Quarterly Conversations with the Federal Reserve Bank of St. Louis

Live from Community Bank
Lexington, Tennessee

November 12, 2014
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Agenda

• Ability-to-Repay (ATR) and Qualified Mortgage (QM) Questions and Answers (Q&A) – Leslie Hurst

• Federal Reserve Offsite Loan Review Initiative and New Loan Coverage Examination Requirements – Carl White and Mark Buethe
  – Comments on the Federal Reserve’s Offsite Loan Review Initiative – Billy Bingham and Edna Hughes, Lewisburg Banking Company

• Q&A – Julie Stackhouse and presenters
ATR and QM Q&A

• Presented by Leslie Hurst, Examiner
ATR and QMs

**ATR**
- Effective January 10, 2014
- Regulation Z - 1026.43(c)
- Required on all covered transactions
- Specifies certain underwriting criteria to consider
- Does NOT specify HOW to consider the underwriting criteria

**QMs**
- Effective January 10, 2014
- Regulation Z - 1026.43(e)
- Institutions are NOT REQUIRED to originate QMs
- Creates presumption of compliance with ATR
- Provides bank with safe harbor OR rebuttable presumption of compliance with ATR
Consequences of Violation

• Technical or substantive violation depending on situation
• Dodd-Frank Act specifies remedies for violations.
  – “A consumer who brings a timely action against a creditor for a violation of TILA Section 129C(a) may be able to recover special statutory damages equal to the sum of all finance charges and fees paid by the consumer... This recovery is in addition to actual damages; statutory damages in an individual action or class action, up to a prescribed threshold; and court costs and attorney fees that would be available for violations of other TILA provisions...”
    • Timely = Three years from occurrence
  – “Consumer may assert a violation of TILA Section 129C(a) as a defense to foreclosure by recoupment or set off...”
ATR

• Coverage of rule
  – Transactions secured by a dwelling (also known as “covered transaction”)
    • Not limited to first liens or primary residences
  – Exclusions:
    • Home equity lines-of-credit (HELOC)
    • Timeshare
    • Reverse mortgages
    • Temporary/bridge loans
    • Construction-only loans
    • Housing Finance Agency programs
    • Community development and nonprofit lenders
    • Loans in connection with certain federal emergency economic stabilization programs
ATR (continued)

- Eight factors to consider:
  - Consumer’s current or reasonably expected income or assets
    - CANNOT use collateral that secures the loan
  - Current employment status
  - Monthly payment on the covered transaction
  - Monthly payment on any simultaneous loan
  - Monthly payment for any mortgage-related obligations
  - Current debt obligations, alimony, and child support
  - Monthly debt-to-income or residual income
  - Consumer’s credit history
• Monthly payment calculation
  – Fixed rate
    • Standard calculation
  – Adjustable rate mortgage loans
    • Use the greater of the fully indexed rate or introductory rate and fully amortize payment
  – Balloon
    • Maximum payment during first five years AFTER the first regular payment is due (not higher priced)
    • Maximum payment, including balloon payment (higher priced)
  – Interest only
    • Greater of fully indexed rate or introductory rate
    • Payment amount to fully amortize loan after recast
  – Negative amortization
    • Greater of fully indexed rate or introductory rate
    • Payment amount to fully amortize loan
QM

• Types of QMs:
  – General QM (standard)
  – Temporary category of QM (eligible for sale)
  – Small creditor portfolio QM
  – Balloon-payment QM (small creditor – predominantly lending to rural and underserved areas)
  – Temporary balloon-payment QM (small creditor)
Small Creditor Designation under this Rule

• Banks are considered small creditors if they meet the following requirements:
  – Assets below $2 billion at end of last calendar year
  – Bank and its affiliates together originated no more than 500 first-lien, closed-end residential mortgages subject to ATR in the preceding calendar year.

• A bank is considered to operate “predominately in a rural or underserved area” if during any of the preceding three calendar years, the bank originated more than 50 percent of first-lien covered transactions in counties considered “rural or underserved” as defined by the Consumer Financial Protection Bureau (CFPB).
  – A list is published yearly on the CFPB’s website.
Frequent Discussion Topics

• Banks are blurring the lines between a higher-priced mortgage loan (HPML) (Section 35 of Regulation Z) and a higher-priced covered transaction (Section 43).
  – An HPML loan is exactly what we have always reviewed - Section 35.
    • You don’t want to accidently violate the escrow requirements of HPML thinking you get 3.5 percent over the average prime offer rate rather than 1.5 percent for first liens.
  – A higher-priced covered transaction relates to whether or not a bank receives safe harbor with their QM and the repayment calculation of a balloon loan.
Question 1

• If we modify an existing balloon, do we have to go through all of the ATR requirements?
Question 2

• Occasionally, we see an employer verification of income where the listed income is provided but it does not match the W-2 submitted by the applicant. If we have conflicting information, is it acceptable to use the W-2 as our official income verification?
Question 3

• If we have a cosigner or guarantor, should their income and/or debts be considered when determining the ATR?
  – If so, is there any guidance for doing so?
Question 4

• If an applicant has a job where they are paid a commission and they change employers but have a similar position with the new employer where they also earn a commission, can the commission income from the previous employer be used to calculate income if the position change occurred within the past year?

• We are trying to determine if we should strictly use the item in B(8)(a) of Appendix Q that discusses the following:
  8. Qualifying Commission Income Earned for Less Than One Year
     a. Commission income earned for less than one year is not considered effective income. Exceptions may be made for situations in which the consumer’s compensation was changed from salary to commission within a similar position with the same employer.

• Or can we also rely on A(3)(b) related to stability of income which read as follows:
  3. Analyzing a Consumer’s Employment Record
     b. Creditors may favorably consider the stability of a consumer’s income if he/she changes jobs frequently within the same line of work but continues to advance in income or benefits. In this analysis, income stability takes precedence over job stability.
Question 5

- The Interagency Guidance on HELOCs Nearing Their End of Draw Periods, issued July 1, 2014, indicates that bank management should establish workout modifications for those borrowers who may be experiencing financial difficulties. It also indicates that banks should ensure modifications are consistent with regulatory guidance, including the Truth in Lending Act. If a bank prepares a thorough analysis to determine suitable repayment based on each borrower’s financial condition, would it also be subject to Regulation Z’s ATR requirements for a modification in the event an interest-only HELOC is modified at the end of the draw period to a fixed-rate principal and interest payout? Would this be considered a refinancing under Regulation Z which would trigger all new disclosures?
Question 6

• In the event a bank originates a construction-only loan and circumstances prevent the loan from being sold on the secondary market, will it be criticized for not determining the ATR at the onset of the construction-only loan?
  – The construction-only terms are interest only with a balloon payment at the end of the construction term. In the event it cannot be sold, a modification is drafted that will change the payments to amortizing principal and interest payments.
Question 7

• What suggestions do you have for banks that would normally be willing to be flexible on consumer loans to help with community development, but the exceptions the bank is willing to make are outside of the ATR requirements and/or QM limits?
  – For purposes of this question, please assume that the credit risk would not pose a safety and soundness issue.
Federal Reserve Offsite Loan Review Initiative and New Loan Coverage Examination Requirements

• Presented by Carl White, Assistant Vice President and Mark Buethe, Supervisory Examiner
Offsite Loan Review Initiative

• Offsite examination work has been completed for years.
• Technological advances have allowed to expand offsite work to the review of loan documents.
• Initiative is part of a continued effort to improve effectiveness and efficiency of supervision.
• The 2013 pilot highlighted potential of the program.
Offsite Loan Review (continued)

• What’s in it for me?
  – Smaller on-site examination teams and/or shorter on-site examination presence
  – Fewer disruptions during examinations

• What’s in it for the Fed?
  – More efficient use of staff
  – Cost-effectiveness – reduction in travel without reducing quality
  – Enhanced training options
More Institutions Are Ready!

- 2013-2014 State Member Banks (SMBs) in District: +10%
- 2013-2014 SMBs with Imaged Loan Files: +15%
- 2013-2014 Candidates (Process Verified by Federal Reserve Bank (FRB) and Institution): +73%
- 2013-2014 Candidates with Favorable Perception of Offsite Loan Review: +79%
Offsite Loan Review Key Points

• Several methods currently being used
  – Export/file transfer – more widely used
  – Virtual private network – seeing increased use, some already have in place
  – Both have advantages
• One size/method does NOT work for all!
  – Tailored approach
    • Particular portfolios/risks
    • Strategy and technology needs to work for both parties
  – Providing for open two-way communication is key
    • Agree on how, when, and who
Loan Coverage Requirements (SR 14-7) (Commercial and Industrial and Commercial Real Estate loans)

• Applies to FRB examinations of community SMBs
• Use of the automated loan examination tool (E-line cards coming!)
• Statistical Loan Sampling (SR 02-19)
  – 1 or 2 rating with stable portfolio/credit risk management (CRM)
  – Core (10/10/5/5 rule) plus random sample
  – Downgrades may require expanding the sample.
• Judgmental
  – All other banks = minimum coverage
    • Sound asset quality and CRM = 20 percent to 30 percent
    • Others = 40 percent or more
• Retail credit – no change
Additional Information

• Community Banking Connections article on offsite loan review
  http://www.communitybankingconnections.org/articles/2014/Q2/loan-reviews-off-site.cfm

• Loan Coverage Requirements (SR 14-7)
  http://www.federalreserve.gov/bankinforeg/srletters/sr1407.htm
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Questions?

You have three ways to ask a question
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2. By phone: Press *1 to ask a live question
3. By email: rapid@stls.frb.org
Thank you!