Say Goodbye to SMALL LOANS

by JOSEPH A. WOODRUFF AND CHRIS DRISKILL

THE CONSUMER FINANCIAL PROTECTION BUREAU (CFPB) continues to promulgate rules with all the subtlety of a bull in a china shop. Charged by statute to ensure that “all consumers have access to markets for consumer financial products and services,” the CFPB has issued overbroad amendments to consumer regulations that will likely harm the very consumers it was designed to protect. The latest and perhaps most significant example of a CFPB regulation that will restrict consumers’ access to credit comes in the form of a final rule amending Regulation Z to implement changes to the Home Ownership and Equity Protection Act (HOEPA). The CFPB’s final rule, issued on Jan. 31, 2013 with an effective date of Jan. 10, 2014, significantly lowers the qualification thresholds for “high-cost loans” under HOEPA, imposes additional obligations on lenders that make high-cost loans and expands HOEPA’s coverage to include certain open-end credit transactions such as purchase money...
mortgages and home-equity lines of credit (HELOCs). (The full text of the final rule is available at www.federalregister.gov/articles/2013/01/31/2013-00740/high-cost-mortgage-and-homeownership-counseling-amendments-to-the-truth-in-lending-act-regulation-z.)

Most mortgage lenders do not make HOEPA loans, and therefore the thresholds for high-cost loans under HOEPA have long acted as de facto limits for mortgage lending. Under the new rule, a large number of existing mortgage products would qualify as high-cost loans, particularly lower-balance mortgages that are typically made to first-time homebuyers. Once the new rule goes into effect, lenders may cease to offer these products, and a significant portion of the consumers that the Dodd-Frank Wall Street Reform and Consumer Protection Act and the CFPB were designed to protect may lose access to the mortgage lending market.

HOEPA and its effect on mortgage lending
HOEPA was enacted in 1994 for the stated purpose of curbing abusive practices in mortgage lending. (HOEPA was part of the Riegle Community Development and Regulatory Improvement Act of 1994.) It created a new set of rules for mortgage loans and closed-end HELOCs that met certain thresholds for annual percentage rate (APR) or points and fees charged at closing.

For loans that meet HOEPA thresholds, lenders are required to make additional disclosures and assess the borrower’s ability to repay prior to closing. HOEPA also created significant additional exposure to legal liability for HOEPA-covered loans.

HOEPA loans are subject to rescission and higher damages for disclosure violations than are allowed for non-covered mortgage loans. Additionally, purchasers and assignees of HOEPA loans are subject to liability for any violations of HOEPA made by the original lender.

The practical effect of HOEPA was to create a de facto cap on mortgage lending at the HOEPA thresholds. The transfer of liability risks to assignees made HOEPA loans impossible to sell on the secondary market, and most banks enacted policies to refrain from making mortgage loans covered by HOEPA.

Indeed, in the preamble to the final rule, the CFPB recognized that “[s]ince the enactment of HOEPA, originations of mortgages covered by HOEPA have accounted for an extremely small percentage of the market.”

Data collected under the Home Mortgage Disclosure Act (HMDA) indicates that HOEPA-covered mortgages have steadily declined since HOEPA’s enactment, falling all the way to just 0.05 percent of originations in 2011.

Nonetheless, the final rule significantly lowers the HOEPA thresholds, which will increase the number of mortgage products covered by HOEPA and cause banks to cease offering those products, thereby reducing or eliminating certain credit markets.

The CFPB’s final rule
The CFPB’s final rule amending Regulation Z lowers the thresholds for high-cost loans, expands the definition of “points and fees” that count toward the high-cost loan threshold, and imposes additional obligations on lenders that make high-cost loans.

Under the new rule, a loan is qualified as “high-cost” if:

- The points and fees charged exceed 5 percent of the total loan amount for loans greater than $20,000. The previous threshold was 8 percent.
- The transaction’s APR exceeds the applicable average prime rate by more than 6.5 percentage points for first-lien mortgagés greater than $50,000. The previous threshold was 8 percentage points.
- The transaction permits the creditor to charge or collect a prepayment penalty more than 36 months after transaction closing or permits such fees or penalties to exceed, in the aggregate, more than 2 percent of the amount prepaid.
- The final rule also expands the definition of points and fees under HOEPA. The most significant change to the points and fees definition relates to compensation paid to loan originators.

HOEPA currently requires all compensation paid directly by consumers to mortgage brokers at or before closing to be counted as points and fees for HOEPA purposes. As the CFPB noted, the final rule “substantially expand[s] the scope of compensation included in the points-and-fees” threshold. The final rule includes in points and fees “all compensation paid directly or indirectly by a consumer or creditor to a mortgage originator from any source.”

However, the final rule incorporates an extremely broad and somewhat ambiguous definition of “mortgage originator.”

Under the final rule, a mortgage originator includes “any person who, for direct or indirect compensation or gain, or in the expectation of indirect compensation or gain, (i) takes a residential mortgage loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan.”

While the full effect of the final rule’s expansive definition is unclear at this time, the CFPB did explain that under the final rule, points and fees will include employee compensation paid by the lender either before or after closing—stating in its proposed comment that the new definition of points and fees “includes the dollar value of compensation paid to a loan originator for a specific transaction, such as a bonus, commission, yield-spread premium, award or merchandise, services, trips or similar prizes, or hourly pay for the actual number of hours worked on a particular transaction.”

In addition to lowering the thresholds for high-cost loans and expanding the definition of points and fees, the final rule imposes additional restrictions and requirements on high-cost loans.

Under the final rule, lenders cannot generally include balloon payments in the terms of high-cost loans, charge fees for loan modifications or charge prepayment penalties. The final rule also puts a cap on late fees for high-cost loans of 4 percent of the amount past due.

Significantly, the final rule requires lenders to obtain confirmation from a federally certified homeownership counselor that the consumer has received counseling on the advisability of the mortgage prior to making a high-cost loan.
These additional restrictions and requirements will serve to harden the cap on mortgage lending at the HOEPA high-cost thresholds and likely eliminate high-cost loans altogether from the products offered by regulated lenders.

The effect on credit markets
Changing the criteria for what qualifies as a high-cost loan under HOEPA may have a dramatic effect on the consumer mortgage credit market. Because HOEPA triggers are effectively the outer limits on lending, lowering the HOEPA thresholds and expanding the definition of points and fees will likely eliminate many consumer mortgage products that lenders currently offer.

In advance of the CFPB’s issuance of the final rule, the American Bankers Association (ABA), Washington, D.C., conducted a survey of its members to determine the likely effect of the final rule’s new triggers on consumer lending. (The ABA published details about the results of its survey in its comments on the proposed final rule, available at www.aba.com/solutions/mortgage/documents/abacommentsoncfpb’shoepaproposalsep72012.pdf.)

The results of the ABA’s survey indicate that the CFPB’s final rule will significantly constrict the consumer mortgage credit market, particularly with respect to lower-balance mortgage lending. A decrease in the availability of lower-balance products will most significantly impact first-time homebuyers, many of whom are members of protected classes under fair lending laws.

The ABA asked its members to review their loans made in the first quarter of 2012 and report what percentage of those loans would be classified as high-cost under the final rule’s new thresholds.

The survey indicated that the new APR and prepayment penalty triggers are not likely to significantly affect lending practices. Only 12 percent of respondents stated that they had made loans that would qualify as high-cost under the new APR threshold, and only one lender reported that it had made a loan that would qualify as high-cost due to the new prepayment trigger.

The new points-and-fees trigger, however, is likely to have a dramatic impact on consumer mortgage lending.

A significant majority of the ABA survey respondents—65 percent—reported that at least some of the loans they originated in the first quarter of 2012 would have met the new points-and-fees threshold. Of the hypothetically affected respondents, more than half reported that greater than 10 percent of their loans would have been classified as high-cost, and one respondent stated that 57 percent of its loans would have met the new trigger.

All of the respondents indicated that if the new regulations had been in place, they would not have made the hypothetically affected loans.

The mortgage loans most likely to trigger the new points-and-fees threshold are lower-balance loans. One ABA survey respondent offered a breakdown by balance of the hypothetically affected loans in its portfolio:

- 60 percent of its loans at or below $85,000 reached the new threshold;
- 67 percent of its loans at or below $80,000 reached the threshold; and
- 100 percent of its loans at or below $61,500 reached the threshold.

The reporting institution’s breakdown by balance comports with established mortgage lending practices and common sense. Lenders make less money from interest on smaller-balance loans and, therefore, need to receive a larger portion of their compensation for the loan through fees to make the product economically viable.

Also, many of the fees connected to the extension of credit—such as application, underwriting and processing fees—are not necessarily tied to the balance of the requested loans. These fees are, at least in part, fixed costs for extending credit. These fixed costs will equal a higher percentage of the loan balance where the balance is lower, leaving less room for origination fees or other broker compensation and making the products less viable.

Indeed, recognizing that perhaps the easiest way to avoid entanglement with the new HOEPA triggers is to simply stop making lower-balance loans, every lender that responded to the ABA survey stated that once the new thresholds were finalized, they would consider imposing minimum loan amounts on their mortgage lending.

Significantly, the ABA survey results actually understate the likely effect of the new high-cost loan triggers because the survey did not account for the expanded definition of points and fees. Moreover, the final rule leaves some aspects of point-and-fee calculation uncertain.

Faced with the broad language of the final rule and uncertainty about certain calculations, lenders will likely err on the side of caution and establish even higher lending limits to ensure that their loans have no chance of meeting the HOEPA triggers.

The CFPB expressly recognized that the new HOEPA thresholds will have the biggest impact on lower-balance lending, stating that it “recognizes that points and fees comprise, in part, a means of recovering costs that may constitute a larger percentage of the loan amount for smaller loans.”

Commenters on the rule provided specific evidence showing that the $20,000 threshold for the new HOEPA triggers was too low. Indeed, the CFPB acknowledged that it reviewed “information indicating that, in a significant percentage of smaller transactions made by some lenders, points and fees currently are charged that exceed the [new HOEPA] threshold.”

Commenters urged the CFPB to either raise the $20,000 minimum loan amount for HOEPA’s coverage or delay issuing the final rule until the CFPB could accurately assess the likely effect of the rule on the mortgage lending market. The CFPB, however, expressly declined to exercise its authority to raise the minimum loan amount or delay issuance of the final rule, stating that “commenters did not provide, and the bureau is not otherwise aware of, data or other information that would support [different] specific numeric thresholds.”

Presented with an opportunity to seek further comment or conduct its own research on the likely impact on credit markets and promulgate a thoughtful and nuanced rule that
effect Dodd-Frank’s intentions without damaging the economy, the CFPB chose to plow ahead, and issued a final rule that may severely constrict or even eliminate mortgage lending for dollar amounts between $20,000 and $100,000.

**Compliance burdens created by the final rule**

The final rule’s expanded definition of points and fees will impose substantial compliance burdens on regulated institutions. The inclusion of employee compensation for mortgage originators is particularly burdensome.

Many institutions have complex formulas for determining originator compensation. Attempting to calculate accurately the originator compensation for each individual loan prior to closing will be difficult and costly.

The CFPB noted that “commenters stated that it would be difficult to determine how much of such compensation to count in the points-and-fees calculation before or at consummation, that establishing systems to make such a determination would be costly, and that including hourly wages would create an incentive for loan originators to spend less time on loans, to the detriment of consumers and in contrast to the overall goal of ensuring, for example, careful loan underwriting.”

The CFPB, however, in what is becoming a recurring theme with both this final rule and its other rulemaking activities, paid lip service to industry concerns but declined to make substantial changes to the final rule to address them.

In discussing loan originator compensation, the CFPB stated: “[T]he bureau is concerned about implementation burdens and anomalies created by the requirement to include loan originator compensation in points and fees [and] the impacts that it could have on access to credit . . . Nevertheless, the bureau believes that, in light of the historical record and of Congress’ evident concern with loan originator compensation practices, it would not be appropriate to waive the statutory requirement that loan originator compensation be included in points and fees.”

**The bottom line**

The CFPB continues to make sweeping changes to consumer regulations with little regard for how its rules will affect lenders, credit markets or the very consumers the CFPB was designed to protect. The CFPB’s final rule implementing Dodd-Frank’s amendments to HOEPA is the latest demonstration of its overbroad rulemaking that may have dramatic, detrimental effects on consumer lending.

As the effects of the CFPB’s final rule begin to take shape, lenders, consumers and anyone else interested in America’s economic health will watch and hope that whatever blow is dealt to the mortgage lending market does not cripple its recent and still-fragile recovery. "MB"

Joseph A. Woodruff is a partner in Nashville, Tennessee, and Chris Driskill is an associate in Birmingham, Alabama, with Waller Lansden Dortch & Davis LLP. They can be reached at joseph.woodruff@wallerlaw.com and chris.driskill@wallerlaw.com.