Wednesday, July 27, 2011

Winning the Future - Losing the Past

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"Winning the Future!" By now, most of us have heard President Obama's new slogan for his 2012 re-election campaign.

But for the mortgage industry and consumers, it seems like something very vital is at stake: causes of the recent financial meltdown are creeping and clawing their way back.

Perhaps we are not so much Winning the Future as Losing the Past.

Famous Last Words

Here are the very last words of the 1616 page Senate's amendments to the House's financial reform bill, which together formed the basis of the Dodd-Frank Act (Dodd-Frank):

> Amend the title so as to read: An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end **"too big to fail"**, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes. (My Emphasis)

The nomenclature "too big to fail," otherwise known by the acronym TBTF, was placed into the legislative language right then and there!

But that phrase "too big too fail" itself never actually made it into the 2319 page Dodd-Frank Act.

Did it just disappear forever or merely reappear with a make-over?

What's In A Name

Dodd-Frank saw to it that the pesky and politically unpopular term "too big to fail" disappeared, but the concept was craftily replaced with a shiny new term, known as a "systemically important financial institution," also prestigiously having an acronym of its very own: "SIFI." (Pronounced in the same way as you would pronounce SciFi!)

Is the SIFI a different kind of indomitable beast than the TBTF monstrosity?

Let's take a closer look, by reading some Dodd-Frank descriptions of this SIFI creature:

- Entities that are systemically important or can significantly impact the financial system of the United States.

- The terms 'systemically important' and 'systemic importance' mean a situation where the failure of or a disruption to the functioning of a financial market utility or the conduct of a payment, clearing, or settlement activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States.

And here is one of several factors that may be taken into consideration, when deciding to protect us from the flailing SIFI:

- The effect that the failure of or a disruption to the financial market utility or payment, clearing, or settlement activity would have on critical markets, financial institutions, or the broader financial system.

Now you might argue that TBTF is a somewhat colloquial expression, a political and

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Now you might argue that TBTF is a somewhat colloquial expression, a political and journalistic tool, but its successor, SIFI, is now enshrined into law along with certain actionable remediation. Conceptually, however, I see very little light between the meaning of the two terms.

So did Dodd-Frank conquer the "too big to fail" beast, wrestling the TBTF to the ground, casting it into chains, pulling off its griftopic mask, and finding underneath the "systemically important financial institution," that rapaciously attenuated SIFI?

Are We Safe From The SIFI?

Let us presume that Dodd-Frank actually provides viable regulatory remedies for keeping this SIFI chained up. As you may know, I have written extensively about the breathtaking lack of formidable brakes in Dodd-Frank to avoid the SIFI debacle. Indeed, certain markets are still exposed to systemic failure, as that term is defined by Dodd-Frank. In some cases, certain markets are inadequately addressed by or they are not even regulated through Dodd-Frank.

In any event, let us just suppose that somehow Dodd-Frank actually has all the regulatory remedies it needs to keep the SIFI under control. What may happen in another meltdown?

Systemic Risk

One of the determinants of the effectiveness of protection from SIFIs is best described in a recent report from Standard and Poor's. It is entitled "The U. S. Government Says Support For Banks Will Be Different 'Next Time' -- But Will It?" Link Here – PDF

Although the title speaks for itself, or begs the question, the report offers the one and only factor that really counts when it comes to SIFIs running loose: government intervention inevitably will crowd out a regulatory framework and trumps everything else! So, inevitably, this is the outcome that may happen.

And I quote:

> It would seem "too big to fail" has ended. But, has it really? Standard & Poor's Ratings Services believes that the primary goal of DFA is to make banks less risky and better capitalized so the need for extraordinary support is reduced. However, given the importance of confidence sensitivity in the effective functioning of banks, we believe that under certain circumstances and with selected systemically important financial institutions (SIFI), future extraordinary government support is still possible. The U.S. government has a long track record of supporting the banking system. But the government's authority to regulate and supervise hasn't always prevented bank failures or the need for selected bailouts or tailored assistance. Time and time again, the U.S. government has found ways - many times reluctantly - to contain systemic risk and limit economic fallout when large financial institutions are on the brink of failure.

And then, referring to Dodd-Frank, comes this conclusion:

> This legislation, in our view, has not addressed the demand side of risk, risk-mitigation efforts, or the fact that a two-tier regulatory system will likely continue to move risks into **the loosely regulated shadow-banking system**.
>
> (My Emphasis)

Translation: S&P understands regulatory risk. The TBTF monster has shape-shifted into the SIFI monster and continues to have the hidden powers to destroy the country's economic stability at some unspecified time in the future. The government will be expected to prop up the "too big to fail" financial institution, irrespective of the regulatory safety net.

Mortgage Industry Nemesis

Near its height, mortgage brokers alone accounted for more than 500,000 people, and originated between 68% and 70% of residential mortgage loans. Then came the wave of predatory lending accusations, attacks on the yield spread premium as a compensation source, allegations of mortgage fraud and steering, and so forth. This was accompanied by foreclosures that eclipsed the Great Depression.

By early 2010 more than 1 million homes were seized, defaults soared to more than 10% percent and foreclosures reached record numbers – in the first quarter alone! Along the way, the number of mortgage brokers shrank to 246,900 by the middle of last year, which is a drop of over 50% from its high. But this was not a shaking out of "bad" brokers over "good" brokers. Many believe that the decline had been due, in part, to more restrictive compliance standards.

And that is just a snap shot of what mortgage brokers have been going through, not to mention the regulatory burdens placed on mortgage bankers, banks, investors, and servicers - each with its own brand of significant and often costly challenges, just to survive and also comply with new regulatory compliance laws.

Wall Street operates by different standards, as it likely should - each market often marches to the beat of a different drummer. But the Credit Default Swap - the "shadow banking" favorite – has not gone away at all; in fact, the CDS market is bigger, more entrenched and far more pervasive than ever.

Other than a devastated mortgage industry and a legitimately wary consumer, and a blizzard of new regulations purportedly in response to the economic crisis, what has actually changed to fully prevent systemic failure?

Straddling Two Worlds

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Impact Mortgage Management Advocacy & Advisory (IMMAAG)

In my recent 2-part article, Ability-to-Repay: Regulating or Underwriting?, I discuss how this one area of legislation alone causes a substantial increase in government encroachment on underwriting, with the effect - intended or unintended - of rationing credit. My conclusions, based on a detailed analysis of this law, is:

1) There is gradual nationalizing of underwriting guidelines.

2) The imposition of an ability-to-repay requirement as a regulatory mandate is an assertion that market forces cannot discipline lenders or incentivize lenders to act in their own self-interest.

3) There is a substantial shift in liabilities, because this mandate shifts the burden of compliance to the lenders in order to assure that their contractually bound borrowers can pay back their loans.

4) The law imposes a new kind of theory for a regulatory framework.

5) This law infantilizes lenders by making them comply with a regulator's *ad hoc* way of rationing the extension of credit.

6) Rationing of credit leads to the diminution of arms-length, contractual counterparties.

7) The law changes the dynamics in the inherent, due diligence tension among the parties to a residential mortgage transaction and raises serious issues about the systemic consequences soon to be engendered.

And yet, the Mortgage Bankers Association sent an extensive letter to the Federal Reserve Board (dated 7/22/11 - one day after the CFPB received its statutory authority over the subject legislation - Link Here) which corroborates my aforementioned conclusions. Nevertheless, the MBA letter also manages to support the concept of the Ability-to-Repay provisions:

- MBA has long supported establishment of an ability to repay requirement for mortgage loans. However, since the requirement will apply broadly and bring considerable liability to lenders and assignees for any violations, it is essential that the rule's QM requirements include unambiguous definitions and means of compliance. Clear "bright line" requirements will ensure the provision of sustainable mortgage credit to the widest array of qualified borrowers at affordable costs.

- If these requirements are implemented incorrectly, however, we are deeply concerned that far too many borrowers will be excluded from affordable mortgage credit and/or will be subject to unreasonably increased financing costs, in turn harming the very people Dodd-Frank was intended to protect and undermining the nation's economic recovery.

Personally, I prefer clear and "unambiguous definitions;" however, the MBA's position seems too embracing, even if it recognizes the effect such legislation could have on rationing credit.

Losing The Past

The dramatic changes that the mortgage industry has gone through are partly of its own doing and partly due to the economic downturn caused by many macro- and microeconomic issues. Some legislation that has been made into law, such as Dodd-Frank, is supposedly a means to prevent another economic meltdown.

Without a stronger real estate market, there really cannot be much of a recovery. We are experiencing a recession that is being made worse by the lack of consumer demand. This is not a recession caused simply by the lack of consumer confidence. If the consumer does not have spending money, or feels the need to sit on the sidelines, the recession will become an ever expanding morass, lasting many years. Despite what the government and political leaders authoritatively proclaim, the recession did not really end, except in the most abstruse technical sense. Nothing could be more obvious!

Laws that promise to prevent the spawning of TBTFs, or their progeny, the SIFIs, or whatever you want to call them, but also institute the wide-ranging set of regulations that are now clogging up the mortgage industry, only economically hurt the consumer, due to higher pricing, pressure on origination efficiency, and impediments to innovation. Many mortgage market participants must pass on their costs, due to the burden of higher overhead and lower profit margins.

Sometimes, over-regulating may be just as ineffective as under-regulating - especially when, in many cases, existing regulations just need to be enforced.

I am privileged to run the first mortgage risk management firm in the country. We navigate regulations day in and day out for our valued clients. Regulations are important to the safety and soundness of a financial institution and protect the consumer. But it is better to have a few, new, smart regulations than a plethora of mediocre regulations.

There is no way to really win the future by not looking back, gaining insights, correctly identifying errors, and then carefully, incrementally, intelligently, providing regulatory remedies that help to preserve the mortgage industry.

"Winning the Future" may be a catchy phrase. But an overbearing approach to regulatory risk will not win the future, though it may assuredly lead to losing the past.

What do you think?

I would welcome your comments.

Please feel free to join the forum below.

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Labels: Ability-to-Repay, CFPB, Dodd-Frank Act, MBA, Mortgage Compliance, SIFI, Standard and Poor's, Systemic Risk, Systemically Important Financial Institution, TBTF, Too Big To Fail

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