DAY PITNEY LLP

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Dodd-Frank Act Ushers in New Regulations for Mortgage Originators

INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed into law on July 21, 2010, will bring about many regulatory changes — some of which are set forth in the Act itself and others that are to be promulgated by federal regulators within the next 30 months. Of particular import, Title XIV of the Act, *The Mortgage Reform and Anti-Predatory Lending Act*, imposes new obligations, standards, and regulations on mortgage originators.

WHAT TITLE XIV OF THE DODD-FRANK ACT PROVIDES

Title XIV of the Act was drafted for the purpose of assuring “that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive.” Some of the most noteworthy changes for mortgage originators are set forth below.

New Minimum Standards for Ensuring Borrowers’ Ability to Pay

The Act imposes a “good faith” duty on lenders — requiring that they make a “reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance … and assessments.” This “good faith determination” requires mortgage originators to consider a variety of documents that evidence a loan applicant’s ability to repay, including “credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio or the residential income the consumer will have after paying non-mortgage debt and mortgage-related obligations, employment status, and other financial resources other than the consumer’s equity in the dwelling or real property that secures repayment of the loan.”

Title XIV also imposes on lenders a duty to verify amounts of income or assets that the lender relies upon to determine the consumer’s ability to repay the loan. In order to “safeguard against fraudulent reporting,” lenders are now required to use Internal Revenue transcripts of tax returns or another method that “quickly and effectively verifies income” by a third party who is also subject to the rules promulgated as a result of this legislation.

Related practice areas:

Consumer Finance and Creditors' Rights

Financial Services

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Integral to the above analysis is the concept of a "qualified mortgage." Aspects of this concept are as follows:

- The mortgage provides that regular periodic payments do not result in an increase of the principal balance of the loan or allow the consumer to defer repayment of principal.
- The mortgage does not result in a balloon payment (a scheduled payment that is more than twice as large as the average of earlier scheduled payments).
- The income and financial resources relied upon by the lender have been verified and documented.
- The underwriting process for a fixed loan is based on a payment schedule that fully amortizes the loan over the loan term, taking into account all applicable costs.
- The underwriting process for an adjustable rate loan is based on the maximum rate permitted under the loan for the first five years and a payment schedule that fully amortizes the loan over the loan term, taking into account all applicable costs.
- The mortgage complies with guidelines and regulations related to ratios of total monthly debt to total monthly income or alternative measures of a borrower's ability to pay.
- The mortgage has total points and fees amounting to no more than 3 percent of the total loan amount.
- The term of the loan does not exceed 30 years.

The Act provides a safe harbor provision for those mortgages that meet the definition of "qualified mortgage" — establishing a presumption in favor of the mortgage originator that the mortgagor is able to pay the loan.

New Loan Origination Standards

Title XIV of the Act requires that mortgage originators "establish and maintain procedures reasonably designed to assure and monitor the compliance" of institutions subject to the Act. Specifically, this provision requires that lenders be qualified and registered as mortgage originators under the applicable federal and state laws. The significance of this registration procedure is that all loan documents will require the inclusion of the mortgage originator's unique identifier, which is to be provided by the National Mortgage Licensing System and Registry.

Prohibits "Steering Incentives"

The Dodd-Frank Act calls for the promulgation of regulations that will prohibit lenders from "steering" borrowers into more costly loans. More specifically, such regulations will prohibit mortgage originators from (a) steering consumers to residential mortgage loans that consumers lack a reasonable ability to pay or that have "predatory characteristics or effects"; (b) steering the consumer away from a "qualified mortgage" toward a non-qualified mortgage when the consumer qualifies for a "qualified mortgage"; or (c) employing abusive and unfair lending practices that promote disparities among consumers of equal creditworthiness but of different race, ethnicity, gender, or age.

Additionally, the Act specifically prohibits mortgage originators from mischaracterizing the credit history of a consumer or the residential loans available to the consumer for purposes of making the loan. Mortgage originators are also prohibited from discouraging consumers from seeking a residential mortgage loan from another lender when the former is unable to suggest, offer, or recommend a loan that is not more expensive.

Prohibits Loans With "Predatory Characteristics"

Mortgage originators are prohibited from steering consumers to residential mortgage loans that have "predatory characteristics or effects." Although the Act does not define the term "predatory characteristics," it gives examples, which include equity stripping, excessive fees, or abusive terms. The Act calls for the establishment of additional regulations prohibiting acts or practices that are abusive, unfair, deceptive, or predatory.

The Dodd-Frank Act also imposes new compensation limitations by prohibiting yield-spread premium bonuses, a practice that increases the total cost of the loan to the borrower. The Act calls for additional new regulations that will prohibit "permitting any yield spread premium or other similar compensation that would, for any residential mortgage loan, permit the total amount of direct and indirect compensation from all sources permitted to a mortgage originator to vary based on the terms of the loan (other than the amount of the principal)."

Additional Liability for Mortgage Originators

The Act imposes liability on mortgage originators who fail to comply with these new minimum standards. It also provides a remedy to consumers for "the greater of actual damages or 3 times the total amount of direct or indirect compensation or gain accruing to the mortgage originator in connection with the residential loan involved in the violation," plus the costs of suit and reasonable attorneys' fees.

WHAT THIS MEANS TO MORTGAGE ORIGINATORS

Title XIV changes the regulatory landscape for mortgage originators, setting tougher new standards and creating new redress for consumers. The full effect of this new legislation has yet to be determined and will become clearer when federal regulatory agencies create the regulations that will implement much of this new legislation. However, it is evident that one of the aims of the Act is to prevent borrowers from being placed in residential mortgage loans that they are unable to repay. Mortgage originators must be prepared to comply with the Act's new minimum standards or face exposure to liability created by enhanced consumer recourse.

The attorneys in the Consumer Finance Group at Day Pitney are readily available to provide guidance to lenders to ensure compliance with the Dodd-Frank Act. Should you have any questions or concerns about how the Dodd-Frank Act affects you, or to request assistance with respect to compliance with the provisions of the Dodd-Frank Act, please contact Joy Harmon Sperling, Esq., jsperling@daypitney.com or (973) 966-8217.

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