The Consequences of the Cost of Compliance

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In response to the financial crisis of 2008, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the most sweeping and comprehensive financial services legislation since the 1930s. One of the central features of Dodd-Frank was the creation of the Consumer Financial Protection Bureau (CFPB), a single federal agency responsible for all consumer protection functions. Prior to the creation of CFPB, these functions had been dispersed throughout the other federal regulatory agencies.

In less than four full years on the job, CFPB has moved with breathtaking speed. For example, in 2013 alone, the bureau adopted more 30 final rules—approximately one final rule for every eight working days. A multitude of other rules have been proposed and are currently pending.

The most impactful for the mortgage servicing industry, obviously, are CFPB's final mortgage servicing rules, which were effective January 10, 2014. The rules implemented the mortgage servicing provisions and requirements under Dodd-Frank and established, for the first time, uniform national mortgage servicing standards. The rules represented a seismic regulatory shift and required the mortgage service industry to fundamentally change the way it does business in order to comply.

In response, servicers have spent millions of dollars and thousands of hours interpreting and implementing these new requirements. Compare the current environment to the pre-crisis environment—in a 2005 Mortgage Bankers Association mortgage servicing cost study, "compliance" was not even a line item.

In addition to CFPB, state legislatures have been equally active, enacting hundreds of bills that impact the mortgage servicing industry. These state laws impose additional yet equally complex and burdensome requirements, including, for example, new notice requirements that must be strictly followed, along with requirements to register loan and borrower information with various state agencies. Municipalities have even gotten into the act, with some cities implementing new foreclosure mediation ordinances. There is truly no comparison of past practices to the current regulatory environment.

These increased compliance costs take on many forms—some are direct costs in terms of legal, compliance, and risk management staff and systems to research, manage, and implement new state and federal regulations and guidelines—along with costs for implementation time. Below are some samples of additional costs:

- Employee training for new processes and procedures;
- Higher technology costs in both hardware and software upgrades to be able to automate these new regulatory requirements;
- Lower loan-to-employee ratios as a result of "single point of contact" regulations and state and federal loss mitigation options;
- Extended pre-foreclosure timelines due to CFPB's 120-day pre-foreclosure period and prohibitions on dual-tracking;
- Longer recovery periods where servicers must advance funds during extended foreclosure periods;
- Legal and consulting expenses to prepare for and respond to regulatory (state and federal) audits and investigations and the costs of examinations themselves;
- Payment of fines and remedial action from examination findings and inevitable CFPB enforcement suits.
- Possible adverse publicity and resulting reputational damage

In short, these additional expenses, have tripled servicing costs in less than a decade. While it is possible that companies may see some regulatory relief in the future, any relief will likely be at the margin, not a wide-scale reduction in the compliance burden. Unfortunately, not all companies are going to survive this new reality.

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Industry Consolidation: Better for Consumers?

To be clear, companies are working hard to comply with the litany of new regulations. However, it is becoming apparent that many companies—especially small and mid-sized companies with limited resources—will not be able to keep pace with the degree of regulatory change that is applicable universally, regardless of company size.

When the mortgage servicing rules were proposed, many financial institutions voiced deep concerns about their ability to comply with the new regulations. Following the rules' effective date, these concerns have continued, although now focus on whether these companies will have the ability to comply and still be a viable business. This is especially true for small and mid-sized entities that are struggling to hire legal and compliance staff, pay for system upgrades, and draft and implement complicated policies and procedures while also preparing for extensive examinations and audits.

This over-regulation is creating a scenario where small and mid-sized financial institutions cannot effectively compete. The regulatory burden requires these companies to spend more and more on compliance, while diminishing their ability to expand and compete with larger institutions. Ultimately, this will lead to industry consolidation, resulting in less competition and higher ultimate costs for consumers. Additionally, this consolidation will, in turn, lead to a consolidation of service providers, which could ultimately cost jobs and hurt the economy.

The Increase in Judicial Foreclosures

Recent legislation in many states has greatly increased the complexity of the non-judicial foreclosure process. These new laws often contain onerous notice and process provisions; they routinely contain private rights of action for borrowers and monetary penalties for non-compliance. The most notable example is California's Homeowner Bill of Rights (HBOR), which amended the state's non-judicial foreclosure process.

Among other features, California's HBOR statute contains a private right of action, which allows a borrower to recover attorney's fees and costs for simply obtaining an injunction. The private right of action also gives borrowers the ability to bring a lawsuit for any material violations. These material violations can lead to significant monetary penalties, including up to $50,000 in statutory damages for violations found to be reckless.

Many studies published contemporaneously with the passage of California's HBOR predicted that the law's requirements would likely result in an increase in the length of non-judicial foreclosures to that approaching judicial foreclosures as servicers struggled to implement the new requirements and evaluated the potential financial liabilities. As a result, many predicted that servicers would turn to the relative legal and financial certainty of judicial foreclosures and use that method in increasing numbers.

Indeed, although it is still early, this appears to be happening. According to RealtyTrac's latest U.S. Foreclosure Market Report, in California, the time it takes to foreclose from the first day of delinquency to completion of the foreclosure process is 993 days, up from 751 days in the first quarter of 2013—an increase of approximately 32 percent. Faced with this lengthening time frame and the potential for increased financial liabilities, more lenders appear to be turning to judicial foreclosure. According to RealtyTrac, out of California's approximately 20,000 foreclosure starts in the first quarter, nearly 1,400 were filed judicially—up from just one judicially filed foreclosure start in the first quarter of 2013. The same trend appears to be happening nationally. The Mortgage Bankers Association's 4th Quarter 2013 National Delinquency Survey shows judicial foreclosure states as still accounting for most loans in foreclosure. As yet another unintended consequence, should this trend continue, it has the potential to overwhelm an already overburdened state court system.

Conclusion:

While no one is advocating a return to pre-crisis practices, the current regulatory environment is threatening the health of the mortgage servicing industry—an industry vital to the national economy. The regulatory burden will cause many companies to either go out of business or be acquired by larger competitors. This will cost many jobs and further weaken the still-uncertain economic recovery. What the industry needs instead is a rational regulatory structure that allows both big and small companies to compete on a level playing field.