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Regulatory brief

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Mortgages: What you don't know about "Know Before You Owe"

Overview

The Consumer Financial Protection Bureau (CFPB) issued its final "Know Before You Owe" rules late last year. The rules create new mortgage disclosure forms and procedural requirements to help consumers better understand the key terms of mortgage loans, and to make loan offers more easily comparable. The rules will apply to mortgage applications starting August 1, 2015.

The new rules consolidate the four disclosures that lenders have been providing consumers under the Truth in Lending Act (TILA) and the Real Estate Settlement Practices Act (RESPA) into two new forms.[1] Although the information necessary to populate the new forms will be largely the same, mapping the data to new forms will require significant changes to lenders' Loan Origination Systems (LOS). Banks will also have to change their operational processes around originations.

Lessons learned from similar efforts, including the implementation of last year's mortgage origination and servicing rules,[2] suggest that successful implementation not only calls for changes to operations, but will also require integrating the new rules into the firm's compliance management system (CMS) and adjusting the firm's management of third-party risk. Checking the box on operational implementation alone will not suffice.

The new rules also present an opportunity for strategic change. The most successful and resilient companies treat disruptions such as these as opportunities to make other beneficial process changes – and to reassess their business models and underlying assumptions.

This **Regulatory Brief** provides (a) background of the new mortgage disclosure rules, (b) an analysis of the rules' challenges and opportunities, and (c) our view on what firms should be doing now.

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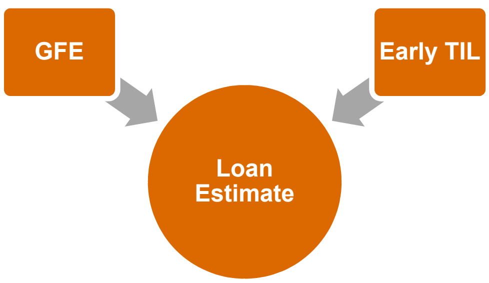
[1] For a detailed analysis of the new disclosure rules see PwC's *CFPB Mortgage Disclosure Rules: An analysis of the Consumer Protection Bureau's "Know Before You Owe" Disclosure Forms* (March 2014).

[2] The last wave of new mortgage rules include the Ability-to-Repay and Qualified Mortgage rules, new mortgage servicing rules, and rules regarding qualifications and compensation for mortgage loan originators, high-cost mortgages, appraisals, and escrow accounts.

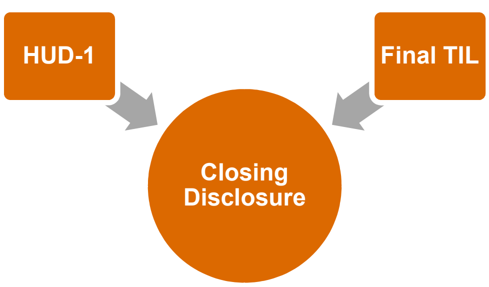
Background: the new rules

The new "Know Before You Owe" rules fulfill a requirement under the Dodd-Frank Act to combine two sets of disclosures that consumers currently receive under TILA and RESPA. These are widely viewed as unnecessarily duplicative and confusing.

A new **Loan Estimate** form will replace the existing Good Faith Estimate (GFE) and the early Truth-in-Lending (TIL) disclosure forms that currently must be provided to the consumer in connection with a mortgage loan application.



The **Closing Disclosure** form will replace the Housing and Urban Development settlement statement (HUD-1) and the final TIL disclosure forms that must be provided to the consumer when a mortgage loan closes.



Challenges and opportunities

Integrating new requirements into the firm's CMS

Firms implementing the new disclosure rules should expect that the CFPB and other regulators will focus their compliance reviews on CMS. In the CFPB's own words:

> "Nearly every examination or targeted review conducted by the CFPB contains an assessment of an entity's CMS, whether it is an assessment of how the entity manages its compliance program enterprise-wide, or how the entity meets its consumer compliance responsibilities within a specific product line."[3]

[3] *CFPB Supervisory Highlights* (Aug. 21, 2013).

In light of this supervisory focus, implementation efforts to integrate the new rules into a firm's CMS are likely to require updates in the following areas:[4]

- Policies and procedures (to reflect the new rules and resulting system and process changes)
- The company's inventory of laws and regulations
- Training programs, identification of monitoring and testing activities, and associated data and MIS requirements
- Procedures for monitoring and testing, and internal compliance audits
- Internal reporting

In some cases, meeting regulatory expectations also will require an action plan to upgrade the CMS itself.[5]

Managing third-party risks

Compliance with the new disclosure rules will involve a variety of third-party service providers. For example, under the new rules, loan estimates may be provided by mortgage brokers; closing disclosures may be provided by settlement agents; and third-party vendors may be relied upon by lenders for their LOS. In these and other instances, although the service is provided by a third party, the lender remains ultimately responsible for the third party's compliance with the rules.

Regulators have increasingly focused their attention on firms' management of the risks associated with such interdependencies. As key examples, in 2012 the CFPB issued guidance on the oversight of service providers,[6] and in 2013 federal banking regulators issued guidance on vendor, supplier, or service provider risks.[7]

[4] According to the CFPB's Supervisory and Examination Manual, a CMS must enable an entity to (a) establish compliance responsibilities, (b) communicate those responsibilities to employees, (c) ensure that responsibilities for meeting legal requirements and internal policies are incorporated into business processes, (d) review operations to ensure responsibilities are carried out and legal requirements are met, and (e) take corrective action and update tools, systems, and materials as necessary. A CMS must contain the following four components: Board and management oversight, a compliance program, consumer complaints response, and compliance audit.

[5] The CFPB has found that nonbanks are more likely than banks to lack a robust CMS, as their consumer compliance-related activities have not been subject to examinations at the federal level for compliance with Federal consumer financial laws prior to the CFPB's existence. See *CFPB Supervisory Highlights* in note 4.

[6] CFPB Bulletin 2012-03, *Service Providers* (April 13, 2012).

[7] See PwC's Regulatory Briefs *More third-party guidance: When should you just do it yourself?* (December 2013), and *Managing third-party risk: It's complicated* (November 2013).

Moreover, many of the CFPB's largest enforcement actions were based on violations that resulted from the actions of third-party service providers.

These examples reinforce the principle that an entity's use of third parties does not diminish the responsibility of its Board and senior management to ensure that an activity is performed safely and legally. The actions also signal the regulators' expectation that entities should practice effective risk management regardless of whether they perform an activity internally or through a third party. Finally, they reflect the regulators' holistic approach to assessing a lender's risk management of third-party relationships – i.e., in addition to including the regulatory-prescribed elements, third-party risk management processes have to actually be effective in managing the risk.

Lenders will need to effectively integrate compliance with the new disclosure rules into their third-party risk management processes.[8] This may require changes to: (a) due diligence processes and standards, (b) contractual agreements, and (c) the way the lender monitors a third party's policies, procedures, performance, and risk management processes.[9]

Making strategic use of the disruption

We find that the most successful companies treat disruptive events as opportunities to improve their operations, business models, and underlying assumptions. Implementation of the new disclosure rules creates an opportunity for firms to reassess the respective roles of the lender and other participants in the mortgage origination process, and the validity of the implicit assumptions underlying those roles. This reassessment may lead to changes in current roles or to other actions triggered by strategic business insights that arise from implementation efforts.

The disruption caused by the implementation of the new rules also provides an opportunity to take a fresh step-by-step look at the processes around originating a mortgage, possibly informed by insights gained through the recent implementation of the new mortgage origination and servicing rules. As a result of that analysis, firms may find that they can cut unnecessary steps from the process, automate manual processes, reallocate roles, or change approaches to outsourcing (by bringing outsourced processes back in-house or vice versa). While the hood is up and the engine is taken apart, you might as well do a few things to make it work better.

What should firms be doing now?

Based on lessons learned from the implementation of the CFPB's mortgage rules, we recommend that firms start quickly and break down implementation into the following steps:

- **Develop a robust governance structure** to (a) monitor implementation plans and track implementation progress against plans, with appropriate escalation protocols for issue management or course corrections, and (b) provide appropriate accountability and oversight.
- **Understand the rules** and official interpretations, and stay abreast of future developments. The new rules that will form the foundation of implementation efforts have been described as complex and cumbersome. Therefore, the CFPB may issue future guidance, clarifications, and corrections.
- **Conduct initial analysis** and identify specific changes required to respond to the new rules and their impact on business operations. A significant number of changes will revolve around the LOS' controls, policies and procedures, and training. The analysis should include impacts on CMS and on third-party relationships in mortgage origination – e.g., with mortgage brokers, settlement agents, real estate agents, appraisers, title companies, insurance agents, and settlement service providers. Interdependencies within the lender's organization (i.e., across systems and across departments) must be analyzed as well.
- **Conduct strategic analysis** of the business implications and opportunities that may arise from the new disclosure rules, challenge current assumptions, and identify possible strategies to optimize the company's business model for future opportunities.
- **Develop an overall approach, an operational roadmap and a project plan** that covers changes both to origination systems and process, and to the company's CMS and third-party risk management. Plans should include critical milestone dates, documentation and functional requirements for system changes, and user-acceptance testing. The roadmap and plan must address internal changes as well as changes dependent on third parties.

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[8] See PwC's *Financial Services Viewpoint*, *Significant Others: How financial institutions can effectively manage the risk of third-party relationships* (September 2013).

[9] Where a third party uses subcontractors to provide services on behalf of a lender, regulators have greater expectations as to (i) transparency of use, (ii) due diligence, (iii) contracting terms, (iv) ongoing oversight, (v) monitoring and reporting, and planning related to contingencies, and (vi) existing relationships, commensurate with the reduced level of control over performance.

- **Determine resources** necessary to implement changes and plan to address any gaps between resources available and needed.
- **Execute the project plan**, including internal reporting, escalation of issues, testing protocols, and periodic re-assessments and adjustment as necessary. Hitting all the milestones is not success by itself, unless it gets you where you need to go.
- **Manage the transition**, including implementing communications channels and monitoring complaints and other feedback (including social media), and developing strategies to quickly address unexpected problems.
- **Manage ongoing compliance** with the new disclosure requirements integrated into the firm's CMS and third-party risk management processes.

Conclusion

Measure twice; cut once. Implementation of the new disclosure rules will be a big job, but it is more likely to get the firm fully where it needs to be by August 1, 2015 if the implementation plan includes the necessary LOS and process changes, changes to the CMS, and management of third-party risks. Companies that will get the most benefit from the disruption – and the time, effort, and resources expended on implementation – are those that take advantage of this opportunity to re-think their underlying business assumptions and how they operate in the marketplace.

Additional information

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