Ten Obstacles to Increased Mortgage Lending*

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August, 2013

The mortgage industry has had a nice refinance boomlet, and a number of houses have been purchased with cash, a signal that speculators are betting that the demand for new purchases will continue and will be met by eager new purchasers. Demographics are saying that there is a pent up demand, even suggesting that it will come in great part from some of our immigrant population. But no one yet has concluded that we are back where we want to be in an ordinary housing cycle; we still are suffering from our housing hangover from the early 2000s.

There are good reasons why that is so, many good reasons. Here are ten of them, which is a partial list at best.

Increased enforcement activity. The Consumer Financial Protection Bureau has announced that it will be aggressive in its enforcement of the large number of new mortgage related regulations it has promulgated during the past two years. That is a reasonable position for the Bureau to take, since the Dodd-Frank Act clearly concluded that the industry had failed to make good loans and needed more and tougher laws to prevent the bad practices that had developed. Now, the regulators have tougher regulations, so it is only natural that they announce they will use them. To ensure that they can do so, the Bureau has hired hundreds of attorneys devoted to enforcement.

For lenders and others in the industry, that means that the sanctions the law provides, much tougher sanctions than existed before, are real threats. Even if a lender or other participant feels fairly confident they are originating and servicing loans by the book, the overriding caution will be to avoid any semblance of operating beyond the boundaries. Be cautious. That translates to originating fewer loans.

Volume and complexity of the rules. While I have not seen a tally of the lines of new regulations that have been adopted in the mortgage space in the

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past two or three years, it is accepted that it has been massive. Thousands of pages heralded the proposals, and the final rules themselves have been adopted only after major changes.

To implement these in a manner that can be automated is important to any large lender. Manual underwriting cannot be done well and certainly not as inexpensively as underwriting in an integrated automated system. Yet in such a system, lenders must be very accurate in their data analysis and must interpret the rules correctly, or modest mistakes can quickly translate into errors on hundreds of loans before being detected. When rule changes are so many and as complex as these, that requires intense effort and testing. None of that can be done quickly, and it is not done yet.

One cautionary note — even many of the final regulations will need further interpretations to provide the necessary certainty.

Uncertainty over regs not yet finalized. Exactly how QRM will operate and what standards it will require remains unknown. What disclosure documents will be required under Reg Z and Reg X has been studied extensively, but the final rules remain under wraps. Yet, both of these rules involve standards for mortgage lending that are crucial. Until they are known, lenders are operating with assumptions and hunches as they try to finalize their production lines.

Intent to emphasize disparate impact theory of discriminatory lending. The Department of Justice, the Bureau, and HUD have all announced that they will insist upon utilizing the disparate impact theory to prove discriminatory lending under the Fair Housing Act. Under this theory, lenders can be found to be in violation of the FHA by demonstrating through statistical analysis that there was a discriminatory impact on a defined group, not necessarily on an individual, even though it is clear that it was not the lender's intent to discriminate.

By itself, the theory discourages mortgage lending because it interjects a major risk to the lender's reputation. But when combined with the Ability To Repay rules of DFA, and their increased penalties, it creates a classic dilemma for lenders. Make only loans that fit within the safe harbor of QM to get some protection from the penalties of violating ATR, and in doing so, find that statistics will most likely show that you are systematically excluding a disproportionate number of members of a protected group from obtaining credit.

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Or even more likely, while most loans will be QM, lenders will make some non-QM loans to very good customers because they know they will be repaid. But that will exaggerate the disparate impact on LMI borrowers.

The best way out of this dilemma is not yet known, but at the very least, it has caused lenders to be cautious. Particularly so because of the ability of dueling statisticians to make the same numbers dance differently.

Problems with GSE enforcement of reps and warrants. Over time, informal practices develop among buyers and sellers of products, particularly when the volumes of such sales are high and repetitive. That happened with lenders who were selling loans to the GSEs. A few years ago, when the good times in mortgage lending were replaced by the bad times, the GSEs changed those practices and began enforcing literally the reps and warrants accompanying those sales. In addition, they failed to provide guidance in advance, and the result has been a reduction in confidence that the GSEs can be trusted on this basic element of economic operations.[1] Lenders are driven to overlay additional requirements to be sure that the loans that they originate are very unlikely to default.

Efforts have been made to improve the relationship, and all parties should be congratulated on that, but transparency still is lacking, and what constitutes a breach still remains opaque in many circumstances. Those conditions chill originations.

Related to this obstacle is one other. The Bureau has decided that any failure to meet GSE requirements, unless they are wholly unrelated to underwriting, will cause loss of agency QM status. This creates strong incentives for lenders to use the more conservative general QM requirements or to have other overlays to GSE requirements to make the loans less likely to default.

Persistence of hostility. Lenders made a series of bad loans a decade ago and for a few years thereafter. Borrowers made a series of misleading statements on loan applications a decade ago and for years thereafter. Credit rating agencies, government regulators, pension funds and other investors, Congress, local governments — all made a series of bad decisions a decade ago and for a few years thereafter. The result was a bubble and a bursting bubble, with the resulting economic fallout we are just now exiting.

[1] See Trust: the Social Virtues and the Creation of Prosperity, Francis Fukuyama.

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All parties but one have been mainly forgiven, or if not forgiven, have now escaped the daily drumbeat of blame and criticism. But lenders continue to be the subject of hostility by historical reference in press releases of government agencies each time they pass a regulation or issue guidance or file a lawsuit, and commentators on the mortgage scene continue to insert somewhere in their comments on whatever the mortgage subject might be that lenders made bad loans and started the whole downturn in the economy.

The result of this constant criticism is a desire on many lenders to either exit the field, or limit their lending to loans for which no one in the future can criticize them. That means that a lot of good loans will not be made out of a continuing concern by lenders that the game isn't worth the price.

Cautious capital. The accuracy of the phrase — money is a coward — has been demonstrated by the flight from the private secondary residential mortgage market. Nearly all residential loans that are currently being made go to the FHA or the GSEs. There isn't a vibrant private secondary market.

Money that could be in the market has seen what has happened. It follows what Congress writes into laws and what regulators promulgate to implement those laws, it sees the hostility in the media and the influence that has on the public, and faced with all of those red flags, it chooses to sit on the sidelines or to flow toward other investment opportunities that are not so tainted and unpredictable.

Lengthy foreclosure timelines. Mortgage loans are priced as low as they are because they are collateralized by residences, an asset that has very good liquidity in most markets. The key to that, however, is the ability of the lender to take the collateral when the borrower doesn't pay. To do that, lenders must foreclose. What lenders have discovered in this cycle is that foreclosure can be a lengthy and expensive process, made even more so by regulators and legislatures that change the rules to try to coerce lenders into giving the borrower a break.

At the present time, generally attributed to numbers produced by Realty Trac, the average foreclosure period is now hovering around 477 days, or about 18 months. In some states, such as New York and New Jersey (judicial foreclosure states), the time required to complete a foreclosure has stretched to nearly three years. Since time is money, the desire is chilled to make secured loans in jurisdictions in which the security has a delay attached to it. That is apparent from the statistics on activity.

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> Among the nation's 20 largest metros, those with the biggest increases in median home prices tended to be in states where a non-judicial foreclosure process has allowed foreclosures to be absorbed by the market more quickly. Seven of the 10 metros with the biggest jumps in median home prices from a year ago were in non-judicial states, while all five metros with flat or declining home prices from a year ago were in states with a judicial foreclosure process."[2]

It should also be noted that the costs of servicing through this lengthy timeline has increased, based on a variety of additional rules that have been promulgated or enforced thorough mortgage dispute settlements.

Uncertainty about secondary market. This is not an intense obstacle just now, since the rules on QM, as well as the Federal Reserve's quantitative easing, have provided the GSEs and FHA with a favored position in the market, one from which they can continue to serve as a conduit for those making loans. In many ways there remains opportunity to process loans off the balance sheet of lenders to third parties.

But strategic plans are currently being considered that have a five year time horizon. They can be made more vigorously if the time horizon has clarity on basic structural points. Will there be GSEs, and if not, what will replace them, when will that happen, and what will be their rules; will the FHA still take no down payment loans; will there continue to be a need for credit overlays and constant negotiations with those entities; etc. So far, the forces that can change the rules and provide clarity on these issues have not come together in any meaningful way.

Other complications. Most mortgages are originated by large lenders, and many large lenders are a part of parent organizations involved in many activities stretching beyond the mortgage market. Executives running the parent organizations must worry about a blizzard of problems constantly, and during the past few years they have become more intense. These problems have involved a growing demand for ever more capitalthat will comfort regulators that we will not lose the previous economic battle if it happens again; a growing belief that bigger is not better and getting smaller is the proper goal for large companies; a recognition by aspiring politicians that

[2] "U.S. Foreclosure activity Increases 2 percent in May boosted by 11 percent rise in bank repossessions." Realty Trac, June 13, 2013.

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attacking these big companies in one way or another is a popular sport and may result in election victories; and other kinds of similar problems. Finding funds to use for particular product lines is becoming harder and harder within these organizations. Funds for the housing operations are no different.

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