Can the vagaries of UDAAP overshadow the relative definiteness of TILA's 'ability-to-repay' requirements?

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The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") brought many changes to the financial services industry and, in particular, to the mortgage business. For the developers, purveyors, and servicers of consumer financial services products, one of the most challenging and, frankly, disconcerting provisions of the Dodd-Frank Act is "UDAAP" — the prohibition against unfair, deceptive, or abusive acts or practices.

The Consumer Financial Protection Bureau ("CFPB") is now on the record as stating that there are no plans for rulemaking under UDAAP. Rather, as CFPB Director Richard Cordray recently testified before Congress, the Bureau will approach UDAAP standards like "abusive" on a case by case, or "situational," basis. While no one at the Bureau will come right out and say it, this approach allows the Bureau to set policy through UDAAP without going through the rigors of the rulemaking process.

The lack of UDAAP rulemaking should strike fears into the hearts of anyone subject to its hazy constraints. And the fear is not warranted for the reasons that some consumer advocates advance; i.e., that, in the aggregate, financial services companies regularly engage in conduct that violates UDAAP. Rather, the fear is derived from the fact that without any guiding rules, the Bureau can use the vague and amorphous UDAAP provisions of the Dodd-Frank Act for almost anything. As a result, consumer financial services companies, including those in the mortgage industry, must exercise extreme caution under the new regime or risk significant penalties which can reach $1,000,000 per day for knowing violations.

One example of the almost limitless breadth of UDAAP — which many argue is nothing more than a smell test — is its potential application to conduct that is covered, even sanctioned, by the provisions of other consumer financial services statutes. To illustrate the power of UDAAP, consider its possible intersection with the Dodd-Frank Act's "ability-to-repay" amendment to the Truth in Lending Act ("TILA").

A BORROWER'S ABILITY TO REPAY

The extent to which mortgage originators are obligated to determine a borrower's ability to repay a loan will have dramatic impact on the mortgage lending industry. Ability-to-pay requirements will directly impact the number of loans that can be originated, and the revenue generated by a lending business. Likewise, these requirements will impact the cost and burden associated with the loan underwriting process and the availability of mortgage loans to less qualified borrowers.

With the Dodd-Frank Act, Congress attempted to strike a balance between consumer protection, on the one hand, and access to housing and fair and affordable loan products, on the other. At the moment, CFPB in the midst of an open comment period relating to a borrower's "ability-to-repay," which will once again test this delicate balance.

The open comment period relates to a proposed regulation that will define which loan products are considered "qualified mortgage(s)" under the Dodd-Frank Act's "ability-to-repay" amendment to the Truth In Lending Act ("TILA"). The "ability-to-repay" amendment states that:

[N]o creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability-to-repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments. 15 U.S.C. § 1639c(a)(1).

The “ability-to-repay” amendment also includes certain “safe harbors” from claims that a lender failed to assess a borrower’s ability to repay the loan if the loan fits the definition of a “qualified mortgage.” The definition for a qualified mortgage encompasses products without specified features, such as balloon payments and hidden charges, which some believe result in a greater likelihood of a borrower’s inability to meet their repayment obligations.

The CFPB has indicated that any final rule will necessarily include a determination as to the legal impact of a “qualified mortgage.” This legal impact will inform whether selling loans that meet that definition will entitle the lender to a complete safe harbor from a claim that the lender failed to consider a borrower’s ability to repay or, in the alternative, whether that definition would afford the lesser protection of a rebuttable presumption that the lender made appropriate assessment of the lender’s repayment ability.

There is no better illustration of the delicate balance that must be struck between consumer protection and available financing than a recent letter sent to Director Cordray by a consortium of unlikely allies: mortgage lending trade groups and civil rights and consumer advocates. While these groups usually find themselves on opposing sides in the context of litigation and advocacy, the consortium requested in the letter that the CFPB issue a rule giving a broad interpretation to the definition of a “qualified mortgage” so as to afford lenders the maximum amount of litigation and enforcement protections associated with selling such loans.

The group wrote that a broad definition of the phrase “is the only way to help the economy and at the same time ensure that the largest number of credit-worthy borrowers are able to access safe, quality loan products for all housing types.”

In other words, anything beyond a broadly defined exemption would upset the careful balance that Congress intended to impose with the Dodd-Frank Act: a vibrant mortgage lending market with readily accessible loans for all borrowers that also protects those same borrowers against predatory lending. Construing “qualifying mortgages,” narrowly would force lenders to limit the availability of loan products in order to manage risk and, as a result, “would undermine prospects for a housing recovery and threaten the redevelopment of a sound mortgage market.”

PREVIOUS FEDERAL ABILITY TO REPAY REQUIREMENTS: HOEPA

While the apprehension surrounding the results of the ability-to-repay open comment period is understandable, it is not the first effort made to regulate the balance by requiring some verification of a borrower’s ability to repay a mortgage. Indeed, there have been previous efforts made on both a federal and state level to reign in perceived abusive practices by imposing on lenders the obligation to verify the ability to repay for at least some borrowers.

The Home Ownership and Equity Protection Act of 1994 (“HOEPA”) amended TILA, as codified at 15 U.S.C. § 1639 and implemented through Section 32 of Regulation Z, 12 C.F.R. § 226.34(a)(4). It provided that a creditor extending mortgage credit shall not extend credit to a:

[C]onsumer based on the value of the consumer’s collateral without regard to the consumer’s repayment ability as of consummation, including the consumer’s current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations.

HOEPA sets forth the requirement that:

A creditor shall not engage in a pattern or practice of extending credit to consumers under mortgages referred to in section 1602(aa) of this title based on the consumers’ collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment. 15 U.S.C.A. § 1639(h).

Yet, HOEPA expressly applies to only specified categories of high cost loans. Specifically, HOEPA regulates three categories of loans that require lenders to consider a borrower's repayment ability where:

(1) For a first-lien loan, that is, the original mortgage on the property, the annual percentage rate ("APR") exceeds by more than eight percentage points the rates on Treasury securities of comparable maturity;

(2) For a second-lien loan, that is, a second mortgage, the APR exceeds by more than 10 percentage points the rates in Treasury securities of comparable maturity; and

(3) The total fees and points payable by the consumer at or before closing exceed the larger of $611 or eight percent of the total loan amount. Credit insurance premiums for insurance written in connection with the credit transaction are counted as fees.

While seemingly broad, HOEPA contains several significant limitations. First and foremost, HOEPA excludes most purchase money loans (but not refinancing, which have become the rule more than the exception given the historically low interests rates). Second, TILA's one-year statute of limitations is applicable to HOEPA claims. Third, the nature of a lender's consideration of the borrower's repayment qualifications is almost impossible for a would-be plaintiff to know about prior to discovery in litigation. Finally, the plain language of the statute applies only to originators engaging in "pattern and practice" type violations, implying that there must be more than a single violation for an originator to face adverse legal action.

Setting aside these limitations, HOEPA and the Dodd-Frank Act's "ability-to-repay" amendment differ in approach. While the former only imposes the heightened ability-to-repay requirements for specified categories of loans, the Dodd-Frank Act's amendment is generally applicable to all residentially secured loans, with the only exemption available for lower risk loan products, i.e., the yet-to-be-defined "qualified mortgages."

Under both laws, Congress sought to protect consumers by restricting not only the sorts of lending products offered and disclosures made, but also by the underwriting criteria used to lend to the target constituents of the legislation. These criteria encompassed confirming the veracity of the documentation used in a loan application and engaging in some sort of mathematical determination as to whether the borrower's income and other expenses would allow for repayment of the full cost (and associated expenses) of the loan.

Regardless of its scope, once the CFPB issues the final rule defining the "qualified mortgage" exception, the relatively mechanical underwriting criteria set forth in HOEPA and the Dodd-Frank Act will be sufficiently well defined to permit those in the business to at least manage their risk in some predictable manner. As far as these mechanical considerations are concerned, when the dust settles, the hope is that the CFPB will regulate mortgage originators in a relatively balanced fashion that accounts for the business interests of the lending industry.

THE UNPREDICTABILITY OF UDAAP

The predictability and balance described above may not be so predictable after all. As Congress described it, the purpose of the ability-to-repay amendment is "to assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability-to-repay the loans and that are understandable and not unfair, deceptive or abusive." 15 U.S.C.A. § 1639b(a)(2). Thus, Congress bound the ability-to-repay amendment to one of the central (and, as yet, largely unexplored) themes of Title X of the Dodd-Frank Act's consumer protection provisions: UDAAP.

Unlike the new modified TILA ability-to-repay provision and the CFPB's proposed regulation addressing it, as well as the ability-to-repay provision HOEPA before them — all of which feature relatively finite contours and clearly defined categories of required conduct — the scope of the general UDAAP mandate is undefined by regulation and untested through enforcement or litigation.

As such, UDAAP could undermine any clarity provided by a final rule regarding the scope of the ability-to-repay provision under TILA. This is the case because the general prohibition against UDAAP arguably includes a de facto requirement that a borrower's ability-to-repay be considered, even when the loan product is a "qualified loan," or even when the lender has otherwise complied with the ability-to-repay amendment.

One source of insight into how the CFPB might interpret the UDAAP standards in the ability-to-repay context is the previous application of the so-called UDAP (unfair or deceptive acts or practices) provisions of the FTC Act and the so-called Little FTC Acts (various state consumer protection statutes), many of which contain prohibitions against "unfair" or "deceptive" conduct.

As it currently stands, these UDAP cases demonstrate that, although courts in most jurisdictions have held that lenders do not have an obligation to determine a borrower's repayment ability, some jurisdictions have found UDAP violations under such circumstances, particularly where the court finds the lender engaged in other egregious UDAP conduct.

The real question is which line of cases will the CFPB follow? Given the climate in the industry, until there is a clear indication to the contrary, we must assume that there is at least a reasonable probability that, under the right policy circumstances, the CFPB will apply UDAAP to ability-to-repay cases.

Generally speaking, the UDAP cases fall into five categories:

Category One: Concealment

Some courts, such as the U.S. District Court for the Northern District of Illinois in Haymer v. Countrywide Bank, FSB, No. 10 C 5910, 2011 WL 2790172, at *4 (N.D. Ill. July 15, 2011), have found that concealment of the borrower's inability to repay the loan from the borrower himself was sufficient for the borrower to state a claim under state UDAP laws.

The Haymer court found that a borrower sufficiently alleged a claim under Illinois' UDAP laws when the mortgage broker failed to include the borrower's income on the loan application and did not inform borrower of their inability to repay the loan. Notably, although the borrower's inability to repay was a significant part of the potential violation, it was viewed as part of an alleged course of misleading conduct by the lender that, in total, would give rise to a state UDAP violation if proven.

Category Two: Totality of the Circumstances

Similarly, federal courts in New York have found potential liability in allegations that a lender failed to consider a borrower's ability to repay, in addition to the lender engaging in some other unfair or deceptive conduct. Thus, the "unfair" or "deceptive" conduct could potentially reside in the totality of the defendant lender's conduct, one such factor being the lender's failure to consider the borrower's ability to repay. The Southern District of New York said in Schwartzbaum v. Emigrant Mortg. Co., 09 CIV 3848 SCR LMD, 2010 WL 2484181 (S.D.N.Y. Apr. 22, 2010) report and recommendation adopted in part, rejected in part, 09 CIV. 3848 (SCR), 2010 WL 2484116 (S.D.N.Y. June 16, 2010), that:

Plaintiffs allege that due to Defendant's deceptive acts and practices, they were induced into signing those documents and did not understand what they were signing. Moreover, they allege that Defendant's deceptive acts included offering them a loan without considering their ability (or in this case, their inability) to pay. At this stage of the litigation, it cannot be determined, as a matter of law, that Defendant's conduct falls outside the ambit of the statute.

These "totality-of the circumstances" cases provide the most likely scenario in which a lender's failure to assess the borrower's ability to repay would give rise to a UDAP violation. Under the reasoning of these cases, although such conduct alone may not constitute a UDAP violation, when combined with other misleading or predatory conduct just might. Plainly, such an approach lacks the predictability of the specific provisions in HOEPA and the amendment to TILA described above. As noted above, UDAAP predictability has not been one of the CFPB's top agenda items.

Category Three: Mandatory Inquiry

New York state courts have held that a lender's lack of inquiry into the borrower's ability to repay the mortgage was sufficient to provide the borrower with grounds to challenge the mortgage. In Emigrant Mortgage Co. Inc. v. Fitzpatrick, 906 N.Y.S.2d 874, 878 (N.Y. Sup. Ct. 2010), the court held that since the lender knew or should have known that it would be impossible for the borrower to make loan payments, the borrower had sufficient grounds to challenge the mortgage under the UDAP provision.

While this black-and-white approach would seemingly provide a predictable framework under UDAAP, notably the court faulted the inability of the lender to assess the borrower's repayment ability when it was asserted as the borrower's affirmative defense in a foreclosure action. In other words, the borrower was arguing that the lender could not complain that it had not been repaid given its awareness of the risk of that result when they made the loan. See also Frawley v. Dawson, 932 N.Y.S.2d 760 (Sup. Ct. 2011) (although not under state statute, suggesting that lender defendant acting negligently by improvidently issuing loan).

Category Four: Unconscionability

There are a number of cases in jurisdictions such as the District of Columbia and New Jersey, where allegations of the lender's affirmative knowledge that the borrower would not likely be able to repay the loan was sufficient to state a claim for conduct that would be considered "unconscionable" under the applicable consumer protection statute.

In Solomon v. Falcone, 791 F. Supp. 2d 184 (D.D.C. 2011), the court denied the defendant's motion to dismiss a claim brought under the District of Columbia's consumer protection statute based on the allegation that the lender engaged in conduct defined under the statute as "unconscionable" because the lender extended loans to the borrower without consideration for the borrower's ability to repay and based upon fraudulent statements made to the borrower. See also In Re Bagot, 2012 WL 734178 (Bankr. D.N.J. Mar. 6, 2012) (knowingly advising borrowers to apply for a refinance of a mortgage that the borrowers could not afford, could constitute an unconscionable commercial practice under the CFA); Garsh v. Wells Fargo Bank, N.A., 11-21543 MBK, 2012 WL 1207220 (Bankr.D.N.J. April 9, 2012) (denying summary judgment of claim under New Jersey's Consumer Fraud Act based on knowing improvident extension of credit on grounds that factual questions remain regarding whether loan was affordable at its inception).

The Dodd-Frank Act's UDAAP provisions do not make reference to unconscionability. Nonetheless, many consumer rights activists and academics have agreed that unconscionability still fits within one or more of the UDAAP standards.

The statute at issue in Salomon expressly prohibited unconscionable conduct in addition to prohibitions against unfair and deceptive conduct. Thus, while one could attempt to squeeze unconscionability into UDAAP based on cases like Salomon, it could likewise be argued that laws prohibiting unconscionable conduct which would not otherwise violate a UDAP provision are simply not a useful predictor of UDAAP under the Dodd-Frank Act.

Category Five: No Duty To Assess Ability to Repay

A number of courts in a variety of states have held that allegations that a lender's failure to consider a borrowers' ability to repay a loan was insufficient grounds to sustain a UDAP claim. See Lopez v. Washington Mut. Bank, F.A., 1:09CV1838AWIJLT, 2010 WL 1558938 (E.D. Cal. Apr. 19, 2010) (dismissing claim under California's Unfair Competition Law ("UCL") premised on allegation that defendants approved a loan knowing that the borrower did not have the ability to repay it); Marzan v.

Bank of Am., 779 F. Supp. 2d 1140, 1152 (D. Haw. 2011) (granting summary judgment on claim under Hawaii UDAP statute for failure to assess a borrower's ability to repay).

These courts reached this conclusion for a variety of reasons, including findings that there was no fiduciary relationship between the lender and the borrower and that, absent some very extraordinary circumstances, lenders do not otherwise have a duty to assess a borrower's ability to repay. Valle v. JP Morgan Chase Bank, N.A., 11-CV-2453-MMA WMC, 2012 WL 1205635 (S.D. Cal. Apr. 11, 2012) ("California law is clear that a lender is not obligated to ensure the borrower's financial ability to repay the loan or otherwise safeguard a borrower's assets."); Perlas v. GMAC Mortg., LLC, 187 Cal. App. 4th 429, 436 (2010) (lender under no duty to assess borrower repayment ability); Renteria v. U.S., 452 F.Supp.2d 910, 922–923 (D. Ariz. 2006) ("The lender's efforts to determine the creditworthiness and ability to repay by a borrower are for the lender's protection, not the borrower's").

CONCLUSION

In short, while the relatively more explicit ability to repay origination and underwriting guidelines will bring some degree of predictability and balance to the co-existent goals of economic recovery, loan affordability, and consumer protection, UDAAP has the potential to disrupt the delicate equilibrium. Yet another reason the CFPB should be providing more explicit guidance on UDAAP.