HMDA Insights : Capitalizing on New Perspectives
HMDA Adoption Costs: Did You Say $2 Billion?

Summary:

- **Two adjustments to ensure consistency and comparability with estimated annual HMDA compliance costs increase the CFPB's estimated one-time HMDA adoption costs from $1.34 Billion to $2.12 Billion, an increase of 58%.**
- **The CFPB's effort to rationalize adoption costs through a "frame of reference" and suggested accounting treatment of adoption costs can only be described as analytical alchemy.**
- **The projected expenditure of approximately $2 Billion to provide the CFPB with 50 additional HMDA data fields indicates an unprecedented cost of $40 Million per data field.**
- **The projected HMDA adoption costs raise a number of critical questions including (i) the reliability of CFPB financial models and related analytics, and (ii) the sufficiency of the estimated benefit of the new HMDA rules to consumers.**

Analysis:

It's difficult, if not impossible, to argue with the CFPB's projected one-time costs to modify processes in response to the new HMDA regulatory requirements. Literally.

On one hand, the estimated one-time adoption costs seem to be comprehensive as they include updating software systems, training staff, updating compliance procedures and manuals, and overall planning and preparation time. On the other hand, there isn't much detail behind the numbers presented in Table 1 taken from the CFPB commentary accompanying the 2015 HMDA amendments.

Table 1 | Estimated HMDA Rule Change Adoption Costs

Institution Complexity	Closed-End Only	Closed-End and Open	Open-End Only
High	$800,000	$1,200,000	No Lenders is this category
Medium	$250,000	$375,000	$250,000
Low	$3,000	$3,000[1]	$3,000

Based on the estimates shown in Table 1, the CFPB projects that the combined overall one-time impact of adopting the new HMDA rules is **between $725.9 Million and $1.34 Billion**.

As we said, we can't argue with these numbers. However, two adjustments seem appropriate to ensure consistency and comparability with the CFPB's estimated annual HMDA compliance costs:

1. *Matching Estimated Cost with Lender Counts.* The CFPB's analysis of recurring HMDA compliance costs under the new rules detailed the number of institutions by reporting profile. We applied the estimated costs in Table 1 to the lender counts in the interest of accuracy, consistency, and comparability. In the interest of conservatism[2], we used the lowest estimated cost for medium complexity institutions rather than attempt to derive a "weighted cost" to account for the mix between closed-end lenders and lenders that provide both closed-end and open-ended products.

[1] "The Bureau believes that the additional one-time costs of open-end reporting will be relatively low for low complexity financial institutions" and "these institutions are less reliant on information technology systems for HMDA reporting and that they may process open-end lines of credit on the same system and in the same business unit as closed-end mortgage loans" thus "the Bureau estimates that the additional one-time cost created by open-end reporting is minimal and is derived mostly from new training and procedures adopted for the overall changes in the final rule."

[2] As suggested by the use of words such as "consistency" and "comparability", the primary author of this document is a CPA. Therefore, the use of the word "conservatism" is in an accounting context and not a political context.

2. *Labor Cost Adjustment.* As noted in our evaluation of the annual HMDA compliance costs under the new rules[3], the CFPB uses an hourly labor rate of $33 in their estimate of recurring annual compliance costs. We believe an hourly labor rate of $50 is much more realistic as it reflects the cost of employee benefits, information technology, and corporate overhead. The $17 difference in the hourly labor rate represents a variance of approximately 50%.

   Adjusting labor costs requires an estimate of the portion of the CFPB's projected adoption costs that are attributable to labor. Based on our experience in compliance systems and compliance components on core processing platforms, the aggregate cost to update software for the new HMDA rules should not exceed $50 Million[4], or approximately 4%, of total projected costs in any known solar system, galaxy, or universe. In the interest of conservatism, our labor cost adjustment assumes that labor costs comprise 75% of the total estimated HMDA adoption costs[5] which translates into $335 Million generously allocated to updating software systems.

The results of our adjustments, presented in Table 2, indicate an estimated range of **$1.184 Billion to $2.12 Billion** for adoption costs.

Table 2 | Adjusted Estimated HMDA Rule Change Adoption Costs

	Number of Respondents	%	Adoption Cost Estimate: Respondent	Adoption Cost Estimate: Aggregate
Lower Bound Estimate				
Tier One | Quarterly	29	*0.46%*	$ 1,650,000	$ 47,850,000
Tier One | Annual	259	*4.14%*	$ 1,650,000	$ 427,350,000
Tier Two	2,015	*32.24%*	$ 343,750	$ 692,656,250
Tier Three	3,947	*63.15%*	$ 4,125	$ 16,281,375
Total	6,250	*100.00%*		$ 1,184,137,625
Upper Bound Estimate				
Tier One | Quarterly	29	*0.46%*	$ 1,650,000	$ 47,850,000
Tier One | Annual	187	*2.99%*	$ 1,650,000	$ 308,550,000
Tier Two	5,111	*81.78%*	$ 343,750	$ 1,756,906,250
Tier Three	923	*14.77%*	$ 4,125	$ 3,807,375
Total	6,250	*100.00%*		$ 2,117,113,625

We believe these adjustments are reasonable but it's important to take our analysis for what it's worth – an attempt to improve an estimate that is not particularly transparent. Regardless, the magnitude of the cost estimate – whether $1.34 Billion or $2.12 Billion – leaves us speechless and demonstrates that the CFPB is adept at using "other people's money"[6] to acquire the data they want to achieve their mandate. In any event, lenders are covering the cost of providing the CFPB with the data that will make lenders' lives more challenging. We're frankly surprised at the lack of substantive "hue and cry".

We'll offer further – and final thoughts – on these numbers after addressing the CFPB's efforts to temper the estimated adoption costs. Specifically:

[3] See "What Cost HMDA Data Quality? Try $425 Million" at www.mortgagetrueview.com.

[4] The primary author was involved in the implementation of significant changes to mutual fund compliance reporting protocols for more than 8,000 mutual funds involving the adoption of XBRL and multi-jurisdictional reporting. The aggregate industry-wide cost of updating compliance systems (including feeds from core platforms) was less than $50 million.

[5] Thus, the CFPB HMDA adoption cost estimates where multiplied by 1.375% (50% hourly rate differential x 75% of gross adoption costs estimated to be labor-related.

[6] Without expressing a political view on the merits of building a wall to protect our borders, perhaps the suggestion that another sovereign nation will pay for a wall to isn't so crazy.

A. **Frame of Reference.** The CFPB offers a creative "frame of reference" for its adoption cost estimate. Specifically, the CFPB indicates that the $1.34 Billion in estimated adoption costs is 0.3% of approximately $420 Billion in total non-interest expenses reported by HMDA Respondents in 2012. This analytical alchemy suggests that the projected costs are immaterial and, therefore, reasonable. This frame of reference is faulty for several reasons including:

- Four lenders account for 56%[7] of the $420 Billion. Adjusting estimated adoption costs and non-interest expenses for these four lenders increases the rate for the remaining lenders from 0.3% to 0.8% of non-interest expenses. Reasonably assuming that the top 29 lenders account for $79 Billion (18.8%) of the $430 Billion and adjusting the associated estimated adoption costs increases the rate for the remaining 6,221 lenders to 1.24%.

- Measuring the adoption costs as a percent of non-interest expense rather than net income before taxes yields a less relevant "frame of reference". Further, using 2012 results (while annual compliance costs are based on 2013 data) yields a lower "frame of reference" estimate due to the strength of 2012 application activity compared to 2013.

B. **CFPB Regulatory Accounting Principles.** Financial reporting rules and regulations, embodied in Generally Accepted Accounting Principles ("GAAP"), are promulgated by the Financial Accounting Standards Board and the Securities and Exchange Commission, respectively. Despite this fact, the CFPB seeks to temper estimated HMDA adoption costs by suggesting that "financial institutions are expected to amortize these costs over a period of year" and then indicate that the annual upper bound cost of $1.34 Billion becomes $326 Million per year by applying a 7% discount rate and a five-year amortization period. Three issues with this approach immediately come to mind:

- First, the application of a discount rate and a five-year amortization period is valid only to the extent that a lender borrows funds to cover adoption costs. Such an approach adds $114.3 Million in interest costs over the five-year period to the $1.340 Billion adoption costs, raising the total cost to $1,634 Billion.[8]

- Second, the capitalization and amortization of expenditures is generally accomplished when qualifying costs are incurred, capitalized, and then amortized over the benefit period. This more likely approach in the event of adoption cost capitalization means the annual amortized cost would be $268 Million and not $326 Million.

- Third, and most importantly, adoption costs are likely a period expense and not eligible for capitalization for reasons that include (i) the avoidance of impairment is different than creating future value, and (ii) difficulty in measuring the duration of any potential future benefit.

The CFPB's accounting treatment suggests a basis of accounting – CFPB Regulatory Accounting Principles ("CRAP") – that supersedes GAAP. For the record, we recommend that mortgage lenders consult with their auditors in determining how to account for HMDA adoption costs.

The CFPB's efforts to temper the adoption costs associated with the new HMDA rules is understandable if erroneous. On more than one occasion in the commentary accompanying the amendments to

[7] Specifically, JPMorgan ($65 Billion), Wells Fargo ($49 Billion), Bank of America ($71 Billion), and Citibank ($51 Billion).

[8] The use of a 7% discount rate indicates another flaw in the analysis and calls into question the CFPB's analytical acuity. The Fed Funds rate available to financial institutions engaged in mortgage lending is currently 50 basis points. Using a discount rate of 50 basis points would produce a significantly lower annual amortized cost estimate.

Regulation C, the CFPB commented about the lack of feedback on the cost of the proposed HMDA rules[9]. This comment suggests that comments from mortgage lenders were prepared without the assistance of the Chief Financial Officer or other accounting professional.

Our view is that mortgage compliance professionals should pass along a copy of the final HMDA rules to their CFO or other accounting professional for an *ex post facto* assessment of the financial consequences of the new rule and, more importantly, the development of a plan to generate a Return on Investment on the HMDA adoption and annual compliance costs.

Perhaps the best way to evaluate the reasonableness of HMDA adoption costs is to evaluate them in the context of the what's being "purchased". Appendix A, which summarizes the HMDA reporting model under the amended rules, indicates that the that the substance of the amendments and the estimated $2.11 Billion adoption costs, is to provide the CFPB with 50 additional data fields – at an average cost of approximately $40 Million dollars per data field. The staggering costs - absolute and per field – leads to one of two conclusions:

- The CFPB's estimates are wrong. While likely the case, this conclusion calls into question the CFPB's ability to measure – and justify – the costs and benefits of their actions in any instance[10].

- The CFPB prepared the HMDA cost/benefit analyses to support the decisions reached based on other factors.

Either conclusion presents incredible challenges – and risks – to lenders.

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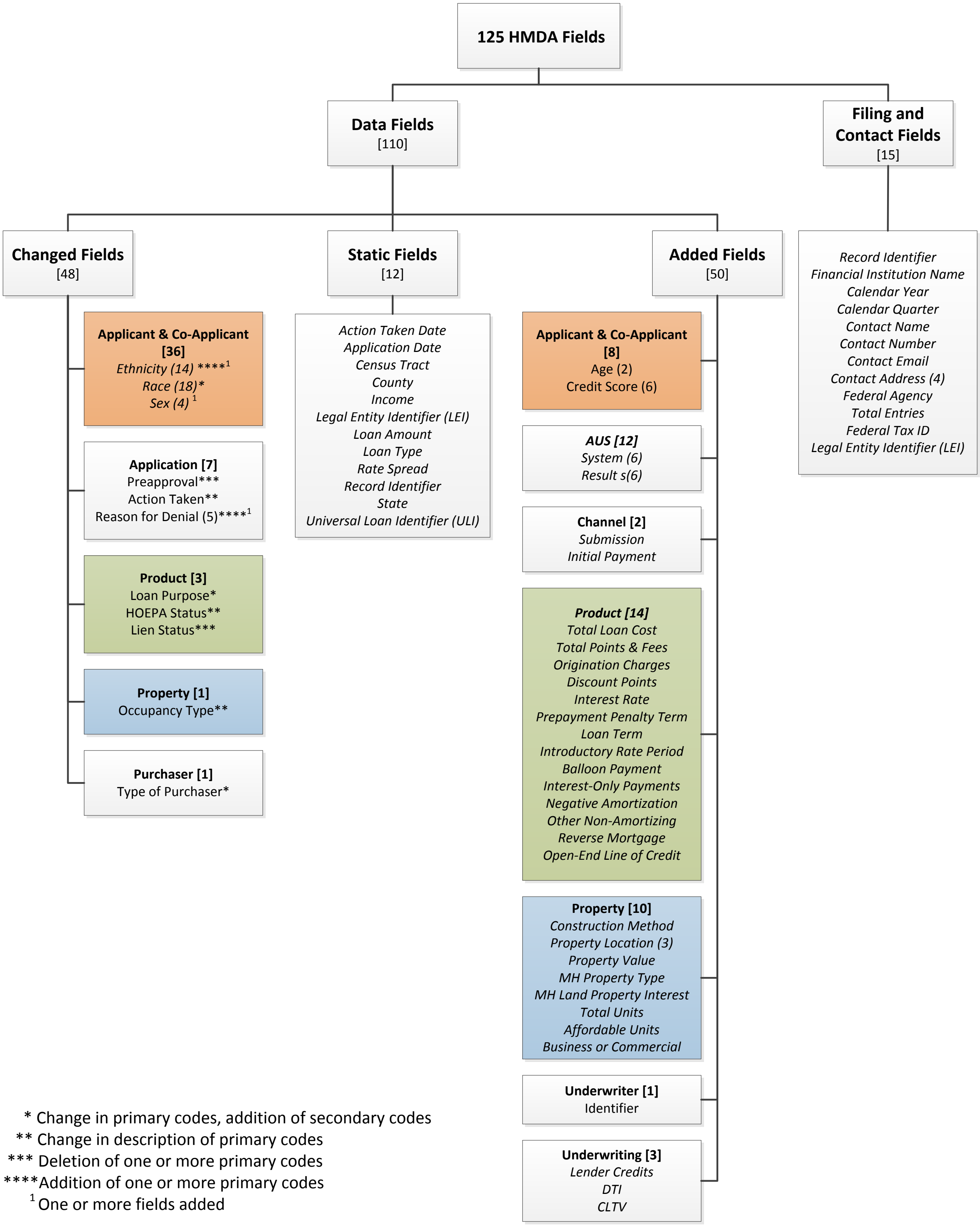
Our next HMDA Insight will (finally) provide specific examples of how the current HMDA data model can drive a lender's growth.

"It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts." *– The Adventures of Sherlock Holmes, A Scandal in Bohemia*

[9] See, for example, Home Mortgage Disclosure (Regulation C); Final Rule, 12 CFR Part 1003, page 6624 which states that "no commenter provided specific estimates on the potential one-time costs of reporting open-ended lines of credit…"

[10] It also calls into question the CFPB's analytical acuity.

Appendix A | HMDA Reporting Fields Pursuant to October 2015 Amendments



* Change in primary codes, addition of secondary codes
** Change in description of primary codes
*** Deletion of one or more primary codes
****Addition of one or more primary codes
[1] One or more fields added