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DFA Changes Suggested in New McCoy Book*

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It is not usual for these articles to resemble book reviews, but a recent book publication prompts a review of the substance of the recommendations offered at the conclusion of the book.

Professor Patricia McCoy is the new head of mortgage matters at the CFPB under the present regime (Assistant Director for Mortgages and Home Equity Markets). As such, it appears as though she will be the most important senior person after Professor Warren on mortgage related issues. She is a prolific author, and with Professor Kathleen Engel, with whom she has co-authored other publications, recently published a book on the recent crisis called The Subprime Virus.

The bulk of the book is devoted to a definitive discussion of What Happened, and is a good recitation of the events of the period and how one played with another to cause a small problem the authors first saw in Cleveland expand to bring down the U.S. economy. While it has tinges of partisan politics in it and some factual statements here and there that can be questioned, those can generally be ignored and do not significantly interfere with the account of events. It would get an honor grade.

None of that, of course, prompts this article.

In the last two dozen or so pages, however, the authors outline ways in which the Dodd-Frank Act did not go far enough in its reform efforts, and left gaps that should be filled, either with aggressive regulatory interpretation or with statutory changes. Because Professor McCoy is now in a position of some authority in the government, her opinions are relevant to what positions CFPB might take on such issues. One assumes that both authors agreed with all of the positions expressed on those pages.

Here are the suggestions they make, most explicit, some implicit, with a

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quick comment or two about each (much more can be said about many of them):

1. Escrows — Residential mortgages must have escrows for the life of the loan.

Comment: It's difficult to see why this would be necessary for prime loans, although I suspect that most borrowers find escrows a convenience, although some might prefer to hold savings in higher yielding instruments.

2. ARMs caps — On ARMs, there should be caps on individual adjustments and caps on total adjustments over the life of the loan.

Comment: Again, for borrowers that have demonstrated the ability to make good choices (call them prime loans and prime borrowers), caps might restrict options they would rationally choose to exercise and which they could demonstrate they could handle.

3. Binding quotes upon receipt of mortgage application — Lenders and brokers must provide binding quotes upon receipt of a mortgage application (they can be withdrawn if information on the application cannot be verified).

Comment: Lenders offered a guaranteed mortgage package a few years ago, but settlement service providers, consumer advocates and others resisted it to the point that the final rule, already at OMB, was withdrawn. It had all of these features, but also other provisions that made it possible to do what is being suggested. Done correctly, this is not a bad idea, but doing it correctly is not easy, intellectually or politically. Perhaps a better approach would be to offer this as an option.

4. Web-based bidding for mortgages — The government should create a web-based bidding process — i.e., consumers have access to a government controlled website that advises borrowers on the best loans for them, followed by the submission of request for bids by the borrowers on the site, a request that can be met by any lender.

Comment: Seems a little ahead of its time, and an approach to mortgage lending that would require massive readjustment of lending platforms throughout the nation. On its face, it seems very inefficient, which always translates into higher costs for consumers.

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5. Vanilla loans — All borrowers must be offered a "vanilla" loan — CFPB could still do this even though DFA neither requires nor forbids it be done.

Comment: First, removing these provisions from the bill did signal that Congress did not want CFPB to do this. Second, a regulation could be drawn that would drive everyone to this product, and that would seem to be a mistake. Third, some borrowers could not qualify for such a loan under nearly any scenario of interest rates — what is to be done with those?

6. Broker and appraiser capital — Establish minimum capital requirements for brokers and appraisers.

Comment: Seems reasonable, and now with the results of the last election in, some of that might be possible. It still would be a heavy political lift, however. And the costs of holding that capital, just as the cost of lenders holding capital, would ultimately be borne by consumers.

7. Government match savings program — The government should match savings toward housing expenses by LMI consumers (kind of a lay away funded, in part, by the government).

Comment: With the pressure on government spending, it is difficult to see past that barrier to imagining more government subsidization of housing.

8. LMI tax credits for savings in certain funds — The government should give tax credits to LMI consumers who utilize specific newly created home ownership funds.

Comment: See comment to number 7.

9. Data publication CFPB — Must ensure that mortgage data be widely and completely published.

Comment: This is in the category of pet peeves, I imagine, since the data the Consumer Credit Center acquired in the HMDA discussions was never shared. The constant risk of access to data is the distortion of statistics to generate law suits and to provoke arguments as opposed to resolving problems and shedding light on an issue. There are also privacy concerns, addressing which may take substantial amounts of data out of the realm of public access.

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10. Ratings updates — Rating agencies should be required to update their ratings periodically.

Comment: Seems reasonable, but agencies would know whether this is possible, prohibitively expensive, etc.

11. Standardization of securitization products — Tax rules should encourage standardization of securitization products.

Comment: Perhaps the goal should not be standardization, but rather the development of as many good products as possible as long as the dictates of the TBA market can be met. Use of tax codes for social purposes instead of revenue raising should be discouraged.

12. Eliminate pay for ratings — Eliminate payment to rating agencies by issuers for ratings.

Comment: The conflict seems apparent, and the burden would be on the rating agencies to show that this is a bad recommendation. Whether it will solve the problem is unclear.

13. Create new rating system for mortgage bonds — Establish a new ratings scale to distinguish mortgage bonds from corporate bonds.

Comment: It is not clear that there is a problem that this recommendation solves, and if not, then primum non nocere seems relevant.

14. Abolish NRSRO designations.

Comment: This seems like a supportable recommendation.

15. Expand assignee liability — Expand assignee liability provisions to assertions of claims as well as defenses in defenses to enforcement actions when actions are brought by assignees.

Comment: The more that assignees are exposed to liability, the less they will want to engage in securitization. To that extent, there is a balance that has to be met between diminution of funds for mortgages and adding another indirect monitor of good underwriting. It's probably unnecessary in the context of other DFA provisions.

16. Create arranger liability — Arrangers — those who are often described

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as sponsors, underwriters, etc. and whose job is to convert loans into securities — must be responsible for unlawful lending by lender.

Comment: See comment to number 15.

17. Limitations on REMIC treatment — No REMIC treatment unless PSAs permit modifications when certain conditions exist.

Comment: It is not clear that government mandates of terms and conditions in these contracts will enhance housing in the country. Nevertheless, the tax code has often been used for purposes different from raising revenue, and servicers can be caught between a rock and a hard place on this — one direction from the government (augmented by bad media stories) and one direction from the investors relating the provisions of the contract.

18. Mark to Market — Mandated mark to market for all assets of financial megafirms.

Comment: This issue has been debated in many contexts over lengthy periods of time, and the arguments for and against this position was not given their dues in the suggestion in the book. It's a much bigger issue than postulated in the book.

19. Executive compensation — Impose stricter executive compensation rules.

Comment: It is fair to say that Congress squeezed as much as it could out of this issue, and there is nothing that has changed since passage that would suggest that trying to make additional restrictions or limitations could be successful.

20. Oversight Council — Reduce size of Oversight Council and streamline process by which it makes decisions.

Comment: The size and complexity of the Council exist because it is not intended that its actions can move quickly or that full debate could be bypassed. In a crisis, it will move quickly enough.

21. Council backup authority — Give Council backup enforcement authority to keep Fed on its toes.

Comment: Seems like a reasonable idea, but it would have to be limited to

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the most egregious situations.

22. No naked swaps — Permit swaps to be used only when one or both parties have an economic interest in the debt referenced.

Comment: This issue also has been recently fully aired with the decision being that which is in the Act.

This is one reading of the suggested changes that the authors recommend. It could be that some of these are not a clear description of the intended changes, and if so, apologies. If not, it is a lengthy and significant list of changes.

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