The Current State of Industry Regulation

With so many rules in place, certain regulatory fixes may serve the industry well

By Stanley M Gordon

Mortgage professionals are acutely aware of the actions taken by Congress through the Dodd-Frank Wall Street Reform and Consumer Protection Act, as implemented by the Consumer Financial Protection Bureau (CFPB). The value of Dodd-Frank and all the regulations issued by the CFPB are debatable with respect to whether or not the mortgage business has been improved. From the consumer's point of view, many qualified borrowers cannot obtain mortgages, and many of those who do qualify have been dissatisfied with the process.

Overall, the industry — while improved in many respects, including loan officer competence — has arguably been set back. Consumers at all levels are being underserved and the national economy has been unnecessarily impaired as a result of the government's efforts to redo the mortgage business. Of equal concern is the unwillingness of Congress to open up Dodd-Frank and modify the act as needed, leaving most issues to regulators who are learning on the job.

There was clearly a need for the government to become involved after the financial crisis and deal with an industry that had gone off course. Subprime mortgages had become economically unsustainable and were detrimental to borrowers and, ultimately, the financial markets.

What has not been recognized, however, is that by early 2007, markets and regulators were belatedly correcting the obvious problems with subprime mortgages and industry practices. The financial crisis of 2008 was not solely a result of the collapse of the subprime market even though the combination of events at the time was seen by many as evidence of the need for large-scale structural revision of certain aspects of the financial system, including mortgage banking.

Lack of confidence

Dodd-Frank reflected policy decisions by Congress that, if implemented properly, would have corrected mortgage business practices without reducing competition and restricting the availability of mortgage financing to the consumers it sought to protect.

Concepts such as the ability to repay, the elimination of yield spread premiums, risk retention, restrictions on loan originator compensation and anti-steering provisions were acceptable to the industry. Although many differing views were expressed on these issues, it was not felt that these policy choices would negatively impact the fundamentals of the mortgage finance industry to any significant degree. In the eyes of many, however, the details in some Dodd-Frank policy determinations — along with the thousands of pages of CFPB regulations — have not served the public or industry well.

For example, the government set detailed underwriting criteria for qualified mortgages (QMs) and for determining a borrower's ability to repay. Although the law allows for a deferral to Fannie Mae and Freddie Mac underwriting requirements for now — as well as allowing the Federal Housing Administration (FHA), U.S. Department of Agriculture and the U.S. Department of Veterans Affairs (VA) to adopt their own QM rules — Congress has, in effect, become the industry's underwriter.

This decision arguably reflects a Congressional lack of confidence in the ability of the market to properly implement Dodd-Frank's policy positions. In the same respect, the excessive specificity in Dodd-Frank and CFPB regulations has created excessive compliance costs and placed the resulting financial risk of many issues, such as the validity of a QM, squarely on the shoulders of the industry.

For some organizations, this new legislative and regulatory system has made it almost impossible to function efficiently. Countless mortgage applicants go through an agonizingly slow and confusing process, which has frustrated borrowers and originators alike. Delays in obtaining loan approvals are often

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unnecessarily long because underwriting goes overboard trying to cover all conceivable issues related to the risk of future liability.

Self-employed applicants have an even harder time, if they can get a mortgage at all. Loan originations are down even in the midst of low interest rates. Mortgage bankers and brokers are turning away qualified borrowers because of overzealous underwriting, which many would cite as a reaction to — and a result of — our new legislative environment.

The impact of QRM

The qualified residential mortgage (QRM) requirements of Dodd-Frank present a related issue, since they have impacted the securitization of mortgages, which recycles funds to originate new mortgages. In the absence of this process, the industry would be back to a system in which banks and a comparatively small number of originators have to portfolio their loans.

The QRM risk-retention requirements for securitizing non-QM loans have, to date, dramatically limited the availability of mortgage credit for Alt-A borrowers. This is a large segment of the market, well above subprime, with borrowers that have some credit blemishes often caused by the effects of the last recession.

The Alt-A market includes a large percentage of middle-class people in the United States who have historically been creditworthy, entry-level homebuyers. Few lenders have chosen to serve this market to date because of the QRM risk-retention requirements and the limited securitization opportunities for these loans. The FHA and VA have essentially become the only major sources of lending for this disenfranchised segment of borrowers.

The magnitude of regulations

When the CFPB began issuing regulations, it seemingly wanted to address in detail every possible action that might be taken by the industry to circumvent Dodd-Frank. Normally, legislation states a legal principle and issues some guidelines. Regulations and legal decisions then follow as necessary when industry actions occur.

The alternative chosen by Congress via Dodd-Frank has been an overly broad delegation of authority to the CFPB, which has chosen to hardwire the industry in advance on many issues, such as originator profit plans and borrower credit limitations at closing.

Perhaps even more alarming is the sheer magnitude of the regulations that the CFPB has issued. Over time, this may challenge the tax code in size and complexity. The net result is a regulatory scheme fraught with ambiguity and unanswered questions that few professionals feel qualified to handle or provide advice about to their clients.

For example, the CFPB recently informed loan originators that they are responsible for the quality and compliance of their service providers. Although well-intended, some would consider this an example of a federal agency acting beyond its legislative authority in an effort to shape an industry.

As another example, Dodd-Frank specifies that the fees retained by a service provider affiliated with a mortgage banker or broker (such as a title agency) must be included in the 3 percent QM calculation. This rule discriminates against affiliated business arrangements and precludes many of these service providers from participating in mortgage transactions at certain levels of the market.

Congress has been slow to respond to this problem, although as of press time, corrective legislation had passed the House of Representatives and was before the Senate. Interestingly, the CFPB has exhibited a willingness to look into whether there is any empirical basis for this discrimination.

In response to all of these regulations, the industry has hired more staff and counsel to do their best to comply with the law and all of its uncertainties, all in the context of massive regulatory fines, an aggressive regulator, and the high risks and costs of class actions. Some industry service providers have simply left the industry altogether or are being pushed out of business as the complexity and risk of the new laws and regulations create a trend toward consolidation in an industry that was historically well served by competition at all levels.

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Ultimately, this legal and regulatory environment will balance out as the mortgage industry educates Congress and the CFPB. Unfortunately, this may occur at the expense of companies that could not afford to adjust to the current structure. Furthermore, a large segment of the market will continue to be underserved until advocates realize that the legislative changes they asked for have left their constituents behind. On an encouraging note, the CFPB is attributing more credibility to the information it is receiving from the mortgage industry, particularly the Mortgage Bankers Association, which should support necessary legislative adjustments. ■