely payments (i.e., no 30-day-late or worse) for the first 24 monthly payments due under the loan.[31]
2) For QM rebuttable presumption loans: the loan becomes a QM safe harbor loan if the borrower makes timely payments for (i) the first 24 monthly payments due under the loan, for loans that begin as QM rebuttable presumption loans, or (ii) the first 12 monthly payments due under the loan immediately following conversion of a Non-QM loan to a QM rebuttable presumption loan pursuant to the test set forth in (1) above.
3) For QM safe harbor loans: the loan is granted relief from the ATR/QM test and the borrower deemed conclusively to display an ability to repay if the borrower makes timely payments for (i) the first 24 monthly payments due under the loan, for loans that begin as QM safe harbor loans, or (ii) the first 12 monthly payments due under the loan immediately following conversion of a QM rebuttable presumption loan to a QM safe harbor loan pursuant to the test set forth in (2) above.
4) Once a loan breaches a timely payment test, the loan would remain in whatever bucket it is in at the time of the delinquent payment.[32] Each prong would be a "one-shot" test, meaning the timely payment clock does not reset and the loan would remain in its current bucket going forward. Failure of any timely payment test would not be conclusive evidence of a borrower's inability to repay, although a judge would be able to evaluate the underlying facts that led to the test failure.

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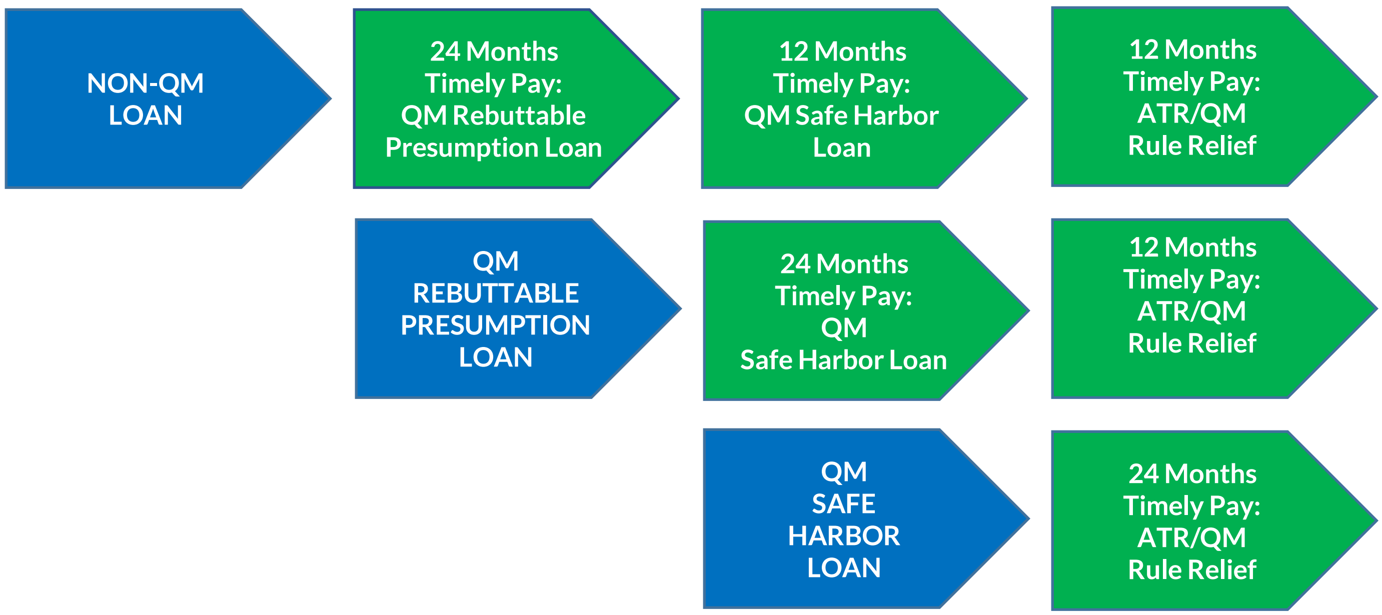
[30] See https://www.federalregister.gov/documents/2013/01/30/2013-00736/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z (at printed page 6462).
[31] By "30-day-late," we mean the "MBA method" of calculating delinquency – i.e., the monthly payment is not made by the end of the calendar month in which such payment is due, with equivalent rules for odd due date and non-monthly payment loans.
[32] A loan that moves into a higher bucket (e.g., Non-QM to QM rebuttable presumption and so on), would therefore retain its status in the higher bucket once attained, and can never drop (or drop back down) into a lower bucket.

*(Figure 2)*

**REVISED ATR/QM RULE PERFORMANCE-BASED RELIEF TEST**




The performance test framework would afford sufficient time for the loan's performance to reflect on the lender's underwriting standards and ATR determination, and provide clarity, certainty, and relief to lenders where appropriate without sacrificing consumer protections.

**Time to implement revisions**

It is important that revisions to the ATR/QM rule coincide with the expiration of the QM Patch. Ideally, the CFPB should provide between six to twelve months' lead time to allow market participants to prepare their policies and processes, or such other period required by general industry consensus.

**Conclusion**

The Milken Institute appreciates the opportunity to share our views on the QM rule ANPR. This is a pivotal time in housing finance. Through its decisions, the CFPB can reconstruct the primary market gates and better define safety, soundness, and opportunity for borrowers, industry participants, and the overall economy. There is a baby in the initial iteration of the ATR/QM rule, and there is bathwater, however unintended. We look forward to continued dialogue and collaboration with you and other stakeholders in evaluating responses to the ANPR and improving the ATR/QM rule so that it can serve the needs of the future housing finance ecosystem.

Sincerely,

**Milken Institute – Center for Financial Markets**
Eric Kaplan – Director, Housing Finance Program
Michael Stegman – Senior Fellow
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