[2016 Emerging Issues 7414, Dodd-Frank: Does it Apply to Your Client's Owner-finance Mortgage Business?]

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Dodd-Frank: Does it Apply to Your Client's Owner-finance Mortgage Business?

Summary

Following the home mortgage crisis of the recent Great Recession and the public outcry against alleged "predatory lending" practices, Dodd-Frank (Dodd-Frank Wall Street Reform and Consumer Protection Act) was enacted by Congress into law in 2010.

Article

Following the home mortgage crisis of the recent Great Recession and the public outcry against alleged "predatory lending" practices, Dodd-Frank (Dodd-Frank Wall Street Reform and Consumer Protection Act) was enacted by Congress into law in 2010. With respect to home mortgage lending, Dodd-Frank had two principal objectives: making mortgage lenders responsible for ensuring that their prospective borrowers had the ability to repay their loans, and regulating loan servicing to provide homeowners with more information, more uniform practices, and enhanced opportunities to avoid foreclosure.

Dodd-Frank was not a stand-alone law, but rather amended several existing laws. In regard to real estate investors, the most significant amendments were to the Real Estate Settlement Procedures Act (RESPA, *12 U.S.C. §§ 2601* -- 2617) and the Truth in Lending Act (TILA, *15 U.S.C. § 1601* et seq). (Note: Dodd-Frank also transferred authority over the S.A.F.E. Mortgage Licensing Act, *12 U.S.C. § 5101,* and related Regs to CFPB, see 12 CFR 1007 et seq). The new Consumer Financial Protection Bureau (CFPB) was established and empowered to implement and enforce the Dodd-Frank rules in the mortgage industry. Final implementing regulations for Dodd-Frank were published by the CFPB in 2014.

Many small investors and entrepreneurs have found themselves in legal twilight zone in the wake of Dodd-Frank, left wondering if they are henceforth exposed to civil liability for regulatory non-compliance with the law's multi-faceted requirements.

Key CFPB Regulations:

Regulation X (12 CFR 1024) – implementing RESPA:

- Primarily concerned "servicers" of loans, but imposed less stringent requirements on "small servicers" [1] who service 5,000 or fewer mortgage loans or who service mortgage loans that they or their affiliates did not originate.
- "Servicer" under Reg X means the person responsible for the servicing of a mortgage loan, including

[1] The term "small servicer" is actually defined in Reg Z (§ 1026.41(e)(4)(ii)), but is incorporated into Reg X as well.

the person who makes or holds a mortgage loan if such person also services the mortgage loan.
• Established new requirements on servicers in regard to:

o Issuing periodic statements with specified content

o Disclosing interest rate adjustments

o Prompt payment crediting and payoff statements

o Limitations on force-placed insurance

o Error resolution and information requests

o General servicing obligations

o Requirement of early intervention with delinquent consumers

o Continuity of contact with delinquent consumers

o Provision of loss mitigation procedures to avoid foreclosure if possible and prohibit foreclosure until there is at least a 120-day delinquency

o Granting consumers a private right of action to sue servicers
• Small servicers are exempt from many of the foregoing requirements, but not the rate adjustment provisions, prompt crediting and payoffs, force-placed insurance restrictions, error resolution and information request obligations, and prohibition on initiating foreclosure until after 120 days delinquency or while a consumer is performing under the terms of loss mitigation agreement.

Regulation Z (12 C.F.R. 1026) – implementing TILA (Subparts C, D and E are relevant to home finance):

• Imposes disclosures regarding interest rates and amounts in mortgage loan transactions
• Establishes stringent requirements for "high cost mortgages" that exceed the "average prime offer rate" by 6.5% for first-lien transactions (or 8.5% on mobile home transactions < $50k).
• Establishes heightened requirements for "higher-priced mortgages" that exceed the "average prime offer rate" by 1.5% (generally), including:

o Escrow requirement

o Requirement for appraisal or second appraisals

o "Loan Originator" restrictions, including compensation, steering, and registration/qualification requirements.
• Regulates loan servicing practices, including payment processing, pyramiding of late fees, payoff statements, notification of sale or transfer of mortgage loans, periodic statements, valuation independence
• Imposes a requirement that creditors verify consumer's ability to pay a mortgage loan by reference to eight underwriting factors
• Establishes safe harbors from underwriting requirement for "qualified mortgages" for "small creditors" (who originated < 500 first lien transactions during each of the past 3 calendar years) and in certain other cases (1026.43(e)).

• Imposes civil liability for failure to comply via ability of consumer to recover actual damages, attorneys fees, penalties equal to twice the amount of finance charge involved, and class actions.

Exemptions from Regulations X and Z

The complexity of Dodd-Frank and its severe repercussions for non-compliance have created substantial fear and uncertainty in the owner-finance community. Such financers want to know whether their risk/reward calculus has materially changed in terms of potential civil liability for lending missteps. Most owner financers maintain their loan volume at a sufficiently low level (5 or fewer transactions per 12-month period) to avoid registration as a mortgage loan originator under the SAFE Act (although comparable state laws may contain stricter requirements). A review of Regulations X and Z indicates that, if such financers are careful to avoid a few pitfalls, such a limited loan origination volume should likewise exempt them from the requirements of these regulations.

Regulation X

The regulations generally apply only to "servicers" and "small servicers," and the definition of these terms is broad enough to include persons who make or hold mortgage loans that they service themselves without any apparent *de minimis* exclusion comparable to the SAFE Act.

However, a closer reading of the labyrinthine Reg X indicates otherwise. First, under the definitions subsection of § 1024.2, a "*servicer*" is limited to "a person responsible for the servicing of a federally related mortgage loan (including the person who makes or holds such loan if such person also services the loan)." The definition is dependent upon the separately-defined term "*federally related mortgage loan,*" which is defined to include multi-faceted contexts and applications. Reg X states that it is applicable to federally related mortgage loans, and presumably no others. *See* § 1024.5(a). However, from the perspective of small, non-bank mortgage lenders, its application is generally limited to subsection (1)(i)(D), as follows:

(1) Any loan (other than temporary financing, such as a construction loan)

(i) That is secured by a first or subordinate lien on residential real property, including a refinancing of any secured loan on residential real property upon which there is either:

(i) That is secured by a first or subordinate lien on residential real property ...; and

(ii) For which one of the following paragraphs applies. The loan:

…

(D) Is made in whole or in part by a "creditor," as defined in section 103(g) of the Consumer Credit Protection Act *(15 U.S.C. § 1602*(g)), that makes or invests in residential real estate loans aggregating more than $1,000,000 per year. …

An examination of the definition of "creditor" under *15 U.S.C. § 1602*(g) (TILA) indicates that it covers any person who "regularly extends" consumer credit and who is the person to whom the debt is initially payable. It further states that "any person who originates 2 or more mortgages referred to in subsection (aa) of this section in any 12-month period or any person who originates 1 or more such mortgages through a mortgage broker shall be considered a creditor for purposes of this subchapter."

Subsection (aa) doesn't appear to apply as it is only an exculpatory clause, so the drafters must have intended to refer to subsection (bb), which identifies the criteria for a high cost mortgage (i.e., charging the average prime offer rate plus 6.5%).

Assuming that the owner-financer doesn't make any high-cost mortgage loans, when does he "regularly extend" credit? The implementing regulation for *15 U.S.C. § 1602*(g) appears to be found at 12 CFR 1026, which explains in subsection 1026.2(a)(17)(v) that "[a] person regularly extends consumer credit only if it extended credit … more than 5 times for transactions secured by a dwelling in the preceding calendar year [or in the current calendar year]." This is consistent with a similar provision discussed below under Regulation Z which indicates that a person who makes five or fewer home mortgage loans per year is *not* regularly extending credit and is therefore not considered a creditor.

Applying these definitions to Reg X, it seems clear that an owner financer who makes or invests in $1 million or less in residential real estate loans per year would *not* be considered a servicer and thus would not be subject to the provisions of Reg X. It also appears that a person who does not regularly extend consumer credit – most likely including anyone who originates five or fewer transactions secured by a dwelling that are not high cost mortgages – would fall outside of Reg X's provisions irrespective of the aggregate amount of such loans.

Such excluded owner financers would therefore *not* have to concern themselves with even the "small servicer" regulations and penalties under Reg X, such as the prohibition on foreclosures prior to accrual of a 120-day payment delinquency.

Regulation Z

In the context of regulating mortgage loans, Reg Z imposes a broad array of requirements on "creditors," "servicers," and in limited respects, "loan originators." There is a great deal of discussion in the secondary literature about the safe harbor (§1026.36(a)(1)(D)) from the definition of "loan originator" for seller financers who provide financing for three or fewer properties, but these commentaries appear to miss a broader exemption for seller financers.

For example, § 1026.35 imposes mandates for administration of higher-priced mortgage loans on "creditor(s)" and § 1026.43(c) prohibits "creditor(s)" from making mortgage loans unless it determines that the consumer will have a reasonable ability to repay the loan.

The term "creditor" is defined in § 1026.2 to mean "a person who regularly extends credit that is subject to a finance charge or is payable by written agreement in more than four installments (not including a down payment), and to whom the obligation is initially payable, either on the face of the note or contract, or by agreement when there is no note or contract." The statute goes on to clarify that "a person regularly extends consumer credit only if it extended credit (other than credit subject to § 1026.32 [relating to "high cost mortgages"] more than 25 times (or more than 5 times for transactions secured by a dwelling) in the preceding calendar year… [or] the current calendar year." The statute further states that a person is considered to regularly extend credit if it originates more than one high cost mortgage in any 12-month period.

Thus, a typical seller financer who limits himself to 5 transactions per year that are not in the high cost category, appears to escape coverage of Reg Z altogether. This is also confirmed in the Federal Reserve's "supermanual" for interpreting Reg Z (http://www.federalreserve.gov/boarddocs/supmanual/cch/til.pdf), which includes a flowchart for determining Reg Z application to persons and transactions and "kicks out" persons who don't qualify as "creditors" and don't "regularly extend" consumer credit from coverage. *See* supermanual, p. 6.

The definition and regulation of "loan originator[s]" in § 1026.36 are more problematic. Loan originators must make specified disclosures to consumers and observe various guidelines in the conduct of their business. Although persons who assist creditors and consumers in arranging consumer credit "for another person" are included within the definition, it includes "creditors" only if they don't finance the transaction out of their own resources or from a bona fide line of credit. In addition, "creditors" who engage in consumer credit activities *are* considered "loan originators" for purposes of subsections (f) [registration under SAFE Act] and (g) [inclusion of its name and NMLSR ID on loan documents].

But what about seller-financers who aren't "creditors" at all because they don't engage in more than five transactions annually?

There is a safe harbor under § 1026.36 from the definition of "loan originators" for persons who provide seller financing for the sale of three or fewer properties in any 12-month period, provided that the person did not construct the residence in the ordinary course of his business, the financing is fully amortizing, the person determined in good faith that the consumer has a reasonable ability to repay, and the financing has a fixed rate or limited adjustable rate features.

The language of § 1026.36 could be read to imply that seller-financers who are not "creditors" but exceed the three-transaction safe harbor are subject to regulation as loan originators. However, the exclusion from § 1026.36 appears to be broader than just the 3-transaction safe harbor, since non-"creditors" *who aren't acting for others* appear to be excluded from "loan originators" category by definition. Stated differently, a seller-financer who originates five home loan transactions in a calendar year and doesn't assist in, or arrange, such loans for another person, apparently can be considered neither a "loan originator" nor a "creditor." Also, although § 1026.36(c) prohibits or mandates certain actions by "servicers," it incorporates the definition of "servicer" from § 1024.2(b), which stipulates that they must be servicing a "federally related mortgage loan." Therefore, those who don't qualify as "creditors" under *15 U.S.C. § 1602*(g) (*i.e*., regular extend credit and avoid high cost mortgage loans) or who do qualify but limit themselves to an aggregate $1 million per year, aren't bound by § 1026.36(c).

Conclusion

Dodd-Frank and Regs X and Z implementing it appear on their face to impose formidable obstacles on small owner-finance business persons. A good deal of misinformation presented on the web and in various seminars has chilled activity in this area by confronting investors with legal uncertainty. A closer reading of the governing regulations, however, indicates that small home financers can operate without observing, or becoming civilly liable under, Dodd-Frank's burdensome mortgage regulations if they carefully limit their transaction volume in accordance with the CFPB's criteria. Nonetheless, many of the regulatory requirements – such as sending detailed annual escrow statements, avoiding excessive escrowing, and providing extra time for mortgagee to cure their loan defaults before proceeding to foreclosure – can and should be viewed as "best practices" guidelines. As practices mandated by Regs X and Z take hold nationally in the mortgage marketplace, homeowners and their attorneys will eventually become accustomed to them and will increasingly challenge owner-financers who aren't following them.

About the Author(s)

Larry Chek

Larry Chek is a Partner in the Palmer-Manuel Law Firm. His practice focuses on bankruptcy, debt restructuring and workouts, and creditors' rights.