

Mortgage Lending Rules

Sensible Reforms for Banks and Consumers



American
Bankers
Association®

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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. rules and regulatory practices affecting residential mortgage finance:

- (a) *empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;*
- (c) *foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; and*
- (f) *make regulation efficient, effective, and appropriately tailored.*

The American Bankers Association¹ offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- **Recent regulatory activity in mortgage lending has severely affected real estate finance. The existing regulatory regime is voluminous, extremely technical, and needlessly prescriptive. The current regulatory regimen is restricting choice, eliminating financial options, and forcing a standardization of products such that community banks are no longer able to meet their communities' needs.**
- **ABA recommends a broad review of mortgage rules to refine and simplify their application. This white paper advances a series of specific areas that require immediate modifications to incentivize an expansion of safe lending activities: (i) streamline and clarify disclosure timing and methodologies, (ii) add flexibility to underwriting mandates, and (iii) fix the servicing rules.**
- **ABA advises that focused attention be devoted to clarifying the liability provisions in mortgage regulations to eliminate uncertainties that endanger participation and innovation in the real estate finance sector.**

Introduction

Over the past 9 years, the mortgage finance sector has been the focus of frequent and intense regulatory change, including extensive reformations ordered under authority of the Dodd-Frank Act. For a full decade, beginning in 2008, federal regulators have been enacting major rulemakings at an incessant pace. These regulatory reforms continue to this day, imposing severe impacts on mortgage lending operations across all banks.

The import and magnitude of this torrent of federal rules are difficult to overstate—the new regulations are sweeping and affect every aspect of mortgage lending, including modified

¹ The American Bankers Association is the voice of the nation's \$17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard \$13 trillion in deposits, and extend more than \$9 trillion in loans.

disclosure forms and timetables, required underwriting methodologies, loan term prohibitions, limitations on fees and pricing, requirements regarding third party relationships, allowable compensation to employees, staff registration and training requirements, appraisal and valuation obligations, counseling disclosures for borrowers, servicing procedures, servicing-related prohibitions, escrow account requirements, data reporting requirements, record retention responsibilities, fair lending, and other areas. These continuous rule expansions have made mortgages the riskiest and most labor-intensive products that banks can offer.

The stifling burdens brought by these regulatory changes have made it difficult for institutions to stay profitable or even continue operations in their markets. In a qualitative sense, the mortgage reform rules are very prescriptive and detailed, placing significant impediments to banks' abilities to properly serve their communities or tailor products that meet local needs. These rules are often defective in that they contain errors and fail to clearly define implementation requirements and liabilities. In a quantitative sense, the new rules are extremely lengthy and complex, spanning thousands of pages of regulatory and interpretive material, and carrying substantial administrative and legal liabilities. Further, substantial amounts of unofficial agency guidance is added subsequent to final rule issuances and the validity of these materials is often uncertain. In this sense, a most significant impact to ABA-member banks engaged in real estate lending activities is the burden and confusion brought about by the sheer volume of reforms that have occurred in a short span of time. The intense regulatory activity is destabilizing business models and legal/risk calculations across all markets.

The damaging impact of ongoing regulatory reforms is evidenced by ABA survey data reflecting a continuing decrease in product choice and elimination of financial options across the board. There is an undeniable increase in costs that are directly attributable to this regulatory torrent.

- 97% of banks responding to our surveys report that their institutions have experienced higher mortgage specific costs as a result of recent regulatory reforms.
- 84% of responding banks report that they are being forced to hire additional staff as a direct result of new regulations.
- 93% report that legal/regulatory consulting costs are swelling because of new regulations.
- Reliable market studies by Mortgage Bankers Association suggest that over the past decade, the cost of originating a mortgage has increased by 72% over the past decade, from approximately \$4,376 in the third quarter of 2009 to approximately \$7,562 by the fourth quarter of 2016.

Our banks do not formally report to ABA when they exit market segments, but we can confirm that a significant number of community banks have ceased mortgage operations entirely in response to the heavy regulatory burdens and increase in legal risks. Many more have discontinued specific mortgage products as a result of increased regulatory burden, leaving consumers with fewer options in the marketplace.

As it affects mortgage servicing, the recent CFPB servicing rules as well as new Basel III capital requirements have driven up the cost of mortgage servicing for all banks. The annual cost of servicing a performing loan more than doubled from \$59 in 2008 to \$175 in 2015, whereas the annual cost of servicing a nonperforming loan more than quadrupled from \$482 to \$2,375 in the same time period. As the cost to service mortgage loans has increased, mortgage servicing has been increasingly acquired by non-bank mortgage companies, including REITs, hedge funds, and

private equity firms that are able to leverage significant economies of scale because they are not subject to Basel III's unfavorable capital treatment of mortgage servicing assets.

Recommendations

As a threshold position, ABA is fully supportive of well-regulated markets where well-crafted rules are effective in protecting consumers against abuse. Banks support clear disclosures and processes to assure that consumers receive clear and comprehensive information that enables them to understand the transaction and make the best decision for their families. ABA does not, therefore, advocate for a wholesale deconstruction of existing consumer protection regulations; rather, ABA believes that full-scale reviews of, and careful fixes to, existing regulations must be undertaken to assure that the laws are necessary, protective, effective, balanced, and certain in their application.

ABA has collected a long and detailed list of the various elements that must be fixed and corrected to remove legal uncertainty, duplication, and unnecessary impediments to mortgage financing. This paper focuses on a select number of targeted and critical regulatory provisions that can be readily fixed to relieve regulatory burdens and boost their legal certainty and ability to lend.

The recommendations below fall into four general areas—

- *Reforms to Disclosure Requirements:* ABA recommends a series of steps to streamline and clarify the disclosure methodology applicable to the origination of residential mortgage transactions. These recommendations will offer security to banks that they are “doing it right,” thus removing legal doubts that hamper operations and swell costs.
- *Liberalize Underwriting Mandates:* ABA advances various recommendations that will expand responsible lending but still maintain protections that afford consumers the assurance that they are receiving loans that they can afford.
- *Fix the Servicing Rules:* ABA recommends numerous reforms that will correct servicing regulations to avoid unintended consequences and encourage banks to service residential mortgages.
- *Clarify Liabilities and Cures:* ABA advises that more attention be devoted to liabilities in mortgage regulations; these provisions are so laden with uncertainties that they greatly endanger participation and innovation in this entire sector.

ABA believes that targeted and focused adjustments to current regulations will go a very long way in repairing most of the defects that adversely impact bank lenders and capital reinvestment into their communities. The recommendations are as follows—

TILA-RESPA Integrated Disclosures:

- *Revise TRID Tolerances:* Under current TRID regulations, creditors must observe closing cost tolerances that prohibit fees from increasing beyond initial disclosures by specific amounts. TRID's cost tolerance system is extremely convoluted, operating under a three-prong tolerance system that contains uncertain exemptions and rules for corrections. ABA believes that the current tolerance system should be entirely eliminated and replaced with a “single tolerance” standard of 10%, with more focused applicability.

Under this proposal, a single 10% tolerance would apply to all lender fees, and fees charged by providers that are specifically required by the lender. The tolerance would exclude fees for services that are not credit-related (recording fees, government taxes) and settlement fees, where a specific provider is not required by the lender. All fees not subject to the 10% tolerance would continue to be regulated under RESPA's "Good Faith" standards.

ABA's approach would ease compliance burdens without removing consumer protections. The single-prong approach eliminates the extremely convoluted tolerance system imposed under current rules, where the tolerance limits vary in accordance to the type of service, if the service is required by the lender, if a provider was initially disclosed to the borrower by the lender, and whether the borrower is permitted to shop for the provider. The existing regulations demand very complex systems to manage compliance risks, and often results in unpredictable (and unfair) liabilities for the lender based on other parties' actions, such as those of the title insurance company, that are extremely difficult to control.

Under the current tolerance rules, estimated credits offered by lenders for no-cost mortgage loans may not be later reduced to match actual costs. This often results in payments being made paid to borrowers even where the payment does not cover any transaction cost. To avoid this awkward result, many lenders have simply stopped offering these consumer-friendly products. Lenders should be permitted to adjust estimated credits to match actual costs without being unfairly penalized by this inflexible rule.

- ***Remove Three-Day Waiting Period:*** Currently, TRID provides that the final Closing Disclosure (CD) be provided to the consumer three business days before the settlement—this requirement should be eliminated (and replaced by the former RESPA rule mandating one-day advance availability). The delay is unnecessary and detrimental to consumers in mortgage transactions—(i) it does not enhance consumer protection in refinance transactions, as borrowers have an absolute right of rescission that provides greater protections; and (ii) it is unsuitable in the home-purchase setting, as purchase money transactions generally involve dynamic and fluid negotiations, and price/cost adjustments right until the point of settlement. Our banks report that TRID's 3-day delay often frustrates borrowers that need to close on their homes under tight deadlines, or require the use of loan proceeds for immediate purposes.
- ***Permit Correction of Closing Disclosure:*** Current regulations should be amended to allow a creditor to issue corrected Closing Disclosures at settlement to update last minute fee changes without having to absorb increases not attributed to the creditor. Presently, creditors are held responsible for many justified fee changes, even "borrower-requested" changes, merely because the cost adjustments occur after an initial Closing Disclosure was issued. This requirement has forced lenders to incorporate expensive and very rigid loan origination systems with inflexible processes to avoid even minor fee adjustments that cause liabilities for lenders and extended delays for consumers. ABA believes that lenders and consumers will be helped by allowing legitimate and good faith cost adjustments to occur up to the point of settlement, without penalizing stakeholders.
- ***Exempt Construction Loans & Temporary Financing:*** Temporary financing transactions that generally encompass construction lending should be entirely excluded from TRID coverage. Construction loans are complex transactions with third party building contractors involved that often times do not allow meaningful disclosure to consumers within three days from learning the 6 trigger items for disclosure. As a result, a creditor's good faith estimate can be wildly inaccurate given that the construction contract may not be executed (some consumers may not even have a builder identified) at the time of the disclosure. TRID's current construction loan disclosures require

computation flows that are convoluted and yield erroneous numerical outcomes. Confusion with numerous provisions of the rule, including disbursements of construction contract costs, the projected payments table, and variations applicable to the alternative disclosures, among other issues. The ongoing regulatory disarray has sparked a concerning flight away from construction financing by many banks.

ABA believes that temporary financing transactions that generally encompass construction lending should be excluded from TRID coverage. Construction-to-Permanent loans are generally structured as a single loan with two distinct phases. The second, or permanent phase, of the transaction will be fully subject to TRID disclosures, and the consumer will be well protected on the long-term financing of the overall project. The initial phase, or pure “construction” phase, which concerns contractor negotiations, disparate disbursements of funds at times and in amounts that are unascertainable at the start, and interest-only payments to the lender by the consumer, is a form of temporary financing that should be exempt from TRID.

Ability to Repay – Qualified Mortgages:

- ***Portfolio Loans Should Qualify as QM:*** Under existing Ability-to-Repay (ATR) rules, lenders must determine whether a borrower has a reasonable ability to repay a mortgage, and must document the loan applicant’s income, before the loan is consummated. Loans that are originated under specific underwriting guidelines, as defined in the regulation, qualify for more favorable safe harbor treatment as a Qualified Mortgage, or “QM.” ABA believes that all mortgages originated and held in a bank’s own portfolio should be considered QM, and should be afforded safe harbor legal treatment. This approach is consistent with safe lending principles because holding loans in portfolio means that the bank is retaining 100% of the risk on that loan. Banks will offer portfolio products only when they can adequately assure that it is a “safe” loan and can absorb the full risk of repayment. Since institutions are not likely to make unsound loans in instances where the loan is held in-house, the ability-to-repay protections are inherent in the underwriting analysis that the bank chooses to apply.
- ***Eliminate the 43% Debt-to-Income Standard:*** In order to attain a presumption of compliance, or “Qualified Mortgage” status (QM), a lender must assure that the DTI on the loan is no greater than 43%. Instituting such a rigid DTI limitation is arbitrary, misplaced and results in inflexible underwriting conditions that are resulting in the rejection of many creditworthy applicants. The rule’s forced focus on one data point—the DTI—is not conducive to allowing banks to review a mortgage applicant’s fuller credit picture. The codification of a hard-lined DTI ratio halts any ability to consider viable compensating factors that open credit possibilities for deserving consumers.

The QM rules should not prescribe inflexible underwriting criteria. Since the Dodd-Frank legislation instructs the regulator to take into account debt-to-income ratios when setting QM standards, the solution is to increase the DTI threshold to a higher level in order to afford lenders more leeway in setting their own standards, in full consideration of their communities’ needs and their appetite for risk.

A more appropriate alternative standard for considering an individual’s ability to repay would be a well-defined residual income analysis. ABA urges that the QM rules should provide that, in addition to DTI, creditors have the option of considering residual income to determine whether an applicant qualifies for a loan. For instance, the Veteran Administration’s residual income test is an established and market-accepted standard that would provide an excellent model to serve as an alternative to the QM DTI requirement.

- **Revisit and Expand Appendix Q:** Under the QM rules, Appendix Q sets forth the definitions and standards for calculating “debt” and “income” for purposes of calculating the DTI limits applicable to attaining safe harbor treatment. The guidelines set forth in Appendix Q were generally derived from the FHA Insurance program, and as such, constitute only one option among many market standards for safe underwriting. Various other guidelines currently exist—whether they be from Freddie Mac, Fannie Mae, the VA, or the Federal Home Loan Banks—that are as safe and established as the FHA guidelines. These additional alternatives must be made available as acceptable guidelines for allowing banks to certify loans into QM status.
- **Consider Acceptable Replacement for the GSE/Agency Alternative QM:** The ATR regulations contain a special “GSE QM,” which provides that loans that comply with GSE underwriting specifications automatically qualify as QM. This special GSE QM continues to be a critical QM alternative in the current market. However, this alternative is only temporary and is set to expire once GSEs are no longer in conservatorship or until 2021, whichever is earlier. ABA urges the CFPB to initiate a formal process for soliciting stakeholder input to begin the development of a workable and transparent set of criteria for the configuration of a viable QM standard that replaces the “GSE Patch.” The new QM standard must be as broad as the current GSE QM, and must be sufficiently robust to completely replace it. The standard must set forth methodologies that achieve flexible underwriting standards, and they must be fully consistent with Dodd-Frank requirements. ABA believes that this endeavor is urgent in light of the impending sunset requirements for this special provision.
- **Eliminate the Points and Fees Test:** In order to qualify for QM’s safe harbor treatment, the points and fees payable in connection with a loan cannot exceed certain thresholds. This so-called points-and-fees test is extremely complex, with definitions that are unclear and often inconsistent in their application. There should be a reconsideration of the points-and-fees thresholds as this item is among the most convoluted elements of the law and threatens high liability for banks. More importantly, this test operates as a redundant consumer protection provision, as price controls that achieve the same end are found elsewhere in mortgage regulations. The points-and-fees test often poses a significant hurdle to qualifying consumers into mortgage loans.
- **Raise the RESPA Servicing Rule Threshold:** The new servicing rule requirements under RESPA are extensive, are an overreaction to the financial crisis when servicers could not keep up with the barrage of loans going into default, and go too far in specifying exacting detail of how to service a mortgage loan. The threshold to trigger compliance with many parts of the servicing rules is just 5000 mortgages, or just 1 mortgage whose servicing rights are purchased when the lender will be servicing for others. The servicing rules require precision to orchestrate that translates into a need for increased staffing that a small servicer cannot afford. The threshold should be increased to 25,000 mortgages, or 1000 loans whose servicing rights are purchased, so that only large servicers will be bound by the increased complexity.

Mortgage Servicing Regulations:

Many banks that make residential mortgage loans also engage in mortgage servicing, which primarily consists of collecting mortgage payments and forwarding them to the “owner” of the loan; collecting insurance and tax payments; and addressing problems such as late payments, delinquencies, and defaults.

Banks commonly sell mortgage loans into the secondary market “servicing retained.” Under this approach, a bank sells the loan to an investor but retains the right to service the loan. This strategy is an important way for banks to maintain valuable customer relationships, while selling long-term credit assets in order to manage interest rate risk. Servicing mortgage loans for investors is a specialty of many U.S. banks and has provided a strong source of fee income for decades.

Collectively, recent complicated servicing rules, inappropriately targeted capital requirements, and inconsistent regulatory policy are creating an environment that discourages banks from servicing mortgage loans, which provide important and long-term relationships with consumers. The following targeted recommendations will foster and enable increased mortgage servicing activities in banks.

- **Simplify and Clarify the Servicing Rules.** Since 2013, the CFPB has issued six rulemakings that govern mortgage servicing practices. The rules apply to payment crediting, periodic statement requirements, error resolution, information requests, force-placed insurance, communicating with delinquent borrowers, and loss mitigation. All mortgage borrowers deserve high-quality mortgage servicing that is accurate and responsive to customer inquiries. However, some aspects of the CFPB servicing rules are over-engineered and need to be rationalized. Some of the most convoluted aspects of the rules were not required by the Dodd-Frank Act. Rather, CFPB elected to issue certain provisions using its “discretionary rulemaking authority.” For example, when a borrower requests a loan modification, the CFPB’s loss mitigation rules trigger complicated and inflexible procedural and timing requirements. While it is in a lender/servicer’s economic interest to work with financially distressed borrowers, the rules are overly rigid and subject servicers to civil and regulatory penalties for non-compliance. Failure to comply with the various notice and response times within the allotted timeframes could subject servicers to supervisory or other consequences if a deadline is exceeded by one or two days—even when there is no borrower harm. Since these draconian directives are non-legislative, CFPB must reconsider these requirements with more rigorous regulatory impact analysis.
- **Limit Successors in Interest.** Recent amendments to the servicing rules provide “successors in interest” with the same rights as mortgage borrowers, even if the successor does not assume the mortgage loan obligation. As a result, a successor in interest who is not obligated on a mortgage loan—but rather has a mere, possibly unperfected, ownership interest in mortgaged property—is entitled to detailed information regarding the mortgage loan. This is particularly concerning in situations where a transferor borrower is still living (e.g., a non-borrowing spouse obtains title to the property as part of a divorce settlement). While ABA appreciates the objective of preventing unnecessary foreclosure in successor in interest situations, this aspect of the servicing rules constitutes significant overreach by CFPB and is altogether inconsistent with a borrower’s expectation of privacy and confidentiality. For this reason, the successor in interest provisions of the servicing rules should be limited to situations involving the death of an obligor. In addition, servicers should be protected from RESPA liability as to non-obligor successors.
- **Repeat Requests for Loss Mitigation.** Subject to very narrow exceptions, servicers must comply with the CFPB’s loss mitigation procedural requirements for all loss mitigation applications submitted by a borrower. ABA does not oppose considering a borrower for loss mitigation multiple times. However, any requirement to do so should permit restrictions on the frequency and number of times that a servicer is required to comply with the loss mitigation requirements over the life of a loan. In other words, there should be a limit on the frequency with

which banks are required to apply the loss mitigation rules for repeat loss mitigation applications. Requiring a borrower to perform under a loss mitigation arrangement for a minimum period of time before the loss mitigation requirements are triggered again would also help to provide a more effective allocation of resources by enabling servicers to focus their loss mitigation personnel on helping borrowers who are in genuine need of assistance, such as those filing their first loss mitigation application rather than those who may be manipulating the loss mitigation process.

- **Need for Flexibility when Rules Change.** Since 2013, servicers have been faced with a continual stream of amendments to the servicing rules. In fact, servicers have questions about how to interpret and apply regulations that go into effect less than 6 months from now. In such an environment, regulatory and supervisory flexibility is warranted. The ongoing amendments necessitate programming and systems changes that are much more complex than a few computer keystrokes. As has been the case with many of the CFPB's mortgage-related rulemakings, once vendors provide the necessary upgrades, banks may need several months to implement and test the changes, revise internal policies and procedures, and train staff. For these reasons, coordinated, inter-agency flexibility is needed.
- **Capital Treatment of MSAs.** As the CFPB servicing rules have dramatically increased the cost of servicing (particularly for delinquent loans), banks are also dealing with unfavorable capital treatment for mortgage servicing assets. The Basel III capital rules mandated a significant increase in bank capital and provided unfavorable capital treatment to mortgage servicing assets. The Basel III capital provisions on MSAs—which apply to all U.S. banks regardless of size—were suggested by regulators from foreign countries that have vastly different mortgage systems than our own and that do not have MSAs. Agencies must reopen deliberation in this area and better consider the impact of the onerous new rules on the U.S. marketplace and American consumers.

The new limits on the extent to which banks may include MSAs in Tier 1 capital calculations make it very expensive for banks to hold MSAs in excess of the Basel III thresholds. The increased capital requirements result in higher funding costs, which in turn create a disincentive for banks to service mortgage loans that they make to their customers. The Basel III capital requirements do not apply to non-bank servicers, and an active regulatory arbitrage is draining MSAs from the secure and experienced hands of the banking industry.

Clarify Liabilities and Provide for Cures:

A critical element of uncertainty under the current regulatory regime continues to be the scope and effect of RESPA and TILA's liability provisions given the application of the new regulations and the overhaul of all mortgage-related disclosures. Since the launch of the new Dodd-Frank rules, banks have expressed significant anxiety about the mix of old and new statutory remedies, which engender considerable doubt as to which statutory provision applies to which particular circumstance, and the extent to which statutory penalties affect non-creditors, including investors. The continued uncertainty in liability forces industry stakeholders to assume that the more stringent liability will apply in all instances of non-compliance, even if that is not the intent of the legislation or the Bureau. In the long run, the resulting impact to consumers is significant—lenders and investors will limit exposure to uncertainty and confusion, and this will result in diminished product choice and increased costs for borrowers.

ABA recommends that agencies provide more detailed descriptions of the specific statutory provisions under RESPA and/or TILA (or other applicable statutes) as they apply to TRID. It is only through a more precise description of the statutory authority for each disclosure element that industry stakeholders and government authorities will be able to properly identify penalties and liabilities applicable under the law. Regulators must craft matrices that explicitly address how liability might attach to any specific compliance point. Any such matrix should include: (1) each regulatory provision that provides for a disclosure item or requirement; (2) a description of the statutory section relied upon for each disclosure item or requirement; (3) if curable, how it may be cured, e.g., as a tolerance refund, as a non-numeric clerical error, or under Section 130(b) of TILA; and (4) clarifying comments, where needed.

If regulators provide a matrix as described, issued as official commentary to the regulations, it would facilitate proper application of the law, and would allow market participants to recognize and manage their responsibility and/or accountability in the transaction.

Finally, and of equal importance, ABA urges that regulators expand the availability of cure provisions across all mortgage regulations. Current mortgage rules involve technicalities and delineate methodologies and computations that govern how triggers are set or how disclosure figures must be calculated and reflected in forms and apportioned in mandated comparison tables. Often, technical oversights occur that do not affect consumer choice or understanding. Even where they do, lenders often have ample opportunity to fix mistakes so that consumers are not harmed or misled in their decision-making. The regulations must apply to reasonably allow banks to correct hyper-technical and clerical oversights without triggering penalty provisions or forcing the process to begin anew. The rules must provide for official ways to correct mistakes and afford ways in which lenders can deal directly with consumers to resolve harmless or clerical lapses.