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Defining Prudent Underwriting: An International Struggle

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In an attempt to insulate credit markets from the high-risk residential mortgage lending activities that threatened the global financial system in 2008, regulators both in the United States and elsewhere are seeking to impose stricter residential mortgage underwriting standards. Specifically, the U.S. Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act[1] ("Dodd-Frank") in part to create "Grade-A" designations for residential mortgage loans that meet stringent underwriting requirements and other criteria. Those loans may enjoy a presumption of compliance with certain federal laws, and some may also be exempt from economic risk retention requirements that will apply to other loans.

Meanwhile, the Financial Stability Board ("FSB"), an international body that monitors and makes recommendations about the global financial system, issued Principles for Sound Residential Mortgage Underwriting Practices[2] (the "FSB Principles" or the "Principles") for consideration by the FSB's participating jurisdictions.[3] While the Principles do not delve into the details of specific underwriting practices, even to the extent of Dodd-Frank, they do suggest a targeted approach to imposing stricter requirements.

As described below, while many agree on the end-goal of achieving tighter residential mortgage underwriting, the devil is in the details. The FSB, like the regulators in the U.S. and elsewhere, is struggling to define any actual standards or specific criteria for achieving that goal. That lack of clarity spooks creditors and investors in the residential mortgage market, and threatens the supply of available mortgage credit, particularly for first-time and low-income borrowers. Without clearer standards, lenders may shy away from making loans to anyone, particularly those with less than stellar credit. Moreover, without greater certainty with respect to assignee liability and risk retention requirements, secondary mortgage market participants may lose their appetite for purchasing or securitizing loans that do not meet the highest underwriting criteria.

FSB Principles of Sound Residential Mortgage Underwriting Practices

The FSB, based in Basel, Switzerland, was established after the 2009 G-20 London summit as a successor to the Financial Stability Forum ("FSF"). The FSB includes all G-20 major economies,[4] prior FSF members, and the European Commission. On April 18, 2012, the FSB issued its Principles, expressly seeking to develop "an international principles-based framework for sound underwriting practices." The Principles include standards regarding: (A) effective verification of income and other financial information; (B) reasonable debt service coverage; (C) appropriate loan-to-value ratios; (D) effective collateral management; and (E) prudent use of mortgage insurance.

The FSB Principles suggest best practices to be implemented in some fashion by member jurisdictions. However, as the FSB itself is not a regulatory body, the Principles do not attempt to establish specific rules that must be implemented or enforced. For example, the Principles do not mandate international loan-to-value ratios or down payment requirements, nor do they prohibit specific loan features. Indeed, the FSB acknowledges that the Principles are not meant to be a one-size-fits-all approach to international underwriting standards. The FSB states that the Principles "should be implemented according to national circumstances, and as appropriate to national institutional arrangements, whether through legislative, regulatory, or supervisory measures, or through industry practices." While deferring to local implementation, the Principles emphasize that the consequences of weak residential mortgage underwriting practices in one country can be transferred globally through securitization of mortgages underwritten to weak standards.

The Principles are predicated on safety and soundness considerations – to improve institutions' (and markets') financial stability. They focus only on the credit-granting decision itself, and do not delve into other responsible practices, such as those related to post-origination loan servicing or administration, or overall credit risk management. Most notably, the Principles are not predicated on consumer protection (although strict underwriting, to the extent it lowers default and foreclosure rates, benefits consumers in general).

United States Proposed Rules: Ability to Repay/Qualified Mortgage and Risk Retention/Qualified Residential Mortgage

While the FSB Principles offer very high-level recommendations regarding residential mortgage underwriting, the United States in contrast is attempting to establish somewhat more detailed designations for strictly underwritten "Grade-A" mortgage loans. Dodd-Frank approaches underwriting discipline and imposes other restrictions through both a mandated ability-to-repay determination and a requirement to retain economic risk on the issuance of securities. Dodd-Frank then requires those agencies to define two sets of mortgage loans representing enhanced underwriting standards and other characteristics that can enjoy relief from those requirements: the Qualified Mortgage ("QM") and the Qualified Residential Mortgage ("QRM").

The Federal Reserve Board ("FRB") issued a proposed rule last year regarding Dodd-Frank's ability-to-repay determination and the scope of the QM definition ("the QM proposed rule").[5] As a proposed regulation under the Truth in Lending Act, the QM proposed rule was inherited by the Consumer Financial Protection Bureau ("CFPB"), which is currently working on a final rule, which may be issued this summer. With respect to the economic risk retention requirement in securitizations and the QRM definition, the FRB, Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission ("SEC"), Federal Housing Finance Agency ("FHFA"), and Department of Housing and Urban Development ("HUD") issued a proposed rule in 2011 ("the QRM proposed rule"),[6] and are currently considering public comments and crafting a final rule.

Ability to Repay/Qualified Mortgage Proposed Rule

Under Dodd-Frank and the QM proposed rule, a creditor is generally required to undertake stricter underwriting of residential mortgage loans, but arguably would have certain alternatives for meeting that requirement. Dodd-Frank requires a creditor to make a reasonable and good faith determination that a consumer of a residential mortgage loan will have a reasonable ability to repay the loan according to its terms, including any mortgage-related obligations. In making that determination, the creditor must consider the consumer's current or reasonably expected income or assets, current employment status (as applicable), monthly payments on the proposed loan and on any known simultaneous loan, current debt obligations, debt-to-income ratio, or residual income, and credit history.

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A creditor that seeks more certainty in assuring that it has originated a compliant residential mortgage loan may, however, make a QM and take advantage of Dodd-Frank's presumption that such a loan satisfies the ability-to-repay requirement described above. The QM designation requires that a loan not just meet strict underwriting requirements but also be free of certain risky mortgage loan features. The CFPB is considering two options for defining a QM loan.[7] Under one option (the "safe harbor" option), if a creditor originates a QM, the creditor (and its assignee) will be *deemed* to have complied with the ability-to-repay requirement described above. Under the other option (the "presumption" option), a creditor or assignee of a covered transaction is *presumed* to have complied with the ability-to-repay requirement.

The first option, which would operate as a safe harbor of compliance with the ability-to-repay requirement, would define a QM as one with the following characteristics:

- The loan does not contain negative amortization, interest-only payments, or balloon payments, or a loan term exceeding 30 years;
- The total points and fees do not exceed 3% of the total loan amount;
- The borrower's income or assets are verified and documented; and
- The underwriting of the mortgage: (A) is based on the maximum interest rate in the first five years; (B) uses a payment schedule that fully amortizes the loan over the loan term, and (C) takes into account any mortgage related obligations.

While meeting this safe harbor requires verification and documentation of the borrower's income or assets (i.e., an analysis of the borrower's ability to repay), it also requires originating a loan without certain risky features or high up-front costs to the borrower.

The second option would operate as a rebuttable presumption of compliance with the ability-to-repay requirement (and thus provide less certainty to creditors and their assignees). Under that alternative, in order to originate a QM, the loan would have to include all of the verification, documentation, and other features described above, *and* the creditor would be required to consider and verify the following *additional* information:

- The consumer's employment status;
- The monthly payment for any simultaneous loan,
- The consumer's current debt obligations;
- The total debt-to-income ratio or residual income; and
- The consumer's credit history.

Although the creditor would only have the benefit of a *presumption* of compliance with the ability-to-repay determination, the creditor would be responsible for considering several additional factors of the borrower's ability to repay. As this proposed QM definition requires the consideration of the consumer's credit history, the creditor also would be required to analyze a factor related to the consumer's *willingness* to repay.[8]

The U.S. mortgage industry is waiting anxiously for the CFPB's final rule defining QMs, as creditors have a strong (some would argue insurmountable) incentive to originate only those loans. Loans falling outside of the QM definition would not be prohibited, but will be subject to scrutiny for noncompliance with the ability-to-repay requirement, and the greater risk of liability for both creditors and assignees. The final rule is expected late this year.

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Risk Retention/Qualified Residential Mortgage Proposed Rule

Congress also established (but did not define) another set of "Grade-A" residential mortgage loans, QRMs, required by statute to be a subset of QMs. In general, in order to instill discipline in the underwriting and origination of loans (including residential mortgage loans), Dodd-Frank requires securitizers to retain 5% of the credit risk in connection with loans pooled into securities, unless an exception applies. Dodd-Frank then created an exception to that risk retention requirement for QRMs (and other types of loans), in order to provide an incentive to originate those exempted loans.

Dodd-Frank tasked several federal agencies to define QRMs. In summary, the QRM proposed rule would mandate a (controversial) 20% down payment, verified borrower credit history, and specific loan-to-value and debt-to-income ratios. With respect to product features, a QRM loan must not contain negative amortization, interest-only payments, or balloon payments, or a term exceeding 30 years. Moreover, for adjustable-rate QRMs, the interest rate increases must not exceed: (A) 2% in any 12 month period; or (B) 6% over the life of the mortgage transaction. Although Dodd-Frank directed the agencies to establish a definition of QRMs based upon historical data indicating a lower default risk, the QRM proposed rule includes factors beyond the origination of the loan, including standards for servicing the loan. For example, as proposed, a QRM loan would have to incorporate loss mitigation features, such that a creditor must initiate specified loss mitigation activities within 90 days after the mortgage loan becomes delinquent.

Like the QM designation, creditors will have an incentive to originate loans that constitute QRMs, because QRMs are exempt from the 5% credit risk retention requirements that Dodd-Frank imposes upon securitizers. Note, however, that Dodd-Frank also exempted from the risk retention requirement loans that are insured or guaranteed by the FHA or VA, respectively. Further, the QRM proposed rule would exempt mortgage-backed securities that are issued and guaranteed by Fannie Mae or Freddie Mac, as long as those entities remain under the FHFA's conservatorship. As exempted FHA/VA/Fannie Mae/Freddie Mac loans currently make up the bulk of the U.S. residential mortgage market, the main thrust of the incentive to originate QRM loans will only come when and if Fannie Mae and Freddie Mac are no longer subject to the conservatorship.

Similarities among the FSB Principles and United States Proposed QM/QRM Designations

Despite their structural differences at this stage, the FSB Principles and United States proposed QM and QRM designations share several themes, but with varying granularities.

Verification and Documentation of Income

The FSB Principles and United States QM/QRM designations both focus on verification and documentation of the potential borrower's income. The FSB Principles, for example, encourage jurisdictions to ensure that lenders inquire into and verify an applicant's income, document income history for each applicant, and maintain records of such documentation. The Principles further provide that income verification should be derived from "authoritative sources," and that when fraud is detected, recourse should be available to the jurisdiction's legal system. Finally, the Principles encourage jurisdictions to look beyond a borrower's income (which measures one's *ability* to repay), and look to other financial information that sheds light upon the borrower's *propensity* to repay.

In like fashion, income verification is a key element of the QM proposed rule. With respect to the QM designation, as discussed above, both proposed alternatives (the safe harbor and the presumption) require that a creditor consider the consumer's current or reasonably expected income or assets, other

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than the value of the dwelling that secures the loan. Moreover, with respect to the presumption alternative, the QM proposed rule would require that if the creditor relies on income from the consumer's employment in determining repayment ability, the creditor must consider and verify the consumer's current employment status (which may be verified orally, as long as the creditor prepares a record of the information). Next, the QM proposed rule would require, with respect to both the safe harbor and presumption alternatives, that a creditor must verify the borrower's income or assets using third-party records that provide reasonably reliable evidence (e.g., an IRS tax return).[9] Thus, unlike the FSB Principles, which merely suggest that a borrower's income be verified by "authoritative sources" (which undoubtedly vary by jurisdiction, occupation, and borrower), the QM proposed rule attempts to flesh out those requirements somewhat by pointing to reliable sources and methods of income verification.

The QRM proposed rule does not contain a comparable verification of income requirement. However, as we note above, FHA/VA loans and Fannie Mae/Freddie Mac mortgage-backed securities are exempt from the risk retention requirement without having to qualify as QRMs, and those entities generally impose requirements to consider, verify, and document income.

"Debt Service Coverage"

By addressing "debt service coverage," the FSB emphasizes the importance of a broad consideration of the borrower's ability *and propensity* to repay the loan. Among other factors, the FSB Principles urge jurisdictions to require lenders to consider a borrower's other debt obligations and nondiscretionary expenditures in addition to the mortgage loan, as well as the borrower's expected income over the loan term. Similarly, assessing a borrower's aggregate debt obligations is key in both the QM and QRM proposed rules.

Specifically, the FSB Principles provide that a lender should consider the potential borrower's other obligations, including the level of other debt (secured and unsecured), the interest rate and outstanding principal on that debt, and any evidence of delinquency. The Principles recommend establishing maximum debt-to-income ratios, and indicate that lower maximum ratios may be warranted in certain circumstances (such as when there are risks of a real estate bubble in all or part of the market).

Moreover, the Principles suggest that lenders should discount temporarily high borrower incomes and should not assume continued real estate appreciation. Further, if the loan extends past normal retirement age, the Principles would require the lender to take appropriate account of the adequacy of the borrower's likely income and repayment capacity – a requirement that would likely draw close scrutiny from civil rights lawyers in the United States seeking to prevent age discrimination.

The QM and QRM proposed rules similarly incorporate measuring a borrower's total credit obligations (without expressly referring to whether, for example, a borrower is reaching retirement age). While the QM safe harbor option would focus on a borrower's income and assets, the presumption option would require further considerations regarding the consumer's credit carrying capacity or propensity to repay. Specifically, the QM presumption alternative would require consideration of the borrower's ability to make monthly payments for any simultaneous loan, the total debt-to-income ratio or residual income, and the consumer's credit history. At this time, those QM proposals do not include specific ratios or other numbers.[10]

In contrast, the QRM proposed rule would set specific numerical parameters regarding a borrower's ability to service the debt. Specifically, in order to qualify as a QRM, the creditor must determine, as of a date no more than 60 days prior to closing, that the ratio of the borrower's monthly housing debt to the borrower's gross income does not exceed 28%, and that the ratio of the borrower's total

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monthly debt to the borrower's monthly gross income does not exceed 36%. Moreover, in order for a loan to be considered a QRM, the creditor must verify and document within 90 days prior to the closing that: (A) the borrower is not currently 30 days or more past due, in whole or in part, on any debt obligation; (B) within the previous 24 months, the borrower has not been 60 days or more past due, in whole or in part, on any debt obligation; and (C) within the previous 36 months, the borrower has not been subject to certain bankruptcy proceedings, personal property repossession, or a foreclosure, deed-in-lieu, or short-sale on a one-to-four family property.[11]

Loan-to-Value Ratios

Both the FSB Principles and the QRM proposed rule address loan-to-value ("LTV") ratios. (The QM proposed rule does not suggest standards for LTV ratios, maximum loan amounts, or down payment requirements.) However, the FSB Principles do not encourage the member jurisdictions to impose a hard cap on LTV ratios in all circumstances (although they state that jurisdictions may want to consider prohibiting loans with LTVs over 100%). Instead, they suggest that jurisdictions adopt "prudent" LTV ratios with an "appropriate" level of down payment that is derived from the borrower's own finances. Moreover, the Principles suggest that the LTV ratio must be calculated from the "real value" of available equity. That value could be calculated on the basis of a robust and prudent approach to property appraisals, considering all loans that are collateralized against the same property, and fully assessing any increases in loan authorization. The FSB Principles also encourage jurisdictions to ensure that lenders refrain from relaxing LTV ratio standards during real estate booms. To the contrary, the FSB Principles indicate that jurisdictions should require lenders to consider lower LTV ratios when there are risks of a real estate bubble in all or part of the market. Similarly, jurisdictions with prolonged foreclosure processes may want to require lower LTV ratios.

In contrast, the QRM proposed rule would address LTV ratios, and the related factor of down payment sufficiency, head on. In order for a purchase money mortgage on a one-to-four family dwelling to be considered a QRM, the LTV would not be allowed to exceed 80% at the time of closing, without any consideration of whether the loan has mortgage insurance. For refinancing, the LTV limits are proposed to be even lower, at 75% for a rate-and-term refinancing, and a mere 70% for a cash-out refinancing. Thus, for QRM loans, the borrower would have to make a substantial down payment, plus provide cash to pay closing costs.

While the QRM proposed rule seeks to provide clear boundaries and promote loans with an historically low likelihood of default, this 20% down payment requirement has led many in the U.S. mortgage industry to argue that the agencies have tipped the balance too far. Such a substantial buy-in requirement, without considering whether the borrower purchased private mortgage insurance to cover the risk of default, is predicted by some to erect a huge obstacle to the availability of affordable mortgage credit, particularly among certain populations and in certain localities, without being an essential predictor of default. The QRM proposed rule does not provide any flexibility in that strict requirement – even if the borrower presents other compensating factors (like significant income or assets that would tend to decrease the likelihood of default). Thus, the QRM proposed rule takes a markedly stringent approach, not present in the FSB Principles (or even the QM proposed rule), and threatens the balance between prudent underwriting and credit availability.

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Collateral Management

The FSB Principles recommend that an appraiser must be independent from a lender's mortgage processing, underwriting, and origination processes, and should be skilled and diligent. Similarly, United States policymakers have demanded higher appraisal standards – for example, by requiring complete appraiser independence in connection with mortgage loan underwriting. Specifically, Regulation Z of the Truth-in-Lending Act generally prohibits a person who prepares a valuation or performs valuation management services from having an interest, financial or otherwise, in the property or the transaction, and addresses separations between the property valuation function and the loan production function.[12]

Compliance with Regulation Z's appraiser requirements is necessary generally for all U.S. mortgage loans. However, the QRM proposed rule also emphasizes the importance of solid property valuation. The QRM proposed rule would require, among other things, that a QRM be supported by a written appraisal that conforms to generally accepted appraisal standards, as evidenced by the Uniform Standards of Professional Appraisal Practice, the appraisal requirements of the federal banking agencies, and applicable laws. The U.S. agencies, like the FSB, recognize that an appraisal must be prepared by an independent third party who is experienced, competent, and knowledgeable.

Points of Divergence -- The U.S. Goes Further

Notwithstanding numerous thematic similarities, there are several important points of departure between the FSB Principles and the United States QM/QRM designations.

Mortgage Insurance

The FSB Principles acknowledge that lenders in certain jurisdictions use mortgage insurance as a form of credit support for mortgage loans, and as a way to provide additional financing flexibility for lenders and borrowers. Nevertheless, the FSB Principles suggest that, notwithstanding the presence of mortgage insurance, a lender should conduct its own thorough due diligence regarding a borrower's ability to repay. They also urge jurisdictions to subject all mortgage insurers to appropriate prudential and regulatory oversight, including their exposure to risk concentrations.

The QM proposed rule does not address mortgage insurance (other than in connection with calculating points and fees). However, as indicated above, the QRM proposed rule expressly forbids the consideration of a borrower's purchase of mortgage insurance to soften the 20% down payment requirement. Thus, private mortgage insurance (often relied upon by first-time or lower-income home buyers in the U.S.) would not assist a loan in escaping risk retention. Many comments from the public on the QRM proposed rule urge the regulators to change that position.

Servicing and Loss Mitigation Requirements

United States regulators, at both the federal and state levels, are keenly focused on residential mortgage loan servicing practices and loss mitigation efforts. While loss mitigation efforts are key to avoiding foreclosures and minimizing losses, it is not immediately clear that servicing and loss mitigation practices are a necessary feature of the credit decision itself or of heightened underwriting standards. Nonetheless, in the QRM proposed rule, the agencies assert that timely initiation of loss mitigation activities often reduces the risk of subsequent default, and that up-front disclosure of the policies and procedures governing a servicer's loss mitigation activities will inform borrowers and provide clarity regarding the consequences of default (thus arguably reducing the likelihood of default). As a result, the QRM proposed definition would incorporate required default mitigation standards. Specifically, a mortgage originator must commit, among other things, to: (A) mitigate the risk of default on the mortgage loan by taking loss mitigation actions, such as loan modification or other loss mitigation alternatives, in the event the estimated net present value of such action exceeds the estimated net value of recovery through foreclosure (without regard to whether the particular action benefits the interests of a particular class of investors in a securitization); (B) take into account the borrower's ability to repay and other appropriate underwriting criteria in such loss mitigation actions; and (C) initiate loss mitigation activities within 90 days after the mortgage loan becomes delinquent (if the delinquency has not been cured). Moreover, the originator must disclose these default mitigation commitments to the borrower at or prior to the closing of the loan transaction. As discussed, these loss mitigation requirements have been controversial as they arguably impose back-end requirements on front-end, origination-centric standards. They certainly seem to heighten the moral hazard risk, by explaining to the borrower up front how much assistance the servicer will provide upon default. As noted above, the FSB is focused only on the credit granting decision, and does not make recommendations regarding timely default management techniques.

Limitations on Costs and Fees

In addition to the underwriting, servicing, and other requirements described above, the Dodd-Frank QM and QRM proposed definitions would both generally impose a 3% cap on up-front costs and fees that may be imposed upon a borrower. Again, while non-QRM and non-QM loans would not be prohibited, lenders may be effectively compelled to comply with that 3% cap. Like the proposed QRM servicing standards, such fee limitations do not directly address the borrower's ability or propensity to repay the loan, but instead reflect consumer protection concerns. Points and fee restrictions are contained in many U.S. anti-predatory lending regulations, aimed at determining which borrowers need special disclosures or other protections.[13] The FSB Principles do not address consumer protections like limits on up-front points or fees.

Implementation

As explained above, implementation in the U.S. of the tightened underwriting standards is underway – Congress directed regulatory agencies to implement requirements (and exceptions from, or safe harbors for, those requirements). In the end, the regulators are unlikely to prohibit many particular underwriting practices or loan product features, and creditors and securitizers will (at least arguably) have certain options in fashioning their compliance with those requirements. Providing such compliance options, rather than express prohibitions, may foster a balance between specificity and flexibility, or between prudent underwriting and the availability of affordable credit. However, the options and incentives may have their own unintended results. For instance, if a lender chooses to make only QMs or QRMs, will it be subject to scrutiny if those lending principles result in excluding protected classes of consumers or certain geographic regions? The debate still circles around whether the standards are clear enough to provide the certainty that creditors and the financial markets require, and whether borrowers of all types and from all areas will be able to obtain residential mortgage loans at an affordable rate or with any choice of financing features. In any event, Dodd-Frank imposed deadlines for the implementation of the QM and QRM rules, reflecting the urgency of Congress to address residential mortgage origination reform.[14]

The FSB Principles similarly recognize an important role of government in establishing stricter underwriting requirements, suggesting that the Principles' framework be centrally set by regulators and supervisors, as described above. Among other things, the Principles state that regulators should be given authority to: (A) set monitoring and data collection requirements regarding residential mortgage underwriting; (B) require entities under their prudential and regulatory framework to be capable of tracking portfolios and originations according to the mortgage underwriting standards observed; and (C) align other parts of the supervisory framework (e.g., stress-testing, compensation regulations or guidance) with the objective of ensuring prudent lending practices in the mortgage market. The Principles also suggest that jurisdictions should periodically review their adopted framework. As stated in the Principles, "[a] forward-looking approach should be developed as much as possible, taking into account the fact that significant delinquencies generally appear some years into the life of a loan. The framework should also be mindful of the phase of the cycle in each jurisdiction, and thus avoid adjustments that enhance the procyclical nature of mortgage markets." In addition, the Principles, unlike Dodd-Frank and the QM and QRM proposed rules, encourage jurisdictions to require that lenders' boards of directors approve the lenders' mortgage underwriting policies. However, unlike the United States designations, the FSB Principles do not set any deadlines or otherwise express urgency for the jurisdictions to consider and adopt new requirements.

Conclusion

Despite United States attempts at greater clarity, both the United States' proposed QM and QRM designations and the FSB Principles struggle to articulate clear, harmonized, objective criteria regarding sound underwriting practices for residential mortgage loans. While the QM/QRM proposals and the FSB Principles share many factors that we can all agree are important to strong underwriting (e.g., the verification of income), both struggle with the details in the context of formulating workable and enforceable standards. Dodd-Frank and the QM/QRM proposals have taken one approach to that dilemma – by declining to establish hard-and-fast mandated underwriting requirements, but rather, by establishing categories of loans that enjoy compliance presumptions or freedom from costly risk retention. The FSB jurisdictions may just be getting started.

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[1] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203).

[2] "FSB Principles for Sound Residential Mortgage Underwriting Practices" (Apr. 18, 2012), available at www.financialstabilityboard.org.

[3] Similarly, the United Kingdom's Financial Services Authority ("FSA") issued a Consultation Paper in July 2010 entitled "Mortgage Market Review: Responsible Lending" (CP 10/16). The FSA is an

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independent nongovernmental body authorized by statute and funded by the financial services firms it regulates. The Consultation Paper (available at http://www.fsa.gov.uk/library/policy/cp/2010), like the FSB Principles, offers a comprehensive set of enhanced underwriting proposals.

[4] The G-20 major economies are the European Union and the following 19 members: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States.

[5] Throughout this client alert, references to the QM proposed rule are contained in 76 Fed. Reg. 23790 (May 11, 2011).

[6] Throughout this client alert, references to the QRM proposed rule are contained in 76 Fed. Reg. 24090 (April 21, 2011).

[7] The CFPB is tasked with defining QM loans that are conventional loans, free of government insurance or guarantees. With respect to loans insured, guaranteed, or administered by the Federal Housing Administration (FHA) and Department of Veterans Affairs (VA), Dodd Frank requires that those agencies, in consultation with the CFPB, prescribe rules defining which of those loans will be QMs. Those FHA or VA rules may generally revise, add to, or subtract from the criteria otherwise used to define a QM. Neither agency has issued its rules, although the agencies likely are waiting for the CFPB to finalize its QM rule first.

[8] *See e.g.*, QM Proposed Rule, 76 Fed. Reg. at 27425.

[9] Examples of other records the creditor may use to verify the consumer's income or assets include: (A) Copies of tax returns the consumer filed with the Internal Revenue Service or a state taxing authority; (B) IRS Form W–2s or similar IRS forms used for reporting wages or tax withholding; (C) Payroll statements, including military Leave and Earnings Statements; (D) Financial institution records; (E) Records from the consumer's employer or a third-party that obtained information from the employer; (F) Records from a Federal, state, or local government agency stating the consumer's income from benefits or entitlements; (G) Receipts from the consumer's use of check cashing services; and (H) Receipts from the consumer's use of a funds transfer service.

[10] However, in response to recent data issued by the FHFA, the CFPB on May 31, 2012 re-opened the comment period for the QM proposed rule in order to re-assess, among other things, whether the final rule should set maximum debt-to-income ratios for QMs. *See* Bureau of Consumer Financial Protection "Notice of Reopening of Comment Period and Request for Comment," Docket No. CFPB-2012-0022 (May 31, 2012), available at www.consumerfinance.gov/f/201205_cfpb_Ability_to_Repay.pdf, and scheduled for publication in the *Federal Register* on June 5, 2012.

[11] Note that the proposed rule contains the following safe harbor:

A creditor will be deemed to have met the credit history verification requirements if: (A) the creditor, no more than 90 days before the closing of the mortgage transaction, obtains a credit report regarding the borrower from at least two consumer reporting agencies that compile and maintain files on consumers on a nationwide basis; (B) based on the information in such credit files, the borrower meets all requirements regarding debt documentation, and no information in a credit report subsequently obtained by the creditor before the closing of the mortgage transaction contains contrary information; and (C) the creditor maintains copies of such credit reports in the loan file for the mortgage transaction.

[12] *See* 12 C.F.R. § 1026.42.

[13] *See, e.g.*, 15 U.S.C.§§1602(bb), 1639; Cal. Fin. Law §§ 4970, 4973; Fla. Stat.§§ 494.0079, 494.00791; N.Y. Banking Law § 6-l; N.C. Gen. Stat. § 24-1.1E.

[14] *See* Dodd-Frank §§ 941(b), 1400(c). However, the CFPB has recently re-opened the comment period with respect to the QM proposed rule. As a result, industry participants are concerned that they may have to implement multiple regulatory changes at once, as January 21, 2013, a key Dodd-Frank implementation date, is fast approaching.

Consumer Financial Services Practice Contact List

K&L Gates' Consumer Financial Services practice provides a comprehensive range of transactional, regulatory compliance, enforcement and litigation services to the lending and settlement service industry. Our focus includes first- and subordinate-lien, open- and closed-end residential mortgage loans, as well as multi-family and commercial mortgage loans. We also advise clients on direct and indirect automobile, and manufactured housing finance relationships. In addition, we handle unsecured consumer and commercial lending. In all areas, our practice includes traditional and e-commerce applications of current law governing the fields of mortgage banking and consumer finance.

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