Navigating the Regulatory Compliance Environment for Investment and Business-Purpose Mortgage Loans

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In today's regulatory environment, lenders making business-purpose loans should be mindful of their federal and state compliance obligations. It is important for lenders to have appropriate policies and procedures in place that address documenting the loan's purpose, along with applicable regulatory requirements. The authors of this article discuss business-purpose mortgage loans and note that it is important to remember that "business purpose" does not always mean "compliance exempt."

Although the regulatory compliance landscape is well-defined for mortgage lenders making loans to consumers, these implications can be less straightforward when it comes to business-purpose loans secured by one-to-four family residential real property, such as "fix and flip" loans and loans on residential rental property. A common misconception is that these types of loans, often made by private or "hard-money" lenders, are generally exempt from the federal and state laws and regulations that govern consumer lending. As the market for these loans proliferates, and regulators turn a closer eye to these activities, it is important to remember that "business purpose" does not always mean "compliance exempt."

APPLICABILITY OF TILA AND RESPA

An important starting point is whether the loans are subject to the Truth in Lending Act ("TILA") and the Real Estate Settlement Procedures Act ("RESPA"). Together with their implementing regulations, RESPA and TILA impose a number of significant compliance and disclosure obligations on mortgage lenders, including but not limited to the TILA-RESPA Integrated Disclosure ("TRID") Rule, the Ability-to-Repay/Qualified Mortgage ("ATR/QM") Rule, the Loan Originator Compensation ("LO Comp") Rule, and the Home Ownership and Equity Protection Act ("HOEPA"), which governs high-cost

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mortgage loans. If a loan is exempt from the coverage of TILA and RESPA, then these requirements will not apply.

However, the flip side to this is that lenders could face stiff penalties (and, with respect to certain violations, private rights of action) by incorrectly categorizing a loan as exempt. Because certain TILA provisions carry assignee liability, investors could likewise face exposure for violations. Consequently, lenders should pay careful attention when determining and documenting whether TILA and RESPA apply.

TILA generally applies to extensions of consumer credit that are primarily for a personal, family, or household purpose, and exempts certain types of credit extensions. For business-purpose lenders, there are two key TILA exemptions to consider. First, loans to non-natural persons are exempt. In other words, if the loan is extended to an entity as opposed to an individual, then TILA will not apply. Second, loans primarily for a business or commercial purpose are exempt. However, this exemption is more nuanced than the exemption for loans to non-natural persons.

The Official Commentary to Regulation Z, the implementing regulation of TILA, sets forth guidance for determining whether a loan can be considered to be primarily for a business purpose. A creditor must evaluate five factors in making a "business purpose" determination:

- the relationship of the borrower's primary occupation to the acquisition;
- the degree to which the borrower will personally manage the acquisition;
- the ratio of total income from the acquisition to the total income of the borrower;
- the size of the transaction; and
- the borrower's statement of purpose for the loan.

A special rule exists for non-owner-occupied rental property. Namely, a loan to acquire, improve or maintain non-owner-occupied rental property will always be deemed to be for business purposes. The threshold for determining owner occupancy is whether the owner plans to occupy the property more than 14 days during the coming year. The Official Commentary sets forth separate business-purpose tests for owner-occupied rental properties. If these special tests are not satisfied, the business-purpose determination would be made by looking at the five-factor test outlined above.

Regulation X, the implementing regulation of RESPA, does not contain a specific exemption for loans to non-natural persons. However, it specifically

exempts loans that are primarily for a business or commercial purpose, and relies upon the definitions and guidance set forth in Regulation Z for purposes of this determination.

OTHER CONSIDERATIONS UNDER FEDERAL LAW

Even if the loans are not covered by TILA and RESPA, other consumer financial laws may still apply, such as:

- the Fair Housing Act ("FHA");
- the Equal Credit Opportunity Act ("ECOA");
- the Fair Credit Reporting Act ("FCRA");
- the Servicemembers Civil Relief Act ("SCRA");
- the Electronic Fund Transfer Act ("EFTA");
- the Home Mortgage Disclosure Act ("HMDA"); and
- flood insurance requirements.

As a general matter, fair lending laws will be a consideration regardless of whether the loan is for the acquisition of an investment property and irrespective of whether the borrower is a corporate entity or an individual. FHA applies to any person or entity whose business engages in "residential real estate-related transactions," which includes the making or purchasing of loans or providing other financial assistance: (a) for the purchase, construction, improvement, repair or maintenance of a dwelling or (b) that is secured by residential real estate. It also applies to the selling, brokering or appraising of residential real property. Similarly, ECOA applies broadly to both consumer and business credit, equally imposing nondiscrimination and notice requirements to all types of credit. In more limited circumstances, both FHA and ECOA can also apply to the creditor's purchasers and assignees.

Other requirements come into play due to the loan's collateral, as opposed to its purpose. For example, the valuation requirements under ECOA, which require creditors to furnish copies of appraisals and other written valuations to applicants, apply to any applications for credit to be secured by a first lien on a dwelling, whether that credit is for a business or consumer purpose. In that same vein, the type and location of the collateral dictates the potential application of the flood insurance laws, irrespective of the business purpose of the loan.

Guarantors, co-applicants or additional signatories are often required for business purpose loans, which can trigger special considerations under Regulation B (the implementing regulation of ECOA), FCRA, SCRA, and

Regulation E (the implementing regulation of the EFTA). For example, FCRA imposes permissible purpose and adverse action requirements on users of "consumer reports," and does not govern business or commercial credit reports. However, lenders that obtain consumer reports on principals, co-applicants, and guarantors should be mindful that FCRA can still apply when a consumer report is used in connection with a business or commercial transaction.

HMDA reporting is another consideration. Under the 2015 amendment to Regulation C, the implementing regulation of HMDA, a closed-end mortgage loan or open-end line of credit made primarily for a business purpose will be an excluded transaction, but this exclusion will not apply if the loan or line of credit meets Regulation C's definition of a home purchase loan, home improvement loan or refinancing. This means that a closed-end mortgage loan or open-end line of credit to purchase or improve a single-family investment property or multifamily dwelling (or a refinancing of such) will not be excluded from HMDA reporting on business-purpose grounds.

STATE LAW CONSIDERATIONS

In addition to federal law considerations, business-purpose lenders may be subject to a number of state law requirements. Some states require licensure for lenders making loans secured by residential real property, regardless of whether these loans are for a consumer or business purpose. Since these requirements vary significantly by state, lenders should carefully review and consider the licensing requirements in each of the jurisdictions where they do business.

In addition to licensing requirements, other state laws governing various aspects of residential mortgage lending—such as those prohibiting referral fees, and unfair and deceptive acts and practices ("UDAP")—may potentially apply to business-purpose loans. Lenders should also be mindful of state laws governing high-cost loans and predatory lending, which are often more expansive than HOEPA. Although these laws typically apply to owner-occupied properties or consumer-purpose loans, this is another reason why it is important for lenders to verify and document the purpose of the transaction.

TAKEAWAYS

In today's regulatory environment, lenders making business-purpose loans should be mindful of their federal and state compliance obligations. It is important for lenders to have appropriate policies and procedures in place that address documenting the loan's purpose, along with applicable regulatory requirements. In addition, investors and purchasers interested in acquiring business-purpose loans should take these considerations into account when

performing due diligence reviews of the assets and the originators as well as when structuring the acquisition and holding of these loans. Although many of the laws and regulations discussed above are viewed as consumer financial laws, in actuality, their applicability can be much broader. The potential consequences of noncompliance can be severe, not only for the originating lender, but for purchasers and assignees as well.