



HMDA and “Temporary Financing”

The debate over the Home Mortgage Disclosure Act's (HMDA) “temporary financing” definition has been growing for quite some time. To understand the exemption, let's first look at Regulation C, specifically, §203.4(d)(3):

“Excluded data. A financial institution shall not report:

(3) Temporary financing (such as bridge or construction loans)”

The problem is that Regulation C never defines “temporary financing”, “bridge loan” or “construction loan”. The Federal Financial Institutions Examination Council (FFIEC) released a memorandum¹ on December 5, 2005, and provided guidance on “temporary financing” in a frequently asked questions² section. That guidance states:

“Temporary Financing. When is a loan “temporary financing” such that it is exempt from reporting?”

Answer: The regulation lists as examples of temporary financing construction loans and bridge loans. See 203.4(d)(3). Construction and bridge loans are illustrative, not exclusive, examples of temporary financing. The examples indicate that financing is temporary if it is designed to be replaced by permanent financing of a much longer term. A loan is not temporary financing merely because its term is short. For example, a lender may make a loan with a 1-year term to enable an investor to purchase a home, renovate it, and re-sell it before the term expires. Such a loan must be reported as a home purchase loan. See 203.2(h)³.”

For some, the confusion was compounded with the above guidance. Let's break the guidance down so that we can understand it. We will take a few sentences at a time and explain what we believe it means. We will also offer our own guidance to help you more fully understand when a loan is exempt because it meets the definition of temporary financing and when it should be reported.

¹ <http://www.ffiec.gov/hmda/pdf/FFIECguidance2005.pdf>

² <http://www.ffiec.gov/hmda/faqreg.htm#TemporaryFinancing>

³ <http://www.ffiec.gov/hmda/pdf/regulationc2004.pdf>

Construction and Bridge Loans

“The regulation lists as examples of temporary financing construction loans and bridge loans. See 203.4(d)(3).”

Regulation C makes it clear in §203.4(d)(3) that construction loans and bridge loans are not to be reported. Unfortunately, these terms are not defined. A construction loan is fairly self explanatory; however, be careful not to confuse construction loans with home improvement loans. If a home is already built, the additional work on the property is considered improvements. You can only erect (construct) a home once. From there you are improving the dwelling.

While the term “bridge loan” is not defined, it is generally understood as the interim financing between the purchasing of one property and the selling of another. Section 203.4(d)(3) and this part of the Q&A make it clear that construction and bridge loans are not be reported.

Examples of Temporary Financing

“Construction and bridge loans are illustrative, not exclusive, examples of temporary financing.”

The Federal Reserve (who authors Regulation C and wrote the HMDA Q&A at the FFIEC website) makes it clear they want to allow room for interpretation in HMDA (this is also what is so frustrating to all of us!). The Federal Reserve Board (FRB) purposely allows financial institutions to interpret these rules, within the boundaries provided, as long as the institution applies them consistently. This sentence in the Q&A allows a broader sense of interpretation for possible future loan products and scenarios created by lending institutions.

Two Phase Financing

The examples indicate that financing is temporary if it is designed to be replaced by permanent financing of a much longer term.

This statement is the one that has caused the most confusion. Normally, temporary financing is replaced by permanent financing. The typical bridge loan will not be fully repaid by the sale of the old home. The temporary loan will be replaced by permanent financing of a much longer term when the old home is sold. Likewise, most construction loans are replaced by a permanent loan. It is the permanent financing from these scenarios that is reported for HMDA. The general rule is, banks should not double report a borrower’s transactions.

But what if the bridge loan will not be replaced with permanent financing? For instance, assume your borrower bought a home in California for \$40,000 back in 1970. Today the home is worth \$500,000. Now this person wants to purchase a home in the Midwest for \$250,000 but needs bridge financing until their California home sells. There is enough equity to pay off the temporary financed amount once the sale is complete. No permanent financing is intended.

When some read the FFIEC Q&A, they believe it says to report the bridge loan described above because it is not “*designed to be replaced by permanent financing*”.

However, this understanding is incorrect as Regulation C clearly states “A financial institution shall not report: Temporary financing (such as bridge or construction loans).” The Q&A may appear to be inconsistent with the regulation; however, the Q&A (or for that matter any guidance: commentary, staff interpretation, etc.) can never contradict the law or regulation. Further guidance is used to fill in the blanks and answer questions, not contradict what has been stated by the law. Therefore, reporting a bridge or construction loan because it is not followed by permanent financing is not accurate.

So what does this sentence in the Q&A mean? We believe it provides guidance to those situations where you don't have a bridge or construction loan, yet you're not sure if it is temporary or short term. In fact, more clarification is provided in the next few sentences of the Q&A.

Short Term vs. Temporary Financing

“A loan is not temporary financing merely because its term is short. For example, a lender may make a loan with a 1-year term to enable an investor to purchase a home, renovate it, and re-sell it before the term expires. Such a loan must be reported as a home purchase loan.”

Some banks have declared all loans of less than a certain term (for instance 1 year or 2 years) as temporary financing. This has never been the intent of HMDA and the Q&A puts this misunderstanding to rest. A short term loan is still reported, if its purpose is to purchase, improve or refinance a dwelling.

A good example of a reportable, short term loan is home improvement financing for 1 year. If the loan is repaid over 12 monthly installments, this loan is not temporary and should be reported.

Another example of short term financing are “splash and dash” or rehabilitation loans. This where an investor will purchase a home and then renovate it to resell for a profit. At the time of application, the purpose of the “splash and dash” was to purchase the investment property; therefore, making it HMDA reportable (as a “purchase”). The fact that the owner plans to renovate by gutting the inside and installing additional amenities does not exempt this transaction from being reported and classified as a construction loan. Remember, you can only construct a home once, from there you are improving the dwelling.

Summary

Our interpretation of “temporary financing” leads us to the following conclusion: when you have a bridge loan or construction loan, it should never be reported. To say it another way, if a loan is not a construction loan and not a bridge loan and it is not replaced by another loan, it should be reported. Below you will find a flow chart to help you better understand temporary financing as it applies to HMDA.

HMDA TEMPORARY FINANCING FLOWCHART

