RMBS Research

Despite Headaches for Originators, TRID Impact to Securitization Appears Limited

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Morningstar Perspective

Potential errors related to a new residential mortgage disclosure rule are not a significant source of credit risk to securitizations. The implementation of the rule six months ago has created industry concern amid instances of mistakes on disclosure forms and lenders' uncertainty interpreting the new requirements. The Consumer Financial Protection Bureau required the new disclosures, which are designed to help borrowers better understand their loan terms and fees. The rule is commonly referred to as TRID, short for TILA-RESPA Integrated Disclosure, as it combines disclosures required under the Truth in Lending Act and the Real Estate Settlement Procedures Act. Morningstar Credit Ratings, LLC's (Morningstar) comfort with the potential credit risk attributed to TRID is partially based on discussions with parties who work closely with TRID such as investors, lenders, attorneys, and due-diligence firms.

Lenders Struggle To Adopt Integrated Disclosures

The implementation of the TRID rule has created challenges for some originators. Difficulties include more paperwork and language in the rule that alternates between being ambiguous and overbearing. The rule, also called Know Before You Owe, imposes detailed requirements for completing disclosures and deadlines for providing disclosures to borrowers. While TRID helps clarify disclosures for borrowers, some of the rule's requirements, such as listing fees in alphabetical order or rounding numbers to certain decimal places, increase the likelihood for technical rule violations that do not hurt borrowers.

The result has been a large number of clerical or formatting errors, which Morningstar believes are nonmaterial, as well as more meaningful errors, which market participants have struggled to cure or understand the effectiveness of a cure.

These difficulties have created uncertainty and concerns among lenders and investors. Recognizing the need to address these concerns, Richard Cordray, director of the CFPB, provided informal guidance in a Dec. 29, 2015, letter to the Mortgage Bankers Association. The letter addresses cure provisions for TRID violations and indicates that provisions in the Truth in Lending Act, which allow for the correction of errors, will continue to apply under TRID. While this is not a legally binding document, Morningstar sees the letter as an indication of what the future stance of the CFPB will be. Others in the industry share the same view. However, the industry is waiting for further guidance on how to deal with violations. Concerns have attracted the attention of U.S. Sen. Bob Corker from Tennessee, who in a March 11, 2016, letter to the CFPB, wrote that the “lack of clarity” surrounding TRID technical errors “has led to confusion throughout the market.” Sen. Corker mentioned investors, originators, aggregators, and rating agencies as parties who have struggled to fully realize the effects of TRID because of a lack of clarity from the CFPB.

Limited Potential for Assignee Liability

Morningstar expects that only obvious errors on the face of documents, such as fee tolerance or disclosure timing violations, will result in assignee liability. In fact, in addressing concerns, Cordray’s letter states that there is “no general TILA assignee liability unless the violation is apparent on the face of the disclosure documents,” which indicates that the standards of TILA still apply. A due-diligence firm should catch these types of material errors, so Morningstar expects such violations to be cured or the loans to be removed from the pool prior to securitization when a due-diligence review is performed on every loan in the pool. Under TRID, many violations can be cured with revised disclosures for up to 60 days after closing. While there has been ambiguity as to which types of violations can be cured postclosing, Morningstar does not view any violations that have been cured with revised disclosures and refund, if applicable, as material credit risks. This view is supported by the CFPB’s letter, which states that TRID allows for “the issuance of a corrected closing disclosure, even after closing,” which can be used as a “component of curing any violations of the monetary tolerance limits.” However, violations that cannot be properly cured after closing, such as failure to provide a loan estimate within three business days of application, may present a risk. Morningstar’s general view is that only violations relating to the timing of disclosure delivery cannot be properly cured. Our view is in line with that of the industry advocacy group Structured Finance Industry Group, which recently drafted a proposal for due-diligence classification of TRID violations. The draft outlines several key areas, including limiting the due-diligence review scope to areas that carry assignee liability, the grading of the exceptions identified during the review, and whether an error on a disclosure would be considered cured if corrected with a subsequent disclosure. The exceptions addressed are in addition to those concerning fee tolerances or non-numeric clerical errors that TRID specifically allows to be cured within 60 days of closing. The draft proposes that a subsequent disclosure can be used to correct most types of errors so that the exception is no longer a material violation. However, the proposal does not identify a remedy for violations relating to the timing of disclosure delivery.

Morningstar would not expect loans with uncured violations to make it into a securitization when due diligence is performed on every loan. Also, while Morningstar considers the grading provided by due-diligence firms, we consider other factors when evaluating the credit risk of TRID violations. Morningstar finds it helpful to learn: the provision violated; the cure method, if applicable; the party who cured the violation; and the number of days to cure from closing.

Lack of Financial Penalties

Another aspect of TRID that limits the credit risk of rule violations to securitization is the minimal financial penalties that investors could face. For violations that make it into a securitized pool, statutory damages for lawsuits brought by individual loan obligors are limited to $4,000 plus attorneys' fees. This value is relatively insignificant, especially when considering both default probabilities and our assumption that not all lawsuits will be successful. There is also limited incentive on class-action lawsuits, as the potential award is limited to $1 million or 1% of the creditor's net worth, whichever is smaller. Moreover, such lawsuits would require common circumstances between borrowers, which may not exist given the diversity of potential violations. There could also be foreclosure defense claims in judicial states, but the expected impact is minimal when factoring in our default probabilities and assumption that not all claims will be successful, especially for errors made in good faith. As discussed, we would expect only errors made in good faith to potentially make it into a securitization when a full due-diligence review is completed. In addition, Cordray, in his letter, wrote that he believes the "risk of private liability to investors is negligible for good-faith formatting errors." Again, we believe that the industrywide fear over the impact of TRID violations to securitization is not supported by the rule or the informal guidance of the CFPB.

Expected Decline in Violations

Morningstar expects the number of nonmaterial violations to drop as originators refine their origination processes and become comfortable with TRID requirements. In speaking with third-party due-diligence firms and lenders, Morningstar found that there already appears to be a noticeable decline in the number of TRID violations since the rule's Oct. 3, 2015, inception. Lenders indicated to Morningstar that the new rule has failed to simplify the mortgage process and has added more paperwork for both lenders and borrowers. The ambiguous regulations under TRID, as well as added paperwork, have created opportunities for errors. The CFPB has recognized the challenges in implementing TRID. Its letter states that examinations by regulators will be "corrective" rather than "punitive" regarding TRID violations for the first few months. Morningstar believes such examinations will contribute to reducing TRID violations, and that lenders will learn from their mistakes and improve their origination processes.

Market Overreaction

Investors and due-diligence firms have reacted cautiously to the TRID rule with regard to securitizations. This reaction was caused by ambiguous language, an initial lack of direction from the CFPB, and a relatively large number of violations to the rule. However, Morningstar believes recent informal clarifications and industrywide collaborations have calmed fears and should make investors more confident going forward. Concerns that errors made in good faith, nonmaterial clerical errors, and formatting errors add significant credit risk to loans seem ungrounded. While the TRID rule may have, at least temporarily, added stress or confusion for borrowers, lenders, and investors, the rule itself has not materially changed the credit risk of mortgages to securitizations. As a result, Morningstar may require modestly higher credit enhancement to transactions where we believe violations with assignee liability are present. However, the due-diligence process should largely eliminate this risk.

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