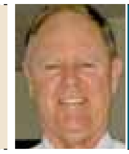

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The Major Problem With Micromanaging

Could excessive regulation threaten the entire mortgage industry?

It's no secret that the mortgage industry has become the focus of intense federal attention as a result of the recent financial crisis. The lack of appropriate regulations and the ineffective enforcement of then-existing regulations are faulted by many for the meltdown. Nowhere was this more evident than at the congressional hearings preceding the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, which created the Consumer Financial Protection Bureau (CFPB), the act's new super-enforcer and the mortgage industry's new sheriff.

Today, the mortgage industry finds itself in the midst of an onslaught of proposed regulations from the CFPB, most of which must — by law — be finalized by the end of January. That said, the complexity of the issues and comments, as well as the CFPB's growing realization that it needs to fully consider the unintended consequences of many aspects of its proposed regulations, may compel the CFPB to ask Congress for a deadline extension for some of the required regulations. Nevertheless, all indications to date are that most of the regulations will be issued on time with a one-year phase-in period.

The CFPB has been given exceptionally broad authority to implement this act. In fact, some argue that this authority is so broad that it amounts to an unconstitutional delegation of the legislative power of Congress. Essentially, Congress has left the job of figuring out the future of the mortgage industry to the CFPB. The CFPB may issue broad regulations, and has the authority to not enforce or even virtually override certain provisions of Dodd-Frank when it deems appropriate.

This delegation of authority to the CFPB suggests that Congress understood perfectly well that, through Dodd-Frank, it was fundamentally restructuring major aspects of the mortgage industry. The likely result could be a number of unintended consequences affecting the viability of the entire industry itself. The CFPB is directed by Dodd-Frank to consider the impact of particular aspects of the statute on competition in the mortgage and real estate services industry, as well as its effect on the delivery of services and the availability of credit in the mortgage market. Some would consider this an admission by Congress that it was legislatively reshaping a complex industry — one that it did not fully grasp — by taking action well beyond the need to rectify certain abuses and practices.

Problems

In reading Dodd-Frank along with some of the CFPB's regulatory discussion drafts and proposals, the lack of a fundamental understanding or familiarity with the mortgage industry is sometimes obvious. Dodd-Frank, for instance, does not properly distinguish between the roles of the various parties involved in the loan-origination process.

One of the most obvious examples of this is the confused statutory definition of "loan originator," which technically treats individual loan officers as distinct entities originating loans separate from their mortgage companies. This results in the loan officer's compensation being viewed as an additional payment from the consumer, rather than being a sharing of money earned by their mortgage company. In the same respect, the role and responsibilities of the correspondent lender were not properly recognized by the CFPB in regulatory proposals this past year.

Nonetheless, mortgage-industry trade associations are making progress in educating the CFPB about the industry, which has been reflected in its later regulatory proposals. In view of the reluctance of Congress to allow any amendments to Dodd-Frank, the CFPB is prepared to use its authority to work around or limit some aspects of the legislation that do not fit with the CFPB's view of the industry as its understanding evolves. This is evident, for example, in the CFPB's analysis of the statute as it relates to loan officer and correspondent compensation, where the bureau is now explaining the logic of its regulatory proposal with a nod to some of the practicalities of the origination process.

The length and complexity of these proposals, as well as related discussion papers issued by the CFPB — such as those for the small-business panels — are overwhelming, to say the least. Recent regulatory proposals that are pending public comment are available for viewing online, and many of these proposals are hundreds of pages in length. This does little to encourage interaction and discussion between the industry and the

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CFPB, outside of certain trade associations and major industry participants.

Compliance

Early on, the mortgage industry accepted the fact that borrowers cannot be steered into overly costly or inappropriate products. Arguably, the same is true for other policy decisions in Dodd-Frank, such as loan officers and mortgage brokers not being compensated on the basis of the terms of a loan (other than a percentage of the loan amount) or the type of loan. If Congress has found, however, that the originator should be paid only by the consumer or the lender — but not both — then that is the law until changed.

Even so, what's occurring is a complicated and possibly overbearing approach by the CFPB to craft regulations that attempt to address all conceivable ways that the prohibitions in Dodd-Frank could be circumvented. There's an implied premise that the mortgage industry cannot be trusted and that all possible deviations must be anticipated and prevented through detailed regulations.

At the same time, many in the industry and the legal profession believe that the CFPB's approach risks creating an environment where compliance is not easily understood or achievable by those being regulated. The penalties for noncompliance, compounded by the prevalence of class-action litigation, may result in a withdrawal of many from the marketplace and a consolidation of providers.

The subjects of a qualified mortgage (QM) — which is integral to originators in determining a borrower's ability to pay, as required by Dodd-Frank — and the related requirement for a 5 percent risk retention by each originator for securitized loans that are not qualified residential mortgages (QRM) will have profound effects on mortgage originations. Dodd-Frank specifically sets forth much of the criteria that the loan originator must follow to determine if the borrower is deemed to have the ability to repay a loan. The CFPB also is authorized to establish debt-to-income levels, which will vary depending on the borrower's equity in the property, although the Federal Housing Administration and the U.S. Department of Veterans Affairs are permitted to set their own standards in this regard.

Market effects

Between Dodd-Frank's specificity on all of these issues and the authority given to the CFPB, the bureau will be in the business of making underwriting decisions that will shape the mortgage marketplace. This easily could lead to a reduction in competition, as well as the development of vanilla mortgage products that, to be compliant with the policy directions of Dodd-Frank, are suitable only for particular classes of borrowers. The flexibility of the lender to accept a different combination of the variables to approve a loan could be reduced, if not eliminated, by this structure. The bottom line is that a large number of otherwise worthy borrowers unintentionally may be excluded from the mortgage marketplace. In this case, brokers and loan officers will subsequently struggle, as well.

Many lenders readily admit that, faced with this new reality, they will only make loans that comply with the QM definition, as the liability for not doing so is too high. Related to this is the debate within the CFPB as to whether following the QM rules will give a safe harbor for the originators or merely a so-called "rebuttable presumption" of compliance. Many litigators observe that a rebuttable presumption evidentiary standard — which has a strong chance of being the standard adopted for QM — could open the door for litigation on this issue by allowing the introduction of other factors to be weighed regardless of the originator's compliance with stated QM rules.

The issue of whether the borrower had the ability to repay could remain open for years, as it may be raised in litigation by the borrower to oppose a foreclosure. If the rebuttable presumption standard is adopted, lenders could chose to become unnecessarily restrictive in approving loans. The cost of credit in this circumstance is likely to increase, which would essentially be a reduction in credit availability for many American families.

There is also a risk that after the CFPB's shaping of the mortgage business and market becomes evident, mid- to small-sized mortgage lenders and correspondents may feel compelled to withdraw from the marketplace altogether. The complexity of this regulatory environment, the excessive risks for noncompliance and the high costs of compliance may cause many to question why they should stay in this business.

Furthermore, the CFPB has stated its position that lenders should exercise oversight to be sure that third-party vendors and service providers perform their services in compliance with the law, implying that lenders may have liability for the actions of these parties. This undoubtedly will come up in CFPB audits, which have been daunting experiences for some of those who have experienced them. This position by the CFPB also may result in lenders being reluctant to use smaller or lesser-known mortgage brokers and other service providers, with the possible result of less competition among those providers.

Another significant but unrecognized undercurrent in Dodd-Frank and the CFPB's proposed regulations is the negative treatment of mortgage companies that use affiliates in the origination process. The assumption is that a mortgage company may circumvent Dodd-Frank's 3 percent origination-fee limitation through such affiliates increasing their charges to the consumer.

Other examples of this bias exist in many of the CFPB's proposals, including the definition of the zero-cost loan alternative in the last loan origination compensation proposal. This area is complicated and the trade associations have begun to educate the CFPB that lender's affiliated businesses, such as title, do not charge the consumer any more than they charge consumers in non-affiliated transactions. The risk to the market if this issue is not resolved is the possible withdrawal or effective exclusion of these affiliated providers from a large segment of the marketplace.

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The complex and highly specific regulatory approach of Dodd-Frank, reflected in the approach of the CFPB in carrying out this law, may have the unintended consequence of causing a consolidation in the mortgage services industry. It also may lead to a heightened effort by lenders to avoid regulatory compliance risks, causing a reduction in the availability of credit.

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At issue is not the policy determinations made by Congress in its effort to establish a sound and fair mortgage business environment. Rather, it's the micromanagement approach required by Dodd-Frank to implement these policies. The CFPB should provide more industry guidance rather than specific management to create an environment that allows flexibility in the mortgage-origination process for all levels of qualified borrowers. ●