The Dodd-Frank Act and the Decline in Home Ownership

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ABSTRACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has changed the landscape of mortgage financing for real estate. Many homebuyers in the United States have been denied mortgages because they have failed to qualify for a qualified mortgage under the new rules. These new rules have disqualified many existing homebuyers from getting another mortgage, and have limited the options of new homebuyers to obtain financing for a new home. Younger age groups have taken on more student loans than in the past and are finding it very difficult to qualify for mortgages under the new rules. Home ownership levels have declined to the lowest level since 1995 the lowest level in nearly 20 years. The future level of homeownership will depend largely on the cost and availability of mortgage financing, both of which are now restricted by Dodd-Frank.

Keywords: Dodd-Frank, Qualified Mortgages, Home Ownership, Consumer Financial Protection Bureau

INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has changed the landscape of mortgage financing for real estate. Many homebuyers in the United States have been denied mortgages because they have failed to qualify for a qualified mortgage under the new rules. Many borrowers were unable to meet the debt-to-income ratio maximum of 43%. Under the new rules for qualified mortgages, points and costs cannot exceed 3% and lenders must independently verify that a borrower "has the ability to repay" via eight different criteria. These new rules have disqualified many existing homebuyers from getting another mortgage, and have limited the options of new homebuyers to obtain financing for a new home.

CHANGES IN HOME OWNERSHIP LEVELS

Home ownership levels in Q3 2014 are 64.4%, down from 69.2% in 2004, and are the lowest since 1995 (US Census Bureau, Vacancies and Homeownership report for Q2 2014 and Q3 2014). By age group, for the Q3 2014, the homeownership rates were highest for those householders ages 65 years and over (80.0 percent) and lowest for the under 35 years of age group (36.0 percent). The rates for householders 35 to 44, 45 to 54 and 65 years and over were lower than the third quarter 2013 rates, while the rate for householders under 35 and 55 to 64 years were not statistically different from the rates a year ago). This report indicates that senior citizens have the highest ownership rates while young people under 35 have the lowest ownership rates. Older citizens that do not have the incentive or need to relocate are holding onto their existing mortgages and homes, while younger citizens, who are more mobile, are finding it more difficult to qualify for a new mortgage. The US Census Bureau reports that about one-quarter of those aged 20 to 29 moved during 2010 while only 4 percent of those aged 55 and over moved during the same year (US Census Bureau Q13 Report). In addition to being more mobile, many younger would-be homebuyers are holding student loan debt. Between 2001 and 2010, the age group 25–34 increased student loan debt from 26 percent to 39 percent, with the median amount rising from $10,000 to $15,000 in real terms. Between 2001 and 2010, for this age group, student loan debt of least $50,000 more than tripled from 5 percent to 16 percent (Harvard, Joint Center for Housing Studies, 2014). For these younger borrowers the ability to meet the debt to income ratio dictated by Dodd-Frank will likely delay any home purchases.

Home ownership has been associated with economic health and upward mobility. According to a recent Harvard Joint Center for Housing Studies report, the housing crisis, which began in 2008 and resulted in an economic recession, has had dramatic effects on the wealth of US citizens. According to the Study,

- Between 2006 and 2011 house prices fell more than 30 percent nationally, wiping out over $8 trillion in home equity (Joint Center, 2012).
- At the height of the crisis, a full one quarter of all homeowners owed more on their mortgages than their homes were worth (Belsky, 2013).
- Mortgage foreclosures increased from the 1980-2006 average foreclosure rate of .32 percent to over 4.9 percent in 2010 (National Delinquency Survey).
- Between 2008 and 2011, more than four million homeowners lost their homes to foreclosure.

- 2012 data also indicated that there were an additional two million homeowners who are at least 90 days delinquent on their mortgage payments. (Harvard Joint Center, 2014).

DODD-FRANK ACT

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111–203, H.R. 4173) was passed in 2010 to "Create a Sound Economic Foundation to Grow Jobs, Protect Consumers, Rein in Wall Street and Big Bonuses, End Bailouts and Too Big to Fail, Prevent Another Financial Crisis." The Dodd-Frank Act consists of 16 major sections, or Titles, addressing such things as Hedge Fund Advisors, Wall Street, Securities, the Federal Reserve, and Mortgages. Of particular concern to the real estate and mortgage industries are Title X, which creates the Consumer Financial Protection Bureau, and Title XIV, the Mortgage Reform and Anti-Predatory Lending Act. Congress enacted the Dodd-Frank Act in 2010 in an attempt to stabilize the economy and to protect homeowners from predatory lending. However, the Act may have unintended consequences in that it is now more difficult to qualify for a mortgage and fewer people now own their homes. Olefson estimates that about 20% of people who have mortgages right now, will not be able to get qualified mortgages (Olefson, 2014).

Consumer Financial Protection Bureau

The Consumer Financial Protection Bureau ("CFPB" or "Bureau") was established under Title X of the Dodd-Frank Act. The Bureau was created to provide a single point of accountability in the federal government for consumer financial protection and gave the Bureau authority to conduct rulemaking, supervision and enforcement with respect to the Federal consumer financial laws; handle consumer complaints and inquiries; promote financial education; research consumer behavior; and, monitor financial markets for risks to consumers (CFPB Strategic Plan).

The CFPB was established with an independent head, led by an independent director appointed by the President and confirmed by the Senate. It has an independent budget paid by the Federal Reserve System. It is able to autonomously write rules for consumer protections governing all financial institutions – banks and non-banks – offering consumer financial services or products. It has the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion and all mortgage-related businesses (lenders, servicers, mortgage brokers, and foreclosure scam operators), payday lenders, and student lenders as well as other non-bank financial companies that are large, such as debt collectors and consumer reporting agencies.

The CFPB consolidates and strengthens consumer protection responsibilities currently handled by the Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Deposit Insurance Corporation, Federal Reserve, National Credit Union Administration, the Department of Housing and Urban Development, and Federal Trade Commission. It will also oversee the enforcement of federal laws intended to ensure the fair, equitable and nondiscriminatory access to credit for individuals and communities. It creates a new Office of Financial Literacy, a national consumer complaint hotline, and makes one office accountable for consumer protections. It works with bank regulators by coordinating with other regulators when examining banks to prevent undue regulatory burden and consults with regulators before a proposal is issued and regulators could appeal regulations they believe would put the safety and soundness of the banking system or the stability of the financial system at risk (U.S. Senate Banking, Housing and Urban Affairs Committee Summary 2010).

Mortgage Reform and Anti-Predatory Lending

Mortgage reform was one of the goals of the Act. The Truth in Lending Act (effective October 2009) prohibits creditors from making "higher-price mortgage loans" without assessing consumers' ability to repay the loans. Dodd-Frank has made specific provisions that need to be met to assess consumers' ability to pay. Section XIV of the Dodd Frank Act amends the Truth in Lending Act (TILA) and provides the foundation for the CFPB Regulations. Section XIV, the Mortgage Reform and Anti-Predatory Lending Act, seeks to establish residential mortgage loan standards, and requires that for residential mortgages originators must make a reasonable and good faith determination based on verified and documented information that the consumer has a reasonable ability to repay the loan according to its terms. The Dodd-Frank Act also established a presumption of compliance for a certain category of mortgages, called "qualified mortgages." These provisions are similar, but not identical to, the Board's 2008 Truth in Lending Act rule and applies to the entire mortgage market rather than simply higher-priced mortgages. The CFPB regulations for financing of real estate include the following *Ability-to-Repay Determinations*:

Creditors must follow certain minimum requirements for making ability-to-repay determinations. At a minimum, creditors generally must consider eight underwriting factors:

(1) current or reasonably expected income or assets;
(2) current employment status;
(3) the monthly payment on the covered transaction;
(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.

Creditors must generally use reasonably reliable third-party records to verify the information they use to evaluate the factors. (Consumer Financial Protection Bureau, 2010).

Monthly payments must generally be calculated by assuming that the loan is repaid in substantially equal monthly payments during its term. For adjustable-rate mortgages, the monthly payment must be calculated using the fully indexed rate or an introductory rate, whichever is higher. Special payment calculation rules apply for loans with balloon payments, interest-only payments, or negative amortization. Creditors are encouraged to refinance "non-standard mortgages" into "standard mortgages" with fixed rates for at least five years that reduce consumers' monthly payments.

Presumption for Qualified Mortgages. The Dodd-Frank Act provides that "qualified mortgages" are entitled to a presumption that the creditor making the loan satisfied the ability-to-repay requirements. The CFPB provides that consumers may show a violation with regard to a subprime qualified mortgage by showing that, at the time the loan was originated, the consumer's income and debt obligations left insufficient residual income or assets to meet living expenses. For all mortgage instruments, it is presumed that the creditor made a good faith and reasonable determination of the consumer's ability to repay.

Non-Qualified Mortgages. The CFPB excludes loans with negative amortization, interest-only payments, balloon payments, or terms exceeding 30 years from being qualified mortgages. A loan generally cannot be a qualified mortgage if the points and fees paid by the consumer exceed three percent of the total loan amount, although certain "bona fide discount points" are excluded for prime loans.

The CFPB provides guidance on the calculation of points and fees and thresholds for smaller loans and establishes general underwriting criteria for qualified mortgages. Monthly payments must be calculated based on the highest payment that will apply in the first five years of the loan and that the consumer have a total (or "back-end") debt-to-income ratio that is less than or equal to 43 percent. The Bureau believes that these criteria will protect consumers by ensuring that creditors use a set of underwriting requirements that generally safeguard affordability. At the same time, these criteria provide clear lines for creditors who want to make qualified mortgages.

A loan is considered jumbo (valid until 12/31/2014) if it exceeds the conforming and conforming high-balance loan limits. The maximum original principal balance limit in 2014:

- The current conforming loan limit for a single-family home is $417,000 for all states—except Hawaii and Alaska, where it is $625,500
- In federally designated high-priced markets in the continental United States, conforming high-balance limits range from $417,001 to $625,500 and, in designated markets in Hawaii, from $625,501 to $721,050. To note, conforming high-balance loans typically have higher interest rates, stricter underwriting and larger down payment requirements than standard conforming loans (Fannie Mae, 2014).

Seller Financing Exclusions

Seller financing has traditionally been a popular way to help home buyers ease into a mortgage. In the past, balloon payments were structured such that the entire amount of the unpaid balance was due within a few years. These balloon mortgages were intended to help those who needed time to obtain conventional financing or other sources of funding in order to buy homes. In the past, a seller could easily hold a "Purchase Money Mortgage" or note for part of the real estate transaction. Effective January 10, 2014, provisions of the Dodd-Frank Act changed the permitted structures of many of these real estate transactions. After January 10, 2014, many seller financing arrangements will no longer be allowed as new rules and regulations effecting creditors (sellers) and loan originators take effect.

Provisions of the Dodd Frank Act are widely applicable to those involved in real estate transactions, including creditors and "originators" of loans. Originators include those who are compensated for actions related to the origination of a loan, such as taking an application, assisting an applicant obtain credit, or negotiating the terms of a loan. Section XIV imposes many requirements on loan originators. It requires originators to lend only to those likely to repay and imposes registration and reporting requirements on them. It also restricts certain methods of compensation. However, certain seller financing loans made to owner occupants do not involve loan originators. In such cases, the law and regulations that pertain only to originators may not apply. Two types of exclusions are available.

The Single Property Exclusion. Natural persons, estates, and trusts that finance the sale of only one owned property in any 12-month period may be excluded from the definition of loan originator if the seller meets the following criteria:

- The seller provides financing for only one property in any 12-month period,
- The seller owns the property securing the financing,
- The seller did not construct, or act as a contractor for the construction of, a residence on the property in the seller's ordinary course of business, and
- The financing does not result in negative amortization, has a fixed rate or an adjustable rate that resets after five or more years (rate adjustments may be subject to reasonable annual and lifetime limits – in addition, the rate must be tied to an index rate such as U.S. Treasury securities indices or LIBOR). (CFPB, 2013 Loan Originator Rule, pg. 20)

An adjustable rate financing that is considered "reasonable" by the CFPB is an annual rate increase of 2 percentage points or less, and a lifetime limitation of an increase of 6 percentage points or less is reasonable. In these cases, the seller/financers are allowed to structure the loan with a balloon payment (as long as there is no negative amortization). The seller does not have to prove that the borrowers have the "ability to pay" or that the borrowers are "qualified borrowers" according to the Consumer Financial Protection Bureau rules.

The Three Property Exclusion. Natural persons, corporations, partnerships, proprietorships, estates, trusts, and other "persons" that sell three or fewer owned properties in any 12-month period may be excluded from the definition of loan originator if the each of the properties meets the following criteria:

- The seller provides financing for three or fewer properties in any 12-month period,
- The seller owns the property securing the financings,
- The seller did not construct, or act as a contractor for the construction of, a residence on the property in the seller's ordinary course of business, and
- The financing is fully amortizing (no balloon payments), has a fixed rate or an adjustable rate that resets after five or more years (rate adjustments may be subject to reasonable annual and lifetime limits – in addition, the rate must be tied to an index rate such as U.S. Treasury securities indices or LIBOR). (CFPB, 2013 Loan Originator Rule, pg. 21)
- The seller has determined in good faith that the buyer has a reasonable ability to repay the loan.

An adjustable rate financing that is considered "reasonable" by the CFPB is an annual rate increase of 2 percentage points or less, and a lifetime limitation of an increase of 6 percentage points or less is reasonable. In these cases, the seller/financers are **not** allowed to structure the loan with a balloon payment, the seller has determined in good faith that the borrowers have the “ability to pay” according to the Consumer Financial Protection Bureau – 2013 Loan Originator Rule (pg. 21).

In spite of apparent exclusion, state law or other federal regulations may prohibit or limit owner financing without an originator and/or render it an impractical alternative.

Special Provisions

The CFPB is concerned that creditors and loan originators may initially be reluctant to make loans that are not qualified mortgages, even though they are responsibly underwritten. The CFPB has defined four types of mortgages, and each category provides a presumption of compliance with the ability-to-repay requirement:

- Traditional Qualified Mortgage (1026.43(e)(2))
- Temporary Qualified Mortgage (1026.43(e)(4))
- Small Creditor Portfolio Qualified Mortgage (1026.43(e)(5))
- Small Creditor Balloon Qualified Mortgage (1026.43(e)(6) and 1026.43(f)).

Traditional Qualified Mortgages (43% DTI) have the following limits on loans features: no negative amortization or interest-only periods, no balloon payments (except for certain portfolio loans by small creditors), and the loan term may not exceed 30 years. Points and fees are capped at generally 3% of total loan amount, with higher caps for loans <$100,000, and up to two additional bona fide discount points allowed depending on rate. The relevant underwriting requirements are that the loan apply the maximum rate in first five years after first payment, full amortization, lender has considered and verified income or assets, current debt obligations, alimony and child support, and that the monthly debt-to-income ratio cannot exceed 43%.

Temporary Qualified Mortgages have the same limits on loan features and points and fees cap as qualified mortgages, but have alternative underwriting requirements. The loans must be eligible for purchase, guarantee, or insurance by Fannie Mae or Freddie Mac (sunsets when conservatorship ends or 7 years), or by HUD, VA, Department of Agriculture or Rural Housing Service (sunsets when agency rules take effect or 7 years). Any factors wholly unrelated to

Small Creditor Portfolio Qualified Mortgages have the same limits on loan features and points and fees cap as qualified mortgages, but do not have the 43% DTI underwriting requirement that qualified mortgages have. In order to qualify, creditors must have <$2 billion in assets and (with affiliates) originate ≤500 covered mortgages per year with no restrictions on location. The loan must generally be held in portfolio for 3 years and the threshold for safe harbor is increased to 3.5% above the average prime offer rate (APOR).

Small Creditor Balloon Qualified Mortgages have the same limits on loans as qualified mortgages (except balloons are not restricted), the same points and fees cap as qualified mortgages, and have the same underwriting requirements except do not require a 43% DTI for the consumer. The creditors must have <$2 billion in assets and (with affiliates) originate ≤500 covered mortgages per year, > 50% of first-lien mortgages made in rural or underserved counties in the preceding calendar year, and the mortgage must generally be held in a portfolio for 3 years. (CFPB Outlook Live Webinar: Small Creditor Qualified Mortgage, December 4, 2013)

The Dodd-Frank Act prohibits prepayment penalties except for certain fixed-rate, qualified mortgages where the penalties satisfy certain restrictions and the creditor has offered the consumer an alternative loan without such penalties. To match with certain statutory changes, the final rule also lengthens to three years the time creditors must retain records that evidence compliance with the ability-to-repay and prepayment penalty provisions and prohibits evasion of the rule by structuring a closed-end extension of credit that does not meet the definition of open-end credit as an open-end plan (CFPB Regulatory Implementation, 2010).

CONCLUSION

The residential mortgage industry has been significantly influenced by the Dodd Frank Act and more change is sure to occur as the provisions of the Act are implemented and enforced. Loan originators and creditors are the primary focus of the Act's Section XIV, The Mortgage Reform and Predatory Lending Act, which generally requires them to determine whether the buyer has a reasonable ability to repay and prohibits certain lending activities and types of loans. Dodd Frank also establishes the Consumer Financial Protection Bureau and gives it broad powers to issue Regulations and coordinate/oversee a number of other bureaus and agencies. While there are some exclusions and special provisions, the Act and the Regulations are far-reaching, broadly applicable, complex, and extensive. The decline on home ownership levels as a result of the Dodd-Frank Act may have the largest impact on the economy and on individual homeowner's lives. The future level of homeownership will depend largely on the cost and availability of mortgage financing, both of which are now restricted by Dodd-Frank.

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