Consumer Financial Protection & Owner Financing

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") introduced a host of new regulations designed to protect consumers and avoid another housing collapse. Key components of Dodd-Frank were designed to create greater certainty that borrowers can repay their home loans. The regulations impose a number of complex parameters that limit available loan terms and require lenders to verify and document the borrower's ability to repay.

The new Consumer Financial Protection Bureau ("CFPB") was established to implement and enforce the Dodd-Frank rules in the mortgage industry. The CFPB regulations implementing Dodd-Frank went into effect on January 10, 2014 and have raised a number of compliance issues for those in the lending industry.

The rules and regulations also introduce compliance burdens for those who are not regularly in the business of making loans. For instance, even sellers who wish to provide owner carry financing in a single transaction must be careful to comply with Dodd-Frank. Owner financing may be an attractive option if a buyer cannot qualify for institutional financing or if the seller prefers the steadiness of monthly mortgage payments as an investment option. While certain exclusions exist under Dodd-Frank for sellers who wish to provide seller-carry financing in connection with the sale of their property, the criteria for qualifying for an the applicable exclusions is complex and rigid.

To complicate matters, even if seller financers in Colorado qualify for certain exclusions under federal Dodd-Frank regulations, they must also comply with separate state-specific obligations. This article will examine federal and state compliance requirements for Colorado sellers who may consider offering financing to fund the sale of their property.

Dodd-Frank Definitions

The default under Dodd-Frank is that a "mortgage originator" includes anyone who performs activities related to the origination of residential mortgage loans, including offering or negotiating terms of a residential mortgage loan. The term "residential mortgage loan" means any consumer credit transaction that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on a dwelling or on residential real property that includes a dwelling. A "dwelling" is a residential structure that contains 1-4 units.

Under the definitions, a "consumer" is a natural person and a "credit transaction" is where the money, property, or services extended are primarily for personal, family, or household purposes. Unless otherwise exempt, mortgage originators for consumer credit transactions secured by a dwelling must be registered and licensed and the loan must meet various ability-to-repay rules.

What do all these definitions mean in practical terms?

When taken together, the definitions broadly state that if a loan that will be secured by a property that the borrower will live in, the person who arranges the loan must have a mortgage originator license. That baseline means that seller financers must be licensed mortgage originators, unless they qualify for an exception. The property securing the loan can be any residential dwelling that contains 1-4 units, including houses, apartments, townhouses, condominium units, cooperative units, mobile homes, and trailers or boats used as residences. The rules apply whether the individual is purchasing a primary residence, second home, or vacation residence. However, the regulations discussed in this article do not apply to loans secured by raw land, commercial properties, or properties used for investment purposes.

Does that mean that no loans can be made to borrowers by those without a mortgage origination license if the borrower plans to use the property for personal, family, or household purposes?

No – certain exceptions were written into the Dodd-Frank rules for sellers who wish to fund the purchase of their property with owner financing. The seller financer is not treated as a “loan originator” if the seller meets certain criteria associated with the sale and finance of a limited number of properties in a 12-month period. The initial exceptions that were originally laid out in Dodd-Frank were modified by the Consumer Financial Protection Bureau during 2013 after receipt of public comments, so sellers need to be sure they are operating from the most current CFPB regulations.

Three-Property Exclusion

The first available exclusion is for sellers who finance the purchase of three (3) or fewer properties in a 12-month period. In order to qualify for the exclusion and make the loan, the following qualifications must be met:

The seller provides financing for the sale of three or fewer properties in any 12-month period. The property must have been owned by the seller and serve as security for the loan. Note that for this exclusion, the seller may include individual sellers, as well as businesses, trusts, and other entities. The seller did not construct, or act as a contractor in the construction of, the residence in the ordinary course of their business. This element means that builders or contractors who are in the business of constructing homes do not qualify for the three-property seller finance exclusion.

The terms of the loan offered must meet the following requirements:

First, the loan must be fully amortizing. That means that the loan must be fully paid off over a set term. Balloon payments are not permitted. Negatively amortizing terms are also not permitted, where monthly payments do not cover the full amount of interest due and unpaid interest is added to the principal balance of the loan.

Second, the person must determine in good faith that the consumer has a reasonable ability to repay. The following “ability to repay” factors for non-exempt residential loans could be taken into consideration when determining the borrower’s ability to make payments: (1) current or reasonably expected income or assets; (2) current employment status; (3) the monthly payment on the proposed loan; (4) the monthly payment on any simultaneous loan; (5) the monthly payment for mortgage-related obligations; (6) current debt obligations, alimony, and child support; (7) the monthly debt-to-income ratio or residual income; and (8) credit history. While seller financers are not required to formally document how they made the good faith ability-to-repay determination, prudent sellers should keep records in case their analysis is ever called into question.

Third, the loan must have a fixed interest rate or an adjustable interest rate that remains fixed for at least five years. If the rate adjusts, it must be tied to a widely-available index such as indices for U.S. Treasury securities or LIBOR. Any annual or lifetime interest rate adjustments must also be reasonable. The CFPB has stated that an annual interest rate increase of two percentage (2%) points or less is reasonable, and a lifetime limitation of an increase of six percentage (6%) points or less is reasonable.

One-Property Exclusion

A less-restrictive set of financing terms and conditions may be utilized if the seller is only financing the purchase of a single property in a 12-month period. In order to qualify for the one-property exclusion, the following qualifications must be met:

The seller must be a natural person and can only finance the sale of a single property in any 12-month period. The property must have been owned by the seller and must serve as security for the loan. For the single-property exclusion, the seller may only be an individual, trust or estate. Corporations, LLC's, partnerships or other seller entities do not qualify for the one-property exclusion.

The seller did not construct, or act as a contractor in the construction of, the residence in the ordinary course of the person's business. This element mirrors the limitation contained in the three-property exclusion.

The terms of the loan offered must meet the following requirements:

First, the financing must have a repayment schedule that does not result in negative amortization. Note that this condition does not require the loan to be fully amortizing, meaning that a balloon payment can be a component of a one-property exclusion loan.

Second, the loan must have a fixed interest rate or an adjustable interest rate that remains fixed for at least five years. These parameters are discussed in more detail above.

Dodd-Frank Summary

Unless sellers qualify for one of the seller financing exclusions detailed above, they will need to utilize a different approach for financing the sale of their property. As a practical matter, that means that buyers will likely have to engage a licensed loan originator to facilitate the financing. Of course, licensed loan originators are typically only able to offer financing on more restrictive terms than could be offered under the seller-financing exclusions.

Despite increased regulations potentially leading to frustrations, sellers should think long and hard before offering loans that do not comply with Dodd-Frank regulations. Failure to comply could result in borrowers being able to recover costs and damages from lenders, seller forfeiture of down payments or finance charges, and borrowers even potentially having an affirmative defense to a lender's foreclosure action.

Colorado Requirements

In addition to having to comply with the new federal Dodd-Frank lending requirements, seller financers in Colorado must also comply with state-specific disclosure requirements. These disclosures are required when making a residential mortgage loan, which is a loan that is primarily for personal, family or household use and that is secured by a mortgage, deed of trust, or other equivalent, consensual security interest on a dwelling or residential real estate. For practical purposes, the definition of a residential mortgage loan under Colorado law is substantially similar to its definition under Dodd-Frank.

When making residential mortgage loans in Colorado, the lender must provide certain written disclosures to borrowers, which include:

1. Certain Loan Terms, including:
The annual percentage rate,
Finance charge,
Amount financed,
Total amount of all payments,
Number of payments,
Amount of each payment,
Amount of points or prepaid interest, and
The conditions and terms under which any loan terms may change between the time of disclosure and closing of the loan. If the interest rate is variable, the written disclosure must clearly describe the circumstances under which the rate may increase, any limitation on the increase, the effect of an increase, and an example of the payment terms resulting from an increase.

2. Itemized Costs of Third Party Fees, including:

Credit report,
Appraisal,
Title report,
Title insurance policy,
Mortgage insurance,
Escrow fee,
Property tax,
Insurance,
Structural or pest inspection, and
Any other third-party provider's costs associated with the residential mortgage loan.

3. If applicable, the amount of any commission or other compensation to be paid to the mortgage loan originator, including the manner in which the commission or other compensation is calculated and the relationship of the commission or other compensation to the cost of the loan received by the borrower.

4. If applicable, the cost, terms, duration, and conditions of a lock-in agreement and whether a lock-in agreement has been entered, whether the lock-in agreement is guaranteed by the mortgage loan originator or lender, and, if a lock-in agreement has not been entered, disclosure that the interest rate and terms are subject to change.

5. A statement that, if the borrower is unable to obtain a loan for any reason through the lender, the lender must provide reports and appraisals paid for by the proposed borrower to the borrower and any new lender who the borrower may designate.

6. Whether and under what conditions any lock-in fees are refundable to the borrower.

7. A statement providing that moneys paid by the borrower to the mortgage loan originator for third-party provider services are held in a trust account and any moneys remaining after payment to third-party providers will be refunded.

While certain groups have urged the Colorado legislature to only make these disclosure requirements mandatory for state-licensed mortgage originators, no exclusion currently exists that exempts private lenders from the disclosure requirements. So under current Colorado law, sellers who offer financing to fund the purchase of their property must make the disclosures described above.

Summary

The lending environment today is more complex and fraught with pitfalls than ever before. Even sellers who want to finance the sale of their own property with a one-time owner-carry loan must be sure that they comply with federal and state regulations. Failure to do so could compromise the lender's ability to enforce the terms of the loan if the borrower defaults.

If you are thinking of making a loan that will be secured by real estate, you need to consult with a real estate attorney who is knowledgeable in this area. This article is not intended to be exhaustive and only deals with a narrow set of circumstances. Please contact me to discuss the specifics of your situation.