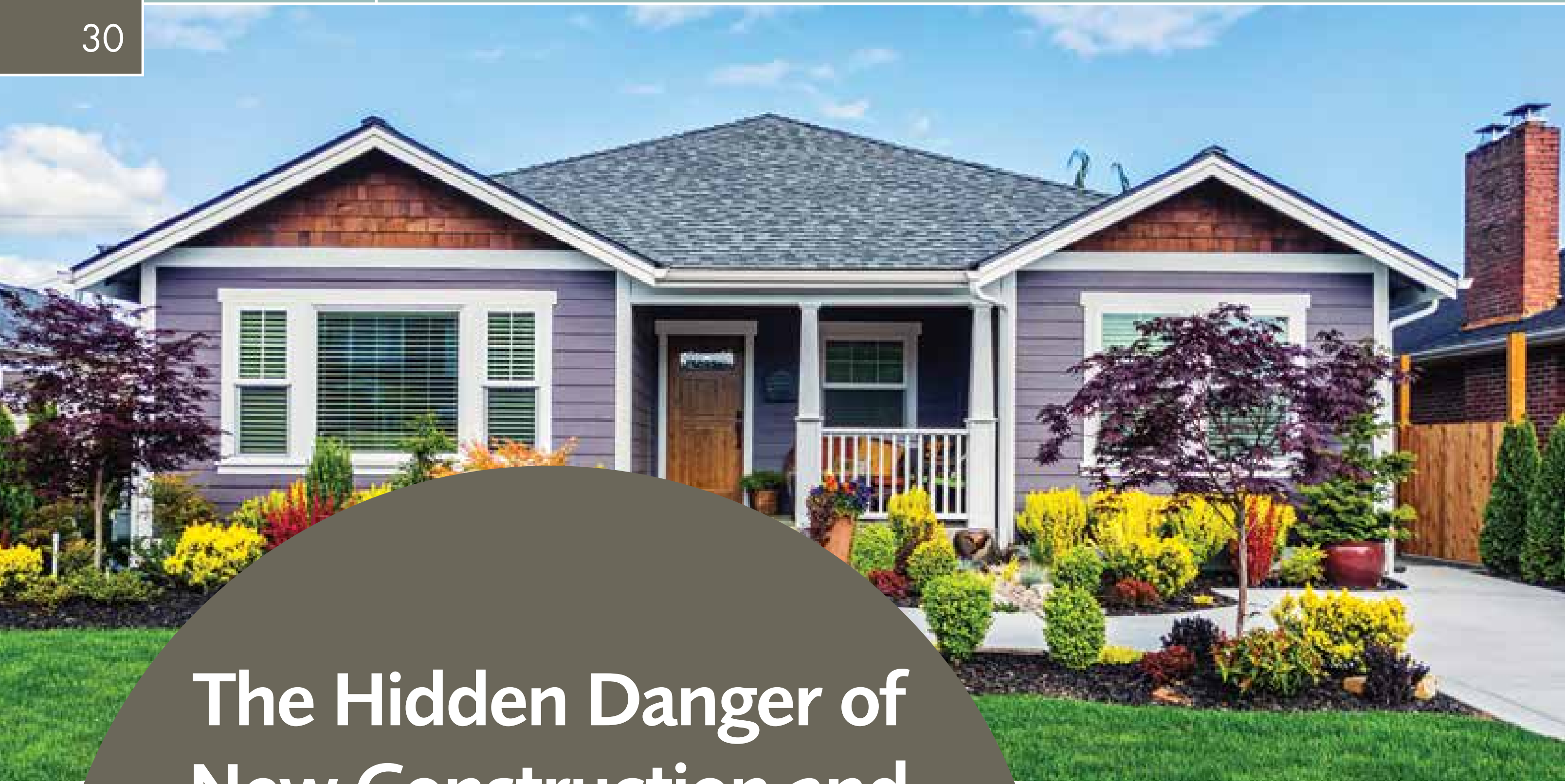

The Hidden Danger of New Construction and the Higher-Priced Mortgage Second Appraisal Requirement

By Kyler McGillicuddy

At a Glance

Though the Consumer Financial Protection Bureau has provided some clarification regarding banking practices since Congress in 2010 enacted the voluminous Dodd-Frank Act, much remains a mystery. For lenders, these unsolved mysteries include exposures to compliance and litigation risk. For borrowers, these mysteries raise the cost of products and services.

As a reaction to the great recession, Congress in 2010 enacted the voluminous Dodd-Frank Act to help protect consumers and rein in wild banking practices.[1] The sheer velocity with which the bill was passed was bound to leave many vague calls for action. And so, as part of the Dodd-Frank Act, the newly created Consumer Financial Protection Bureau (CFPB) found itself imbued with the power to interpret the law and shine clarity into the holes left by Congress — if it so desired.

Though the CFPB has provided *some* clarification during the ensuing decade, much remains a mystery. For lenders, these unsolved mysteries include exposures to compliance and litigation risk. For borrowers, these mysteries raise the cost of products and services. One specific mystery is whether higher-priced mortgage loans under the Truth in Lending Act[2] and Real Estate Settlement Procedures Act Integrated Disclosures (TRID)[3] require an additional appraisal for construction of a new home. Spoiler alert: It does!

Among other things, TRID governs the mortgage process from application to origination and beyond. As part of the mortgage application process, a creditor must abide by the requirements for higher-priced mortgage loans.[4] In essence, a higher-priced mortgage loan covers closed-end transactions secured by the consumer's primary home which exceed an interest-rate threshold.[5] If this threshold is exceeded, the creditor must ensure that certain other requirements are met prior to originating the mortgage.[6] One of these requirements is known in the mortgage industry as the anti-flipping prohibition.[7]

As you might have guessed, anti-flipping regulations[8] address someone buying a property, fixing it cheaply, and reselling it at a massive profit to an unwary buyer. The danger here is that the buyer (and that person's lender) would ultimately find themselves with a property worth far less than originally thought.[9] To prevent this, Congress requires a second appraisal to justify the difference between the price the seller paid to acquire the property and the price the buyer has agreed to pay by analyzing improvements made to the property and market characteristics in the area.[10]

Assuming a loan is otherwise subject to this regulation, we turn now to whether the purchase of a newly constructed primary residence requires a second appraisal. This article only addresses the scenario in which a builder purchased a vacant lot, built a home, and entered into a purchase agreement with a buyer within the time frame discussed below.

The relevant section of the regulation begins by providing a framework for determining when a second appraisal is required. A creditor must obtain a second appraisal if the seller acquires the property within 90 days and the buyer has agreed to pay 10% more, or the seller acquires the property within 180 days and the buyer has agreed to pay 20% more.[11] When I asked whether this section applied to newly constructed homes, the answer received from three different mortgage compliance professionals was a resounding no. These were not people new to the industry either — between them, the trio had more than 60 years of combined experience. However, they had overlooked a key word: property. It might not seem like a significant difference, but like all good legal disputes, it boils down to the words used.

An examination of the regulator's use of the words "property" and "dwelling" started to reveal the answer to our mystery. First, the regulation is replete with the word "dwelling," a term defined within the regulation to essentially mean a residence.[12] The coverage of the higher-priced mortgage loan regulation only applies to transactions involving the "consumer's principal dwelling."[13] By contrast, the additional appraisal requirement applies to "property."[14]

So why did the regulators use the word "property" for the additional appraisal requirement when they could have easily exempted a newly constructed home from an additional appraisal requirement by simply using the word "dwelling" instead? Also, exemptions to the additional appraisal requirements use the word "property" rather than "dwelling," indicating that "property" was purposeful regarding the additional appraisal requirement specifically. Finally, the federal register indicates that the word "property" was used rather than "principal dwelling" because the seller may not have used the property in the same manner as the prospective buyer; the regulators wanted to ensure they referred to the same property.[15] For example, a seller may renovate an abandoned property not currently being used as a home, while a buyer may plan to use it as a primary dwelling. All these reasons indicate that higher-priced mortgages on newly constructed homes are intended to be covered by the additional appraisal requirement.

Like the mortgage compliance professionals mentioned earlier, some may argue against this result for a few reasons. They may claim this result goes against industry awareness and basic reasoning. By the very requirement of the regulation, the purpose of the additional appraisal is to justify the price increase and prevent unwary borrowers from acquiring an overvalued property. The improvements and justification for a price increase on a newly built home are obvious, making the additional appraisal add cost and complexity to an already convoluted regulation. Those holding this position will

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find this author in agreement; however, regulation and reason do not always go hand in hand.

Second, the requirement for an appraisal generally exempts transactions financing the initial construction of a dwelling,[16] but this exemption explicitly applies only to the initial temporary construction phase financing and not to any permanent financing once construction is completed. Therefore, this exemption does not apply to the scenario discussed here.

Third, regulators in the federal register indicate they intended the words "property" and "dwelling" to be interchangeable. As an example, the term "acquisition" is used to refer to "events in which the seller purchased or acquired the *dwelling* at issue."[17] Unfortunately, a page later, "acquisition" is defined by the final rule to apply to "transactions in which the seller had acquired the *property*. . . ."[18] Each reference in the federal register used to indicate that the terms are interchangeable is countered by a reference to the contrary.

The only reason left to explain the use of the word "property" rather than "dwelling" is simple: regulators did not intend to exempt newly constructed homes covered by the higher-priced mortgage regulation from an additional appraisal. When asked whether an additional appraisal was required in this scenario, several federal regulators responded (unofficially, of course) that it was.

The consequence of noncompliance with this generally unknown regulatory requirement is steep. First, the plain words of the regulation state that a creditor shall not extend a higher-priced mortgage loan without obtaining a second appraisal.[19] Federal regulators have discretion to penalize violators with anything from a simple audit finding up to civil monetary penalties which may run into the millions of dollars. Second, civil liability under the statute allows consumers to bring an action within three years of the date of the violation, or as a defense in foreclosure. Costs to the lender in such cases can include forfeiture of interest, closing costs, attorney fees, and damages.[20]

It has been more than five years since TRID was enacted. Its contents still being unraveled, leaving the door open for more unsolved mysteries to emerge from the regulation. ■

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ENDNOTES

1. 12 USC 53.
2. 12 CFR 1026.
3. 12 CFR 1024.
4. 12 CFR 1026.35.
5. 12 CFR 1026.35(a)(1).
6. 12 CFR 1026.35(c)(3)(i).
7. 12 CFR 1026.35(c)(4)(i).
8. *Id.*
9. Mortgage Reform and Anti-Predatory Lending Act: Report Together with Dissenting Views, HR Rep No 111-94, at 59 (1994).
10. 12 CFR 1026.35(c)(4)(iv).
11. 12 CFR 1026.35(c)(4)(i)(A)–(B).
12. 12 CFR 1026.35(a)(1); 12 CFR 1026.32(a)(1); 12 CFR 1026.23(a)(1); and 12 CFR 1026.2(a)(19).
13. *Id.*
14. 12 CFR 1026.35(4)(i)(A).
15. Dep't of the Treasury, Appraisals for Higher-Priced Mortgage Loans: Final Rule, 78 Fed Reg 30, 10388 (February 13, 2013).
16. 12 CFR 1026.35(c)(2)(iv).
17. Appraisals, 78 Fed Reg 30 at 10388.
18. *Id.* at 10389.
19. 12 CFR 1026.35(c)(4)(i).
20. 15 USC 1640(a)–(e) and 12 CFR 1083.