It's Time for a New Regulatory Paradigm

More balanced oversight is required to ensure fair competition in the mortgage industry

By Scott Olson

Ten years ago, Lehman Brothers went bust, followed in short order by a collapse of our nation's housing markets and the worst economic downturn since the Great Depression. Congress responded with sweeping new mortgage rules, with the goal of permanently putting an end to shoddy mortgage practices and ruinous subprime lending.

These new mortgage rules generally apply to all lenders, whether independent mortgage lenders, banks, or credit unions. They include the Ability to Repay and Qualified Mortgage (QM) standards designed to end no-doc loans and faulty underwriting; prohibitions against steering borrowers to higher-priced loans; and more detailed servicing requirements. They come on top of long-time protections like the Real Estate Settlement Procedures Act (RESPA), which prohibits kickbacks, and consumer-disclosure regulations like the Truth in Lending Act.

A review of these regulatory changes shows that they have worked reasonably well. Unfortunately, we continue to see a trend toward regulatory policies that don't reflect the comparative risks of smaller and large lenders and that don't treat traditional banks and non-depository independent mortgage banks (IMBs) comparably. This has undermined the competitiveness of IMBs, particularly smaller ones.

Why is this important to consumers? Because IMBs have led the way since the 2008 housing crisis in providing mortgage access as well as personalized, localized servicing. IMBs' market share of Federal Housing Administration (FHA) loan-origination volume grew from 57 percent in 2010 to 85 percent in 2016, and their growth in Ginnie Mae market share grew from 18 percent in 2009 to 78 percent in 2018, according to Community Home Lenders Association data. Similar, though less dramatic, trends can be found with respect to Fannie Mae and Freddie Mac loans.

In that context, the time has come for a more even-handed approach to mortgage regulation — a new paradigm if you will — that puts the focus on borrowers; bases the extent of regulation on a lender's size and borrower impact; and targets regulatory relief to all lenders, not just banks.

Regulatory focus

Mortgage regulatory policies should be borrower-centric. The emphasis should be on key consumer protections — such as requiring borrowers to have the ability to repay a loan, prohibiting steering of borrowers to higher priced loans, prohibiting kickbacks and high standards to ensure that all mortgage loan originators are qualified.

Borrowers are not well served, however, when mortgage rules become so numerous and supervision so duplicative that only the largest lenders (whether banks or IMBs) have the economies of scale to absorb compliance costs. Over-regulation hurts smaller IMBs (and smaller banks) much more than larger IMBs (and larger banks). As mortgage profit margins shrink, we are seeing smaller IMBs selling out to larger lenders, affiliating with banks to gain deposit insurance or reduce compliance requirements and, in some cases, even closing up shop. IMB-industry consolidation and concentration is bad for competition, which, in turn, is bad for borrowers.

Mortgage policies should not be based on a sector's lobbying strength. Unfortunately, all too often this is the case. When Congress created the Consumer Financial Protection Bureau (CFPB), for example, it exempted 98 percent of banks (those below $10 billion in assets) from CFPB supervision, but exempted no IMBs. More recently, bank lobbyists were able to get Congress to exempt small banks from QM rules for portfolio loans — creating the anomalous result that a key Dodd-Frank Act consumer protection is now dependent on which type of lender a borrower uses.

Rule fairness

Core consumer mortgage protections should not vary based on whether a mortgage lender is a bank or a nonbank lender. One of the most critical consumer protections is the establishment of strong qualification requirements for the mortgage "loan originator" — the personal point of contact with the borrower.

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Just before the September 2008 financial crisis took hold, Congress enacted the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act), which established rigorous qualifications requirements for every mortgage loan originator who works at an IMB. To get a license, a mortgage originator at an IMB must pass a SAFE Act test (with real teeth and a 30 percent failure rate); pass an independent background check; and complete 20 hours of SAFE Act pre-licensing courses. An IMB loan originator also must complete eight hours of annual continuing education.

Congress failed to apply any of these qualifications requirements to mortgage originators who work at banks, however. In fact, there are some 1,500 individuals registered to be loan originators at banks who actually failed (and never passed) the basic SAFE Act test, and we have no idea whether the hundreds of thousands of bank mortgage originators that never took the test are qualified. Since licensing costs can be significant, this regulatory disparity also creates a major cost disparity between banks and IMBs. More importantly, it allows borrowers to potentially be served by unqualified individuals.

Risk assessment

Regulatory policies should be based on tiered regulation tailored to a lender's size, borrower volume, product risk and extent of supervision by its regulators. To listen to the recent warnings of a few think tanks in Washington (in part, funded by banks), the biggest mortgage risk we face today is from IMBs, because of their strong growth in market share over the last decade.

Over the last decade, we witnessed some large banks being forced to pay tens of billions of dollars in fines because they misled investors about risky mortgage loans; failed to follow FHA underwriting guidelines; fraudulently engaged in "robo-signing" large numbers of borrowers into foreclosures; and failed to carry out required loss mitigation to avoid foreclosure and keep people in their homes. Yet, somehow, we are supposed to believe the biggest risk we face today is posed by IMBs.

Unlike banks, which have taxpayer backing for deposits through the Federal Deposit Insurance Corp., IMBs pose no direct taxpayer risk for the simple reason that neither an IMB's assets nor its liabilities are backed by taxpayers in any way and generally pose no systemic risk. The failure of one or even a number of IMBs would cause barely a ripple.

Statutory authority

What about borrower risks? As noted, Congress exempted most banks from CFPB scrutiny. The rationale arguably made some sense. Banks are already supervised for consumer-protection compliance by their primary banking regulator, and smaller banks don't have the same consumer impact that large banks do.

Congress created no such exemption for IMBs, however, no matter how small, despite the fact that IMBs are regulated for compliance with federal and state mortgage consumer-protection laws by every state they do business in. This redundancy has recently come under fire. A June 2017 Treasury Report on regulation said this makes little sense and advocated for an end to CFPB exam authority for nonbanks.

Fortunately, we do not need Congress to act. The CFPB has statutory authority to address this disparity. In establishing CFPB supervisory authority over nonbanks (including IMBs), Dodd-Frank included a statutory requirement that such supervision must be "tiered" — based on factors that include a lender's size, its volume, its product risk and the extent of state supervision.

Consequently, smaller IMBs should be exempt from CFPB exams, and the CFPB should show more deference to and coordination with state exams for mid-sized IMBs. Regarding enforcement, the CFPB should not impose fines or take enforcement action against smaller IMBs unless it first receives a referral from one of an IMB's primary state regulators or from some other federal regulator.

These policies should be formalized in a rulemaking. Even if a small IMB is unlikely to have a CFPB exam, the costs of being prepared for CFPB exams and for CFPB rules intepretations that might differ from those required by a state regulator can add hundreds of thousands, or even millions, of dollars of costs. This can affect an IMB's competitiveness, adding hundreds of dollars of cost for each loan originated — while the same compliance costs for large banks (or large IMBs) are minor in comparison on a per-loan basis.

Balanced Regulation

IMBs have proven that they can out-compete banks when it comes to originating mortgage loans and in providing personalized mortgage servicing. There is no need for a rollback in mortgage rules or a reduction in consumer protections. What is needed, however, is a more balanced regulatory framework.

The CFPB should fully implement its statutory Dodd-Frank requirement to provide tiered regulation of IMBs based on their size, volume, product risk and extent of state regulation. That includes creating a CFPB-exam exemption for smaller IMBs and leaving enforcement in the hands of an IMB's primary state regulator — unless the CFPB receives a referral from that state regulator.

The CFPB also should use the requirement in Dodd-Frank that all mortgage originators must be "qualified" and require that all originators pass the SAFE Act test and an independent background check. Congress and federal regulators should base regulatory requirements and regulatory relief on size and borrower impact, and not on whether a lender is a bank or an IMB. ■