

Hope This Doesn't Create Any Problems

BY JOHN LEVONICK

What does the Dodd-Frank Wall Street Reform and Consumer Protection Act really mean? The crux of the legislation reads like this: Welcome to the world of the “qualified mortgage”—more lending requirements, more risk to originators, less origination revenue. ■ There are many rules imposed by Dodd-Frank that originators are going to have to adhere to, not only as it pertains to their regulated-entity status under the Consumer Financial Protection Bureau (CFPB), but to their investors as well. This new Dodd-Frank Act is going to require originators to have origination and underwriting processes and products locked down and will require additional paperwork to move with the loan into the secondary market. ■ There will be much confusion in the industry with the absence of clear and definitive regulations, and most speculate this clarity won't come for months—maybe years. ■ Until the secondary market gets comfortable

with the exact requirements placed upon the lenders and the application of assignee liability, the liquidity in the primary market will be extremely limited, and access to credit will be equally as limited. The following changes pose the most significant impact on how mortgage originators will be required to conduct operations in the future.

What is the CFPB and what authority does it have?

For those complaining about how this act has resulted in more government, the most glaring example of this is the CFPB. The CFPB is the newly minted regulatory and supervisory authority established to examine and enforce consumer-protection regulations that relate to all mortgage-related businesses, large non-bank financial companies, and banks and credit unions with greater than \$10 billion in assets.

The CFPB is now the primary regulator for non-depository lenders. Excluded from CFPB oversight authority are real estate brokers, people regulated by state insurance regulators, auto dealers, accountants and tax-preparation

service providers.

The CFPB will be led by a director who will be appointed by the president and confirmed by the Senate.

The CFPB will consist of specific offices that will focus on fair lending, equal opportunity, financial education and consumer protection for military personnel and older Americans.

On Sept. 20, the Treasury Department announced that July 21, 2011, will be the “designated transfer date” on which the consumer financial protection functions will be transferred to the CFPB, effectively establishing the timeline for implementing the Dodd-Frank Act's mortgage reforms contained in Title XIV. As of July 21, 2011, the CFPB shall, among other grants of authority, receive its full authority to prescribe rules or issue orders pursuant to any federal consumer financial law, receive staff transfers from the other agencies and officially become

How the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is going to impact the mortgage origination industry.

responsible for the supervision of depository institutions with assets in excess of \$10 billion.

For Title XIV provisions where regulations are required to implement the specific provision, the board or CFPB must issue its final rules by Jan. 21, 2013. The rules must take effect within one year of issuance, meaning that compliance with all rules would be required by Jan. 21, 2014, at the latest.

If the agencies fail to issue implementing regulations, the statutory language will take effect on Jan. 21, 2013. Prior to July 21, 2011, the CFPB will begin conducting research on consumer financial products and services. It will begin to develop its nationwide consumer complaint-response center and begin to plan implementation of its risk-based supervision of non-depository-covered institutions.

Enhancements to origination practices

What does all this mean for the originator? The traditional loan origination process itself is going to go through significant change. What do I mean? Operational and organizational enhancements will be required of mortgage originators to ensure that the Dodd-Frank Act requirements are met.

The Dodd-Frank Act amends the Truth in Lending Act (TILA) to define a "mortgage originator" as any person who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain: 1) takes a residential mortgage loan application; 2) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or 3) offers or negotiates terms of a residential mortgage loan.

A mortgage originator specifically includes any person who represents to the public through advertising or other means of communicating or providing information that such person can or will provide any of the services or perform any of the activities set forth in the definition of "mortgage originator." Originators are required to be licensed and registered according to strict qualifying standards.

In addition to the requirement that loan originators be qualified, licensed and registered, the Nationwide Mortgage Licensing System and Registry—provided unique identifier for a mortgage originator must be added to all loan documentation.

The Dodd-Frank Act amends the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act) by moving the enforcement and rulemaking authority under the SAFE Act from the Department of Housing and Urban Development (HUD) to the CFPB. As a result, the CFPB is charged with developing and maintaining a system for registering loan originators who work for depository institutions or subsidiaries of depository institutions that are regulated by a federal banking agency or the Farm Credit Administration with the

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Nationwide Mortgage Licensing System (NMLS).

The system must be implemented before the end of one year from the date the Dodd-Frank Act became law.

Steering and originator compensation

Wait—there's more change on the way as a result of the Dodd-Frank Act. The act establishes new prohibitions against product steering and prohibits yield-spread premiums (YSPs) as well as other compensation to the mortgage originator that varies based on terms of the mortgage loan, including rate.

Specifically, the act permits compensation to the originator: 1) based on the principal amount of the loan;

2) to be financed through the loan's rate as long as it is not based on the loan's rate and terms, and the originator does not receive any other compensation such as discount points origination points or fees however denominated other than third-party charges from the consumer or any other parties to the transaction; and 3) in the form of incentive payments based on the number of loans originated within a specified period of time.

It is going to be very interesting to see how loans are priced and how brokers are going to compete with retail lending.

YSPs and similar means of originator payment

Now let's talk about the bottom line a bit. The Dodd-Frank Act generally prohibits mortgage originators of residential mortgage loans from being paid compensation that varies based on the terms of the loan other than the principal amount of the loan. This will prohibit, for example, yield-spread premiums.

The term "mortgage originator" generally includes loan brokers and generally does not include creditors; a "residential mortgage loan" is generally a closed-end consumer loan secured by a dwelling or by real property that includes a dwelling.

The act will also prohibit a mortgage originator from receiving an origination fee or charge from anyone other than the consumer, though an exception allows someone other than the consumer to pay the origination fee or other charge if the originator is not being compensated directly by the consumer and the consumer does not make any upfront payment of discount or origination points or other fees other than bona fide third-party charges that are not retained by the mortgage originator, the creditor or an affiliate of the originator or creditor.

Other prohibited steering incentives

The Dodd-Frank Act requires the Federal Reserve to issue regulations to prohibit mortgage originators from:

- Steering any consumer to a mortgage loan that the consumer lacks a reasonable ability to repay;
- Steering any consumer to a mortgage loan that has what the law deems predatory characteristics or effects,

such as equity stripping, excessive fees or abusive terms;

- Steering any consumer away from a mortgage for which the consumer is qualified and that is a "qualified mortgage" under the law, to a mortgage loan that is not a qualified mortgage;

- Abusive or unfair lending practices that promote disparities based on race, ethnicity, gender or age;

- Mischaracterizing the credit history of a consumer or the loans available to the consumer;

- Mischaracterizing or inducing the mischaracterization of the appraised value of the property; and

- Discouraging the consumer from seeking a mortgage loan from another provider if the originator is unable to offer a less-expensive loan.

Underwriting standards—the ability to repay

Dodd-Frank even requires the industry to be a soothsayer of sorts. You must know the borrower on a much more intimate level. The act, subject to refinement by anticipated regulations to be adopted by the CFPB, prohibits originators from making residential mortgage loans unless the creditor makes good-faith determination (based on verified and documented information) that, at the time the loan was consummated, the consumer had a reasonable ability to repay the loan according to its terms, taking into consideration all applicable taxes, insurance and assessments.

The act does contemplate the return of non-traditional products, by creating general requirements for a repayment-ability determination and also special requirements for interest-only loans or variable-rate loans that may permit the consumer to defer repayment of principal or interest.

Exactly how originators will substantiate how these obligations are met is still uncertain. In the absence of clear guidance, maintaining a clear and accurate record of the individual loan underwriting assessments, supported by actual asset and income documentation, should permit originators to prove they met this obligation.

Without this substantive proof, it is a viable argument that a consumer could assert a lender's failure to comply with the repayment-ability determination requirements as a possible defense to a foreclosure or other action to collect the debt by the creditor.

The qualified mortgage

Many have feared the 5 percent rule in the act's drafting, but there may be one saving grace for the private-label securitization industry—the "qualified mortgage" clause. According to Title XIV of the act, the qualified mortgage is a residential real estate loan that meets several requirements including, but not limited to, having fully verified and documented income and assets, underwriting stan-

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dards and ratios within statutory and regulatory threshold requirements, total points and fees that do not exceed 3 percent of the total loan amount, and a safe harbor from a claim that the lender failed to assess a borrower's ability to repay the loan.

This act will have a significant impact on the mortgage secondary markets and the private-label securitization industry—specifically Section 941 of the act, which addresses "regulation of credit risk retention." According to the act, asset-backed securitizers (issuers) of collateralized mortgage obligations (CMOs) are required to retain a non-hedgable interest in the securities they issue. The issuer must retain a

minimum of 5 percent of the credit risk and is required to provide additional disclosures to help investors independently assess credit quality. An exception, or safe harbor, to the credit-risk retention requirements is any asset-backed securities (ABS) that exclusively contain qualified residential mortgages.

The qualified residential mortgage is to be further defined jointly by the federal banking agencies, the Securities and Exchange Commission (SEC), HUD and the Federal Housing Finance Agency (FHFA). It is anticipated to be similar to a "qualified mortgage" as defined in Title XIV of the Dodd-Frank Act, and agencies must be clear so as not to confuse the industry with a definition for "qualified residential mortgage" that may contradict or be mistaken for the "qualified mortgage" in Title XIV.

Product structuring

The act creates further restrictions on the structuring of residential mortgages by establishing a prohibition on the use and application of prepayment penalties, negative amortization and mandatory arbitration.

Prepayment penalties: The act prohibits prepayment penalties within loans that are "not qualified mortgages." It further restricts prepayment penalties to loans that are not adjustable and do not have an annual percentage rate (APR) exceeding the average prime offer rate (APOR) (meaning the average prime offer rate for a comparable transaction as of the date on which the interest rate for the transaction is set, as published by the Federal Reserve Bank) by 1.5 or more percentage points for first-lien loans, 2.5 or more percentage points for jumbo loans or 3.5 or more percentage points for subordinate-lien loans.

Also, it requires a three-year phase-out of prepayment penalties for qualified mortgages and prohibits offering a loan with a prepayment penalty without offering a loan that does not have prepayment penalty.

A "qualified mortgage" loan may provide for a prepayment penalty in the 3-2-1 format. That is, the penalty could not be more than three percentage points, two percentage points or one percentage point of the outstanding loan balance for a prepayment

during the first year, second year or third year of the loan, respectively. Additionally, a creditor could not offer a qualified mortgage loan with a prepayment penalty unless the creditor also offers a loan without a prepayment penalty.

Negative amortization: A creditor may not make a residential mortgage loan that provides for negative amortization other than a reverse-mortgage loan unless a disclosure is provided to the consumer that explains the negative-amortization feature and describes negative amortization in a manner prescribed by regulation. For a first-time homebuyer, the creditor also would have to obtain sufficient documentation to demonstrate that the consumer received homeownership counseling from a HUD-certified counselor.

Arbitration: The act expressly prohibits mandatory arbitration for residential mortgages and open-end consumer credit secured by principal dwellings, except on reverse mortgages.

Changes to TILA

As defined under Title XIV, the qualified mortgage cannot have total points and fees that exceed 3 percent of the total loan amount. This point and fee limit applies the current definition in TILA with the following exclusions: 1) up to and including 2 bona fide discount points, depending on interest rate; 2) any government insurance premium and any private mortgage insurance (MI) premium up to the amount of the FHA insurance premium, provided the MI premium is refundable on a *pro rata* basis; and 3) any

MI premium paid by the consumer after closing (e.g., monthly).

The most prevalent change is the expansion of Home Ownership and Equity Protection Act (HOEPA) coverage, and its restrictions governing high-cost mortgages to the previously excluded loan purpose of purchase-money mortgages. Also, the act lowers APR triggers to cover loans with an APR of more than 6.5 percent above the comparable APOR for first-lien loans (8.5 percent if the dwelling is personal property and the transaction is less than \$50,000) and 8.5 percent above for subordinate loans. It also lowers point and fee triggers from 8 percent of the total loan amount to 5 percent (the lesser of 8 percent or \$1,000 for loans under \$20,000).

Liability

The act establishes that mortgage originators are liable for violations of duty of care and anti-steering prohibitions up to the greater of actual damages or an amount equal to three times the total amount of direct and indirect compensation or gain accruing to the mortgage originator for the loan involved, plus costs and reasonable attorneys' fees.

What exactly does all this mean? For originators, it means know your borrowers. For investors, know your originators and loan-level data. As for all the rest, who knows? I guess we'll find out soon enough. **MB**

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