High-Cost vs. Higher-Priced Mortgages

The differences are many, and private-money lenders should be sure they know the fine details

By David A. Roth

The Dodd-Frank Wall Street Reform and Consumer Protection Act has private lenders running scared, with many private-money organizations having ceased originating loans on personal residences altogether. This is not necessary, however, provided that private lenders carefully follow applicable regulations. The key to finding success with these loans lies in knowing the difference between the definitions of a "higher-priced mortgage" and a "high-cost mortgage.

"A higher-priced mortgage loan is a consumer credit transaction secured by the consumer's principal dwelling with an annual percentage rate (APR) that exceeds the average prime offer rate (APOR) by a given amount. In general, for a first-lien mortgage, a loan is "higher-priced" if its APR exceeds the APOR by 1.5 percent or more. For a subordinate mortgage, a loan is "higher-priced" if its APR exceeds the APOR by 3.5 percent.

Both the higher-priced mortgage and the high-cost mortgage are secured by the borrower's personal residence, but the higher-priced mortgage has only one major criterion in its definition: the previously mentioned APR and APOR conditions. On the other hand, a high-cost mortgage has the following three major criteria in its definition:

1. **The APR exceeds the APOR** by more than 6.5 percent.
2. **The total lender/broker points and fees** exceed 5 percent of the total loan amount. This 5 percent tolerance includes but is not limited to the following: origination fee, broker fee, processing fee, underwriting fee, document-preparation fee, wire fee and loan-servicing set-up fee.
3. **The loan has a prepayment penalty** beyond 36 months from closing or the prepayment penalty exceeds 2 percent of the amount prepaid.

Digging deeper

The differences between high-cost and higher-priced mortgages don't end there, however, and private-money lenders would be wise to make sure that they're clear on all the details of these respective loans. The regulations that apply to higher-priced mortgages are much fewer than those that apply to high-cost mortgages. For instance, when it comes to higher-priced mortgages, originators primarily need to focus on three specific restrictions:

- **They must verify the consumer's ability to repay.**
- **No prepayment penalty is allowed.**
- **Taxes and insurance must be escrowed** and paid along with the loan's principal and interest.

Private-money lenders should realize, however, that an array of other regulations must be complied with for a private personal residence loan to meet the definition of a high-cost mortgage. High-cost mortgages must meet the same three requirements that pertain to higher-priced mortgages, but in addition to these, the following conditions apply, among others: no balloon payment is allowed; the creditor cannot recommend default; the maximum allowed late fee is 4 percent of the past-due payment; points and fees may not be financed in the loan; and no loan modifi-cation or extension fees can be charged.

To complicate matters, the aforementioned requirements aren't the only ones that apply to high-cost mortgages. These loans must also meet the following criteria:

- **The interest rate** cannot increase after a default;
- **No negative amortization** is allowed;
- **Acceleration is allowed only in cases** when the consumer commits fraud or makes a material misrepresentation in connection with the loan, defaults on payment or commits some action or inaction that adversely affects the lender's security interest;
- **Preloan counseling is required;**
- **No financing of any type of insurance** is allowed in the loan;
- **Arbitration or nonjudicial settlements** cannot be required in the terms of the loan; and
- **Loan provisions that bar a borrower from taking legal action** against the lender are not allowed.

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Lending tips

When private lenders and their attorneys see the full array of prohibitions that apply to high-cost mortgages, many of them react by deciding never to close any more personal residence loans. If a private lender keeps its personal residence loan terms below the thresholds in the definition of a high-cost mortgage, however, then the loans will merely be higher-priced mort-gages, and thus only three regulations have to be complied with.

With exactly that in mind, following the guidelines below can allow private-money lenders to safely originate personal residence loans.

1. **Keep the spread between APR and APOR at 6.5 percent or less.** The lower the interest rate, the less the spread between APR and APOR. Also, the further out the balloon date, the less the spread between APR and APOR will be.
2. **Keep the total points and fees at 5 percent or less.** A simple way to check your compliance is to make sure that the adjusted origination fee on the Good Faith Estimate does not exceed 5 percent of the gross loan amount.
3. **Do not put any prepayment penalty in your loan terms.**

If you follow these guidelines, your private personal residence loans will not meet the definition of high-cost mortgages, and the majority of the related prohibitions will not apply. When your private loan is merely a higher-priced mortgage, then all of the terms related to high-priced loans will be allowed. Private-money lenders should still research and comply with the laws of their own states, however, which may be stricter than federal laws.

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Many private investors are not willing to fund a fully amortized loan. Instead, they are more comfortable with a five- to seven-year balloon payment in the note. By originating a higher-priced mortgage, private-money lenders can still put a balloon payment into a personal residence loan. Furthermore, being unable to finance points and fees in a peronal residence refinance loan excludes many homeowners from getting urgently needed financing, because these borrowers often do not have enough cash to pay points and fees out of pocket. By originating a higher-priced mortgage, however, points and fees can be financed.

Bearing all of this in mind, private-money lenders can rest assured that loans can still be done on personal residences as long as they stay within the definition of a higher-priced mortgage. Originating these loans can broaden your company's portfolio of products and bring you new revenue streams in the process. ■

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