

# Supervisory Letter

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NCUA | Office of Examination & Insurance  
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SL No. 14-01  
January 3, 2014

**TO:** All Field Staff

**SUBJECT:** CFPB's Ability-to-Repay and Qualified Mortgage Rule

**ENCLOSURE:** [Dodd-Frank Act Mortgage Rules Questionnaire](#)

This supervisory letter provides information about the new Ability-to-Repay and Qualified Mortgage Rule (ATR/QM) issued by the Consumer Financial Protection Bureau (CFPB). The rule requires mortgage lenders to consider a consumer's ability to repay a home loan before extending credit to them. The rule establishes standards for Qualified Mortgages (QMs) that meet the ability-to-repay requirements, and provides a safe harbor for lenders that originate QMs.<sup>1</sup> **The rule applies to new mortgage loans made on or after January 10, 2014.**<sup>2</sup>

This letter establishes supervisory expectations with respect to credit unions' compliance with the new rule, including ensuring that credit unions meet certain risk-management expectations with regard to QM and non-QM loans. Also enclosed is a new questionnaire that will be incorporated into AIRES to assist field staff in conducting exams related to this rule.

**The guidance in this document applies to the supervision of all federally insured credit unions.** If you have any questions on the following material, please direct them to your immediate supervisor or regional management.

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## I. Background

Sections 1411 and 1412 of the Dodd-Frank Wall Street Reform and Consumer Protection Act require creditors to make a reasonable, good-faith assessment of a consumer's ability to repay any loan secured by a dwelling before extending credit to that consumer. This requirement was

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<sup>1</sup> The complete text of the new rule is available on the CFPB's website at [www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/](http://www.consumerfinance.gov/regulations/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z/).

<sup>2</sup> The Ability-to-Repay and Qualified Mortgage rule is one of seven mortgage-lending-related rules issued by the CFPB in 2013. Credit unions are subject to all of these rules. See the [appendix](#) for a full list of new rules and their respective compliance dates.

written into the Dodd-Frank Act in response to the mortgage crisis, which resulted from many mortgages being made to consumers without regard to the consumer's ability to repay and which led to the nation's recent economic recession.

The CFPB's new rule implements the Dodd-Frank Act requirement and establishes certain protections from liability for QMs. The rule also limits prepayment penalties and requires creditors to retain evidence of compliance with the rule for three years after a covered loan is consummated.

### ***A. Ability-to-Repay Requirement***

The new rule requires that, before or at the consummation of a mortgage loan, a credit union consider at least the following eight underwriting factors and use reasonably reliable third-party records to verify all information on which it relies:<sup>3</sup>

- Current or reasonably expected income or assets (other than the value of the property securing the loan) the consumer will rely on to repay the loan.
- Current employment status (if a credit union relies on employment income when assessing the consumer's ability to repay).
- Monthly mortgage payment for this loan (using the introductory or fully-indexed interest rate, whichever is higher, and monthly, fully-amortizing payments that are substantially equal).
- Monthly payments on any simultaneous loans secured by the same property.
- Monthly payments for property taxes and required insurance, and certain other costs related to the property such as homeowners' association fees or rent.
- Debts, alimony, and child support obligations.
- Monthly debt-to-income ratio and residual income using the total of all of the mortgage and non-mortgage obligations, as a ratio of gross monthly income.
- Credit history.

A loan is not permissible if the credit union does not make a reasonable, good-faith determination that the member has the ability to repay the loan. Credit unions are responsible for developing and applying their own underwriting standards and making changes to these standards over time in response to empirical information, and changing economic and other conditions. Each credit union must establish its own ability-to-repay criteria in the context of the facts and circumstances relevant to their market, organization, and membership.

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<sup>3</sup> Additional factors may be considered, but, at a minimum, these eight factors must be considered.

**B. Qualified Mortgages**

Loans can achieve QM status under three categories: general, temporary, and small creditor. The following table summarizes the types and criteria for QMs.

	General QMs	Temporary QMs	Small Creditor QMs	
			General	Balloon-Payment
<b>Loan Restrictions</b>	<ul style="list-style-type: none"> <li>No negative-amortization, interest-only, or balloon-payment features</li> <li>Loan term may not exceed 30 years</li> </ul>		<ul style="list-style-type: none"> <li>Balloon-payment feature allowed; other restrictions apply</li> </ul>	
<b>Caps on Points and Fees</b>	<ul style="list-style-type: none"> <li>Generally 3 percent of total loan amount; higher cap for loans less than \$100,000</li> <li>Up to two additional bona fide discount points allowed depending on rate</li> </ul>			
<b>Higher-Priced Definition</b>	APR* exceeds the APOR** by 1.5 percentage points or more for first-lien loan and 3.5 percentage points or more for subordinate-lien loans		APR* exceeds the APOR** by 3.5 percentage points or more for both first-lien and subordinate-lien loans	
<b>Underwriting Requirements (alternative)</b>	<ul style="list-style-type: none"> <li>Underwrite based on fully amortizing schedule using maximum rate permitted in the first five years</li> <li>Consider and verify income or assets, current debt obligations, alimony, and child support</li> <li>Determine that the consumer's monthly debt-to-income ratio is no more than 43 percent</li> </ul>	Loan must be eligible for purchase, guarantee, or insurance by Fannie Mae or Freddie Mac, FHA, VA, USDA, or the Rural Housing Service	<ul style="list-style-type: none"> <li>Underwrite based on fully amortizing schedule using maximum rate permitted in the first five years</li> <li>Consider and verify income or assets, current debt obligations, alimony, and child support</li> <li>Determine the consumer's monthly debt-to-income ratio, but the 43 percent threshold does not apply</li> </ul>	<ul style="list-style-type: none"> <li>Loan term must be five years or longer</li> <li>Loan is fully amortized over 30 years or less</li> <li>Must consider and verify debts, income, and debt-to-income ratio or residual income (the 43 percent threshold does not apply)</li> </ul>
<b>Other Requirements</b>	N/A		Must generally hold the loan in portfolio for 3 years	
<b>Expiration</b>	N/A	Earliest of: 1) Date GSE exits federal conservatorship or receivership 2) Date the relevant agency's own QM rule takes effect 3) January 10, 2021	N/A	Small creditors' eligibility to originate balloon-payment QMs expires on January 10, 2016, unless that creditor operates predominantly in rural or underserved areas
* APR = Annual Percentage Rate, ** APOR = Average Prime Offer Rate				

For more information on the QM standard, refer to [NCUA Regulatory Alert 14-RA-01](#) and the CFPB's *Ability-to-Repay and Qualified Mortgage Rule Small Entity Compliance Guide*.

The QM standard is intended to give creditors more certainty about potential legal liability. The new rule provides creditors that originate QMs two different levels of protection from liability. QMs that are not higher-priced<sup>4</sup> have a safe harbor under the new rule, meaning that they are conclusively presumed to comply with the ability-to-repay requirements. QMs that are higher-priced are presumed to be in compliance with the ability-to-repay requirement, but a borrower can rebut that presumption.

### *Small Creditors*

The new rule provides that mortgages issued by small creditors will be considered QMs under certain conditions, provided the creditor has considered and verified a consumer's debt-to-income ratio.<sup>5</sup> The small creditor QM status applies to credit unions that have less than \$2.028 billion in assets and, together with all its affiliates, originates 500 or fewer first-lien mortgages per year. The rule offers a two-year transition period during which all small creditors can make balloon-payment QMs; however, when that period expires (on January 10, 2016) only small creditors serving rural or underserved areas<sup>6</sup> will be able to originate balloon-payment QMs. Small creditor loans will lose their QM status if they are sold or otherwise transferred less than three years after consummation. These loans will retain their QM status if they are:

- Sold more than three years after consummation.
- Sold at any time to another creditor that meets the small creditor asset size and origination volume criteria.
- Sold pursuant to a supervisory action or agreement at any time.
- Transferred as part of a merger or acquisition of or by the creditor at any time.

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<sup>4</sup> General and temporary QMs are considered higher-priced if the loan's annual percentage rate (APR) exceeds the average prime offer rate (APOR) by 1.5 percentage points or more for first-lien loan and 3.5 percentage points or more for subordinate-lien loans. Small creditor general and balloon-payment QMs are considered higher-priced if the loan's APR exceeds the APOR by 3.5 percentage points or more for both first-lien and subordinate-lien loans. The Federal Financial Institutions Examination Council publishes APOR tables at [www.ffiec.gov/ratespread/aportables.htm](http://www.ffiec.gov/ratespread/aportables.htm).

<sup>5</sup> Under the small creditor QM category, no specific debt-to-income limit applies.

<sup>6</sup> CFPB will publish an annual list of rural or underserved counties.

### ***C. Non-Qualified Mortgages***

Credit unions may offer loans that do not qualify as a QM (“non-QM” loans) as long as a reasonable, good-faith determination is made that the member is able to repay the loan based on common underwriting factors in compliance with the ability-to-repay rule. Credit unions can continue to rely on existing underwriting guidelines that are sound and tested, resulting in loans that have generally performed well, as long as (1) the ability-to-repay rule requirements are met and (2) the credit union documents the information it has considered to make its determination.

**IMPORTANT:** Credit unions must understand and adequately address the increased risks posed by non-QM loans held in their portfolios. (See [Guidance for Field Staff](#) for more information about these risks.)

### ***D. Ban on Prepayment Penalties***

Section 107(5) of the Federal Credit Union Act prohibits federal credit unions (FCUs) from charging prepayment penalties; however, state-chartered credit unions’ ability to charge prepayment penalties varies from state to state. Under the new rule, all federally insured, state-chartered credit unions (FISCUs), even those chartered in a state that permits prepayment penalties, are banned from assessing most prepayment penalties, except on certain non-higher-priced QMs with either fixed or step rates.

Prepayment penalties are allowed on these non-higher-priced loans only if the penalties satisfy certain restrictions, are permitted under law, and if the creditor has offered the consumer an alternative loan without such penalties.

### ***E. Record Retention Requirement***

The new rule requires creditors to retain evidence that it complied with the ability-to-repay requirements for at least three years after the origination of the loan. Credit unions may elect to maintain these records for a longer period as outlined in Appendix A (Record Retention Guidelines) to Part 749 of NCUA’s Rules and Regulations.

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## II. Risks Associated with QMs and Non-QMs

In order to comply with the new rule, most credit unions will need to enhance their written loan policies,<sup>7</sup> procedures, and processes with regard to mortgage lending. Credit unions will then need to perform regular periodic reviews to ensure that the rule requirements are consistently met. NCUA's primary objective in reviewing credit union mortgage lending is to ensure that credit unions have sound underwriting practices in place that mitigate certain mortgage-lending risks; nevertheless, there are certain risks associated with QM and non-QM lending that credit unions need to consider.

### A. Credit Risk

The ability-to-repay requirement of the new rule is intended to protect the borrower and the lender by requiring creditors to adequately research, assess, and document the borrower's ability to repay.

While QMs are presumed to have met the ability-to-repay requirements for legal purposes, QM borrowers remain at risk of default in the event of any number of circumstances (such as job loss, a drop in home value, etc.), which translates into credit risk for the lender. Meeting the minimum requirements of a QM loan does not automatically make it a "good" loan. These loans can still present credit risk as a result of:

- Inherent limitations in underwriting methodologies.
- Subsequent events that affect the borrower.
- High loan-to-value ratios.
- Inadequate or weak appraisals.
- Loan servicing or escrow account management problems.
- Weak collection practices and policies.
- Mismanaged loan modification practices and policies.

Non-QM borrowers present similar default risks as QM borrowers. In addition, certain features of non-QM loans, such as listed below, can present additional risk:

- Negative amortization.
- Interest-only or balloon payments.
- "No-doc" (no verification of income) loans.

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<sup>7</sup> Section 701.21 of NCUA's Rules and Regulations requires federal credit unions to establish written loan policies. For FISCUs, regulatory requirements for written loan policies vary from state to state. However, all federally insured credit unions must maintain written loan policies to be considered safe and sound.

- Elevated debt-to-income ratios.

Field staff need to ensure that credit unions have adequate policies that clearly outline procedures and criteria for granting QM and non-QM mortgages, and staff that are trained to grant mortgage loans in this new environment.

### ***B. Liquidity Risk***

Credit unions that originate non-QM loans may find it difficult to find a suitable secondary market for these loans. This may create liquidity challenges in addition to capital management implications for the credit union.

Under the new rule, a credit union that qualifies under the “small creditor” definition may originate QMs with a balloon-payment feature. However, the rule requires that the loan be held in the credit union’s portfolio for three years in order to maintain its QM status. This requirement will have clear liquidity implications that the credit union needs to take into consideration.

### ***C. Concentration Risk***

When a credit union’s loans are heavily concentrated in any sector, it will face the risk that a downturn in that sector will have an outsized impact on the credit union’s overall loan portfolio. Thus, any concentration in mortgage loans presents certain risks. Credit unions need to closely monitor the size and performance of their QM and non-QM portfolios, establish concentration limits, and document those limits clearly in their loan policy. Field staff should look for management reporting that tracks the performance of loans by characteristic (e.g. QM versus non-QM loans). In addition, underwriting standards should be reviewed regularly and modified if the risk of the portfolio increases.

### ***D. Legal Risk***

The new rule provides a presumption that creditors who originate QMs have complied with the ability-to-repay requirements and thus receive a safe harbor that protects them from certain legal action. Higher-priced QMs are provided a rebuttable presumption. Non-QMs are not covered by either protection, meaning that a credit union that originates this type of loan is exposed to a potentially higher level of legal risk. Lawsuits could be initiated by a single borrower or a group of members in the form of a class action lawsuit. If the borrower proves in court that the credit union failed to make a reasonable, good faith determination of the ability to repay during loan origination, the credit union could be liable for legal fees and up to three years of finance charges and fees.

Both QM and non-QM loans can be granted safely with proper controls, procedures, and policies. Nevertheless, legal risks are present and there is no precedent as yet for how courts will interpret the ability to repay rule, in addition to how a court will rule on fact pattern specific scenarios should a credit union be taken to court. Credit unions must consider the cost and implications associated with this risk when deciding if and to what extent to offer non-QM loans, in pricing these loans, in determining appropriate capital levels, and in operating such a program (including the impact on collection and loan modification procedures and the need for periodic review and calibration of the non-QM underwriting criteria).

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### III. Guidance for Field Staff

The ability-to-repay determination in the CFPB's new rule is required of all federally insured credit unions that originate mortgage loans. As with any new requirement in its early stages after becoming effective, in determining supervisory ratings NCUA field staff will take into account a credit union's good faith efforts to comply with the new rule.

The QM provision of the new rule offers certain liability protections to credit unions that originate mortgages, but credit unions are not required to originate only QMs. From a safety-and-soundness perspective, a credit union may originate both QM and non-QM loans, based on its business strategy and risk appetite. NCUA will not subject a mortgage loan to safety-and-soundness criticism because of the loan's status as a QM or non-QM loan.<sup>8</sup>

**IMPORTANT:** A credit union may originate both QMs and non-QMs as appropriate for its overall business strategy and risk appetite. Field staff should not make safety-and-soundness criticisms based on a mortgage loan's status as a QM or non-QM loan.

NCUA continues to expect credit unions to underwrite residential mortgage loans in a prudent fashion and address key risk areas, including loan terms, borrower qualification standards, loan-to-value limits, documentation requirements, and portfolio- and risk-management practices, regardless of whether a residential mortgage loan is a QM or non-QM.

Consistent with this expectation, an improperly underwritten or past-due residential mortgage loan may be subject to criticism at origination or afterward, as appropriate to the facts and circumstances of the loan and regardless of its status as a QM or non-QM.

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<sup>8</sup> See the joint industry guidance issued by the Federal Reserve Board of Governors, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and NCUA on December 13, 2013, available at [www.ncua.gov/News/Pages/NW20131213QualifiedMtgLoans.aspx](http://www.ncua.gov/News/Pages/NW20131213QualifiedMtgLoans.aspx).

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## IV. Exam Procedures

When conducting a review of a credit union's mortgage portfolio, field staff should ensure that the credit union:

- Reviews and updates its policies, procedures, and internal controls directly related to ensuring compliance with the ability-to-repay requirement. At a minimum, the underwriting standards must include the eight required factors.
- Verifies all the information used to determine a consumer's ability to repay using reasonably reliable third-party records. The credit union must retain these records for at least three years.
- Periodically evaluates the program and Allowances for Loan and Lease Losses (ALLL) funding in response to empirical results (based on actual delinquency and loss history) and current economic conditions.<sup>9</sup>
- Establishes concentration limits for the overall real estate portfolio as well as concentration limits for any non-QM mortgages.
- Prices any non-QM mortgages adequately to address the additional risk.
- Retains knowledgeable and experienced personnel who understand the risks related to non-QM mortgage lending if applicable.
- Determines how providing non-QMs will fit into its strategic plan and benefit its members.
- Identifies and tracks non-QMs in the loan portfolio to provide for adequate monitoring regarding loan performance, loss ratio, and ALLL funding pools.
- Addresses legal risks, including having qualified legal counsel review non-QM mortgage loan programs.
- Accounts for the impact these loans will have on Asset/Liability Management (ALM) modeling and liquidity management.

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<sup>9</sup> As part of this evaluation, credit unions should look at mortgage loans that have defaulted early or shortly after any adjustable loan rate resets. These types of defaults could indicate that the credit union is not conducting reasonable, good-faith ability-to-repay determinations.

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## V. Additional Guidance Relevant to the Ability-to-Repay and QM Standards Rule

This document outlines the safety-and-soundness concerns related to QM lending, and builds on previously issued NCUA guidance, including:

- [Ability-to-Repay and Qualified Mortgage Requirements from the Consumer Financial Protection Bureau](#) (Regulatory Alert, 14-RA-01)
- [Appraisals for Higher-Priced Mortgage Loans](#) (Regulatory Alert, 13-RA-08)
- [CFPB's New Rule on Real Estate Appraisals and Other Written Valuations under the Equal Credit Opportunity Act](#) (Regulatory Alert, 13-RA-07)
- [New Escrow Requirements under the Truth in Lending Act](#) (Regulatory Alert, 13-RA-05)
- [Concentration Risk](#) (Letter to Credit Unions, 10-CU-03)
- [Interagency Guidance on Nontraditional Mortgage Product Risk](#) (Letter to Credit Unions, 06-CU-16)
- [Increasing Risks in Mortgage Lending](#) (Letter to Credit Unions, 05-CU-15)
- [Interagency Policy Statement on the Allowance for Loan and Lease Losses](#) (NCUA Accounting Bulletin 06-01)

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If you have any questions on the material in this letter, please direct them to your immediate supervisor or regional management.

Sincerely,

Larry Fazio  
Director, Office of Examination & Insurance

## Appendix: CFPB Mortgage Regulations and Related Resources

The CFPB issued several new mortgage regulations in 2013. Credit unions are expected to be in compliance with these regulations by their effective dates. NCUA has issued, or will be issuing, Regulatory Alerts regarding the compliance requirements for these regulations.

General information about CFPB regulations is available at [www.consumerfinance.gov/regulatory-implementation](http://www.consumerfinance.gov/regulatory-implementation).

Rule	Effective Date
<a href="#">Escrow Requirements for Higher-Priced Mortgage Loans</a>	June 1, 2013
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	
<a href="#">Loan Originator Rule</a>	
Prohibition on Mandatory Arbitration Clauses	June 1, 2013
Loan Originator Compensation Provisions	January 1, 2014
Provisions on Financing Credit Insurance and Including Loan Originator’s Name and NMLSR ID on Loan Documents	January 1, 2014
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	
<a href="#">High-Cost Mortgages and Homeownership Counseling</a>	January 1, 2014
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	
<a href="#">Ability to Repay and Qualified Mortgage Standards</a>	January 1, 2014
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	
<a href="#">Chart: Comparison of Ability-to-Repay Requirements</a>	
<a href="#">Mortgage Loan Servicing</a>	January 1, 2014
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	
<a href="#">Servicing Coverage Chart</a>	
<a href="#">Appraisals and Other Written Valuations</a>	January 18, 2014
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	

<b>Rule</b>	<b>Effective Date</b>
<a href="#"><u>Appraisals for Higher-Priced Mortgage Loans</u></a>	January 18, 2014
<a href="#">Plain Language Summary</a>	
<a href="#">Small Entity Compliance Guide</a>	