What Sarbanes-Oxley Teaches Us About the "Know Before You Owe" Mortgage Disclosures Rule

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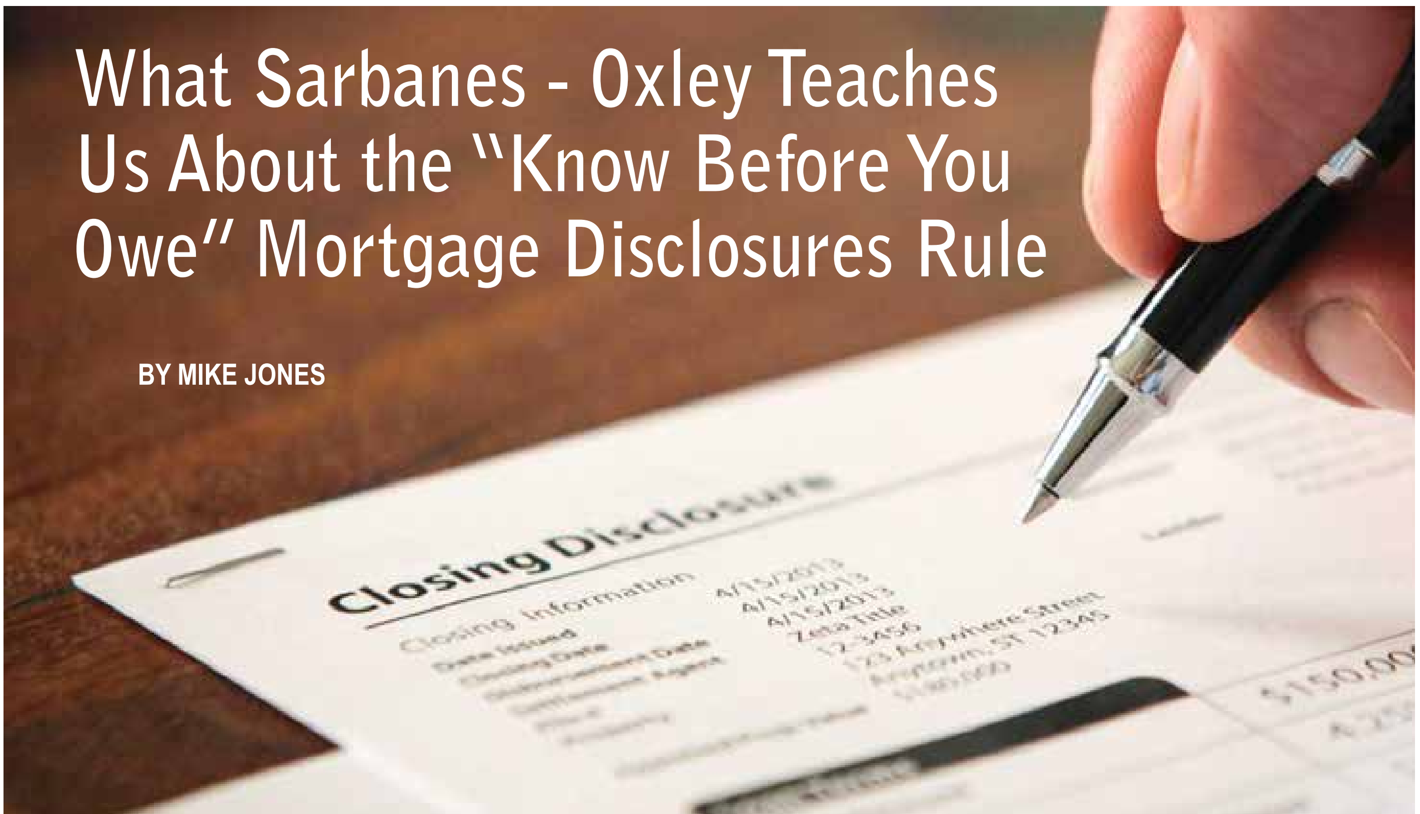
November 2015



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Mortgage lenders have been through a lot. Since the 2008 financial crisis, a complex maze of policy requirements and the threat of financial penalties have caused lenders to fundamentally retool the way they make loans. New regulations can be costly to implement and can introduce new risks that require additional staff and technology to control. Lenders put projects in place to make changes and train people. But when changes take effect and the projects end, the experts often move on to new challenges. But like many things in business and in life, it's not how you solve the problem initially that pays off, it's how you follow through.

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Take the Consumer Financial Protection Bureau's (CFPB) TILA-RESPA Integrated Disclosures Rule (also known as TRID) that has been in effect since October. The rule consolidates mortgage loan cost estimates and disclosures, replacing the Good Faith Estimate, HUD-1 Settlement Statement, and Truth-in-Lending disclosures for many loans.

TRID IS MORE THAN A RULE, IT'S A TRANSFORMATION

The impact of the rule goes way beyond new forms. New timing requirements for delivery of disclosures to consumers, regulatory tolerance levels for cost estimates, and pre-disclosure restrictions caused lenders to transform the loan origination process. The changes were far reaching and involved putting in place new controls and creating new departments to ensure compliance. Some lenders started early in 2014 making changes to business processes and IT systems. One lender reported that the rule led them to change more than eighty percent of the steps to originate a mortgage loan. Many have trained their entire workforces on new requirements that range from sales and underwriting to closing and fee governance to the contact center and help desk.

It's been an enormous and expensive undertaking. It's also one that comes with a risk that lenders get it wrong. Lenders are now starting to close loans that were originated under the TRID rule, and, ▷

despite best intentions and detailed plans, it's not realistic to expect that things always will go smoothly.

SARBANES-OXLEY PROVIDES CONTEXT

So what should lenders do to manage risk and costs now that the TRID rule is in effect?

Consider the lessons learned from another hugely transformational federal mandate. The Sarbanes-Oxley Act of 2002 caused public companies to significantly enhance financial reporting and internal controls in the wake of several high-profile corporate scandals involving companies such as Enron and WorldCom. The law requires senior executives to take individual responsibility for the accuracy and completeness of corporate financial reports. It also increases scrutiny of auditors of public companies by requiring them to obtain substantially more evidence from the companies they audit and holding those companies to higher audit standards. One of the most controversial provisions of Sarbanes-Oxley is Section 404 which requires management annually to assess and report on the effectiveness of internal control over financial reporting. It also requires that an independent auditor attest to the effectiveness of those internal controls. Today, more than thirteen years after it was signed into law, the Securities and Exchange Commission (SEC) continues to actively enforce the Sarbanes-Oxley Act.

PUBLIC COMPANIES TAKE ACTION

Public companies reacted to Sarbanes-Oxley in much the same way the mortgage industry has reacted to TRID. They identified risks. They established, tested, and documented controls. They developed processes to assess and maintain controls year after year. They also made changes to IT systems and trained employees on new processes.

As is the case with TRID, the changes were far reaching. New controls not only included those over processing and reconciling account balances, but also included controls on which other controls depend, such as IT security controls. Important new controls also included those related to the selection and application of accounting policies and controls over the period-end financial reporting process.

Public companies also went about establishing the appropriate control environment, which sets the tone of an organization, influencing the control consciousness of its people. This includes programs such as codes of conduct and fraud prevention that have an important but indirect effect on compliance. Similar to many of today's lenders experiencing TRID, public companies subject to Sarbanes-Oxley struggled to adjust after the implementation.

Public companies staffed up with Sarbanes-Oxley compliance specialists and retained service providers. As required by Section 404, public companies engaged independent auditors to provide attestation. When deficiencies pointed to material weaknesses, or when regulators identified matters requiring attention, companies established programs to plan, prioritize, and monitor remediation activities. As a result, public companies took on additional costs, sometimes totaling millions of dollars per year.

Soon, feedback from the regulated public companies began to focus on higher than expected costs of compliance. Smaller public companies seemed to be the hardest hit. Some public companies considered actions to avoid subjecting themselves to the requirements of Sarbanes-Oxley. A survey taken by the SEC showed that a substantial number of companies considered delisting from U.S. stock exchanges or going private.

THE REGULATORY REGIME SHIFTS

In response to industry concerns that the costs of compliance with Sarbanes-Oxley outweighed its benefits, a series of reforms were enacted. In 2007, the SEC issued interpretive management guidance that provided a top-down, risk-based approach to compliance that aimed to lead companies to more efficient use of resources. The SEC's management guidance allowed public company management to focus on the controls needed to adequately address the risk of a material misstatement of its financial statements. It also allowed management to align its evaluation procedures to those areas posing the highest risks to reliable financial reporting. This meant management could allocate resources to activities such as evidence gathering, documentation, and testing of controls according to its assessment of risk. Notably, the management guidance did not require management to identify every control in a process or document the business process. ▷

At the same time, the SEC approved the Public Company Accounting Oversight Board's (PCAOB) Accounting Standard No. 5 (AS5) which aimed to reduce the amount of time to complete independent audits required by Section 404. It did this by allowing auditors to exercise their judgment, scaling the level of internal control testing to match the size of the company, eliminating unnecessary procedures for audits, and allowing auditors to focus on matters they consider to be most important for internal control, among other reforms.

Over the next several years, the SEC granted extensions to the date of Sarbanes-Oxley compliance for smaller companies considering the disproportionate cost impact they experienced. In 2012, the Jumpstart Our Business Startups Act was signed into law and provided relief to smaller emerging growth companies from obligations imposed by Section 404.

IMPLICATIONS FOR TODAY'S MORTGAGE LENDERS

First and foremost, lenders subject to TRID should take the actions needed to stay in compliance and remediate issues. The cavalry in not coming. Enforcement will begin. Even though Sarbanes-Oxley reforms reduced management's burden, substantial effort was still needed to achieve and maintain compliance.

Some lenders are taking a proactive stance by looking to the new TRID examination procedures to verify compliance before the regulators get involved. This is not a trivial effort. There are over one thousand requirements in the new TRID examination procedures. Verifying compliance in the early days after implementation will help lenders make sure the new forms are consistently displaying the right fees and are delivered at the right time among other complex requirements. It also could help keep them out of trouble with regulators if lenders take actions to set things straight.

Given CFPB's focus on written policies and procedures, wise lenders will not to limit assessments to loan file compliance. Many TRID rule requirements also apply to policies and procedures, which must be designed to ensure and monitor compliance. Recently, CFPB examiners have cited situations where lenders had written policies, but violated Regulation Z by failing to provide written procedures instructing employees on how to comply with the policies. It's fair to say that lenders should avoid similar mistakes in TRID policies and procedures.

Secondly, work with regulators to iron out the tough issues and advocate for changes if needed. A number of TRID requirements are still open to interpretation. With Sarbanes-Oxley, the SEC was sensitive to concerns over the unexpectedly high cost of compliance, leading it to seek approaches and solutions that improved efficiency while obtaining the benefits of better internal controls. Similarly, feedback and communication between the CFPB and the mortgage industry will help inform interpretation and close gaps, and might even influence new and better solutions.

The final take-away from Sarbanes-Oxley is to use the regulation as a springboard for self-improvement. Embrace the challenge of rising compliance costs. The SEC found that after a year compliance costs from Sarbanes-Oxley decreased even without help from the reform package. Arguably, some of the cost improvement resulted from the learning curve and dissipation of fixed start-up costs. And some resulted from active cost control measures. Consider what can be done to better manage origination costs.

The TRID compliance transformation shouldn't end now that the rule is in effect. Lenders should harness the momentum built up during the design and implementation effort and follow through with verification, advocacy, and optimization. That way, compliance investments will both satisfy regulators and benefit the bottom line. That's where the real return on investment is.

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