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The residential mortgage regulatory landscape

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The past year has witnessed unprecedented turmoil in the sub-prime credit markets, fuelled by relaxed underwriting practices, more frequent instances of fraud, low (or 'teaser') initial interest rates, a sharp decline in residential home prices and a corresponding evaporation of borrowers' equity in their homes.

In recent years, lenders marketed loan products that featured minimised initial monthly payments, but with the prospect of significantly higher payments later when the loan was fully indexed, such as so-called 2/28 or 3/27 adjustable rate mortgages (ARMs), interest-only loans and payment-option ARMs. In the lending environment that prevailed until 2007, originators presumed that borrowers would be able to refinance their loans before the payment adjusted to a higher level. Consequently, lenders frequently qualified borrowers based only upon their ability to pay the low initial payment. However, as residential housing prices have either flattened or declined in many regions of the country, sub-prime mortgage borrowers suddenly lost the ability to refinance and avoid sharply higher interest rate resets. As a result, with borrowers unable to make the higher monthly payments, chronic delinquencies and foreclosures have spiked across the United States.

Increased delinquency rates along with rigid accounting rules have made the value of sub-prime assets difficult to quantify. Investment banks have written off billions of dollars of losses in connection with residential mortgage-backed securities. Without a ready supply of capital from Wall Street, many originators have seen their business models implode almost overnight.

This chapter summarises the salient legislative and regulatory efforts that are being undertaken to address these serious challenges. The most significant of these developments and proposals include:

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- the Economic Stimulus Act of 2008;
- the Office of Federal Housing Enterprise Oversight (OFHEO) Directive of February 28 2008;
- the Interagency Guidance on Non-traditional Mortgage Product Risks and the Statement on Sub-prime Mortgage Lending promulgated by the federal banking agencies and adopted by the majority of state regulators, Fannie Mae and Freddie Mac;
- the Emergency Home Ownership and Mortgage Equity Protection Act (HR 3609) and the Foreclosure Prevention Act of 2008 (SB 2636), which are currently in the House of Representatives and Senate (together, the Bankruptcy Cram-Down Bills);
- the proposed amendments to the federal anti-predatory lending law, the Home Ownership and Equity Protection Act;
- the Mortgage Reform and Anti-predatory Lending Act of 2007 (HR 3915) and the Home Ownership Preservation and Protection Act of 2007 (SB 2452);
- the American Securitisation Forum (ASF) Streamlined Foreclosure and Loss Avoidance Framework;
- the Project Lifeline Programme;
- proposed amendments to Regulation X, which implements the Real Estate Settlement Procedures Act;
- the Fannie Mae and Freddie Mac Cooperation Agreement with the New York Attorney General's Office and OFHEO Directive regarding appraisal practices;
- the proposed Emergency Loan Modification Act of 2008;
- the Federal Housing Administration (FHA) Secure Expansion Proposal; and
- various developments at state level.

To varying degrees, these efforts represent attempts to regulate the mortgage industry comprehensively and set new standards for mortgage lending, brokering, servicing, appraisal and disclosure. If foreclosures of borrowers' principal residences continue at the current record pace, there is a greater likelihood that elements of the foregoing legislative and regulatory measures will be adopted.

Highlights

The 2008 economic stimulus package

The Stimulus Act temporarily increases the limitations on the maximum original principal balance of residential mortgages in which Fannie Mae and Freddie Mac may invest. These new conforming loan limits are effective for all mortgages originated from July 1 2007 to December 31 2008. An apparently unintended consequence of the act is the expansion of the scope of the anti-predatory lending laws to define their coverage by reference to the Fannie Mae and Freddie Mac conforming loan limit.

For both Fannie Mae and Freddie Mac, the Stimulus Act provides that the new conforming loan limit will be the higher of:

- the otherwise applicable 2008 Fannie Mae/Freddie Mac conforming loan limit ($417,000 for a single-family dwelling, $533,850 for a two-unit dwelling, $645,300 for three units and $801,950 for four units); or
- 125 per cent of the area median price for a residence of the applicable size, but not exceeding 175 per cent of the otherwise applicable 2008 Fannie Mae/Freddie Mac conforming loan limit ($729,750 for a single-family dwelling, $934,237.50 for two units, $1,129,275 for three units and $1,403,412.50 for four units).

The Stimulus Act does not define the term 'area' or 'median price'. Instead, the act directs the secretary of housing and urban development (HUD) to define these terms no later than 30 days after the date of the enactment of the Stimulus Act. On the evening of March 6 2008 the HUD announced the new conforming loan limits, which are designated by county for each state (the new conforming loan limits are available online at https://entp.hud.gov/idapp/html/hicostlook.cfm) However, if a particular county is located within one of the designated metropolitan statistical areas (MSAs) in the United States, the limit for that county is set equal to the highest county within that MSA.

The OFHEO directive

On February 28 2008 OFHEO removed the mortgage portfolio growth cap limitations on Fannie Mae and Freddie Mac. These asset caps were imposed in 2006 because of accounting errors at the respective government-sponsored enterprises. The removal of the caps allows the government-sponsored enterprises to buy more mortgages. In conjunction with this development, OFHEO also relaxed capital reserve requirements imposed after the accounting scandals. Under those requirements, OFHEO had required capital holdbacks 30 per cent higher than previously required. In a March 19 2008 press release OFHEO announced that it would immediately reduce capital requirement to a 20 per cent level and would begin to permit a significant portion of the capital surplus to be invested in mortgages and mortgage-backed securities.

The Interagency Guidance on Non-traditional Mortgage Product Risks and the Statement on Sub-prime Mortgage Lending

The federal banking agencies and the majority of state regulators have adopted and currently encourage all entities to abide with the non-traditional guidance and the sub-prime statement. Fannie Mae and Freddie Mac, at OFHEO's direction, have also adopted the non-traditional guidance and the sub-prime statement into their underwriting guidelines. Accordingly, lenders are increasingly originating loans in accordance with these two key documents.

The sub-prime statement expresses the regulators' concern that underwriting practices do not take into account that many sub-prime borrowers are not prepared for 'payment shock' (defined as a significant increase in the amount of the monthly payment that occurs when the interest rate adjusts to a fully indexed basis), and that current sub-prime lending practices compound risk for financial institutions. The sub-prime statement curtails the origination of sub-prime loans underwritten on a stated income or reduced documentation basis that include certain risk-layering features, unless there are mitigating factors.

The sub-prime statement is augmented by the earlier non-traditional guidance, which was promulgated in response to concerns about the growing use of certain alternative or exotic mortgage products, including interest-only mortgages (a non-traditional mortgage on which, for a specified number of years, the borrower is required to pay only the interest due on the loan) and payment option adjustable-rate mortgages (a non-traditional mortgage that allows the borrower to choose from a number of different payment options), which allow borrowers to defer payment of the principal and sometimes the interest, and to exchange lower payments during an initial period for higher payments during a later amortisation period. The regulators expressed concern that some borrowers may not fully understand the risks of these products, especially given the lack of principal amortisation and negative amortisation in such products, and because these products may be combined with other features, such as simultaneous second-lien mortgages (a lending arrangement where either a closed-end second-lien or a home equity line of credit is originated simultaneously with the first-lien mortgage loan) and the use of reduced documentation (a loan feature under which an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets), that compound risk for financial institutions. In order to address these concerns, the regulators released guidance regarding appropriate loan terms and underwriting standards, portfolio and risk management practices and consumer protection issues.

The Bankruptcy Cram-Down Bills

The Bankruptcy Cram-Down Bills are separate legislative efforts that target bankruptcy reform related to mortgage loans. HR 3609 was originally introduced by Representatives R Bradley Miller and Linda Sanchez, and later amended and passed by the House Judiciary Committee on December 12 2007 by a margin of 17 to 15. HR 3609 has caused controversy for its provisions allowing bankruptcy judges singlehandedly to modify the terms of mortgages.

SB 2636 was sponsored by Senate Majority Leader Harry Reid and went to the floor of the Senate in the last week of February 2008. Similar to HR 2609, SB 2636 is the focus of major debate for its provisions that allow bankruptcy judges to modify the terms of mortgages. On February 26 2008 the president threatened to veto the bill should it pass both houses of Congress.

There has been intense industry lobbying pressure to alter the provisions of the Bankruptcy Cram-Down Bills which relate to bankruptcy judges' modification power, particularly as many in the industry feel that this would increase mortgages rates severely. The issue is that the ability of bankruptcy judges to change mortgage contracts between a lender and a borrower unilaterally would alter the pricing calculation for lenders and rates would have to increase (some say as high as credit card annual percentage rate levels) to cover the increased lending risk.

Home Ownership and Equity Protection Act amendments

On December 18 2007 the Federal Reserve Board released for public comment proposed amendments to Regulation Z, which implements the Federal Truth in Lending Act, as amended by the Home Ownership and Equity Protection Act. The board issued the proposed amendments pursuant to its rulemaking authority under the Home Ownership and Equity Protection Act, which authorises the board to prohibit acts and practices in connection with mortgage lending that the board finds to be unfair or deceptive, as well as under its general rulemaking authority under the Federal Truth in Lending Act.

Among other things, the board creates protection for a new category of loans called higher-priced mortgage loans. Lenders would be required to verify borrowers' ability to repay the loan obligation, and their income and assets, before making a higher-priced mortgage loan. The proposed amendments are intended to:

- prevent unfairness, deception and abuse by prohibiting certain acts or practices for these higher-priced mortgage loans, and other acts or practices for closed-end credit transactions secured by a consumer's principal dwelling;
- improve mortgage advertising by revising the disclosures that are required in advertisements for credit secured by a consumer's principal dwellings and by prohibiting certain practices in connection with closed-end mortgage advertising; and
- require disclosures for closed-end mortgages to be provided earlier in the transaction.

The Mortgage Reform and Anti-predatory Lending Act of 2007 and the Home Ownership Preservation and Protection Act of 2007

The Anti-predatory Lending Bill (HR 3915) was introduced on October 22 2007. The bill is the most comprehensive effort of this Congress to combat predatory lending and contains many provisions that have been sought for years by consumer activists, including repayment ability and borrower benefit standards, and restrictions on pre-payment penalties and yield spread premiums. The bill also imposes new responsibilities on secondary market participants that have not been included in any previous legislation. Further, the Senate has also passed its own version of this bill, which has also changed several times from its original drafting.

HR 3915 proposes to amend the Federal Truth in Lending Act in three fundamental ways. First, HR 3915 addresses concerns over the mortgage origination process by:

- establishing a federal duty of care for mortgage originators;
- prohibiting originators from steering borrowers to products that are not in the borrower's interest; and
- requiring licensing and registration of mortgage originators pursuant to a qualifying state law or equivalent federal banking regime.

Second, and perhaps most significantly, HR 3915 establishes a minimum federal standard for all

mortgages. This minimum standard includes standards regarding the determination of a borrower's repayment ability and, in the case of refinances, the determination of a net tangible benefit. This section of the legislation also sets forth safe harbours from these standards for mortgage loans that meet certain stringent requirements. Finally, HR 3915 amends the Home Ownership and Equity Protection Act by significantly amending the definition of a 'high-cost mortgage' under that act and by expanding consumer protection for such loans. The great majority of these provisions are not self-executing and must be implemented by the promulgation of regulations by various federal agencies.

As introduced, the legislation contains no federal pre-emption standards and consequently would permit individual states to enact their own laws, which could provide even greater protection for consumers.

ASF framework

On December 6 2007, in an effort to provide relief to beleaguered borrowers and to stem a potential surge in residential mortgage foreclosures, the ASF crafted a streamlined loan modification framework for securitised sub-prime ARMs. Loan modification is an important loss mitigation tool that can prevent a loan from going into foreclosure. However, sub-prime securitisation operative documents generally authorise servicers only to modify loans for which default is reasonably foreseeable, provided that the modification is in the best interests of security holders in the aggregate and would not jeopardise the tax-favoured status of the securitisation trust. The key innovation of the ASF framework is that it seeks to define a group of loans, all falling within specified criteria based on readily available data, for which it can be reasonably determined that a standardised fast-track loan modification is appropriate. The ASF framework allows servicers to use streamlined procedures to fulfil their servicing obligations, while at the same time enabling servicers to offer loan modifications as an alternative to foreclosure. Federal regulators have publicly endorsed the framework as "a sensible response to a serious challenge".

Project Lifeline

The federal government and six large mortgage servicers recently announced the launch of Project Lifeline. These servicers will begin the programme by providing letters to seriously delinquent homeowners nationwide describing a simple step-by-step approach that, if followed, may enable homeowners to pause their foreclosure for 30 days while a potential loan modification is evaluated. Servicers will reach out to homeowners on a nationwide basis using this step-by-step approach with the goal of finding a solution which meets their individual needs. In contrast to the ASF framework, Project Lifeline represents an individualised response to the foreclosure crisis.

Real Estate Settlement Procedures Act amendments

The HUD has released proposed amendments to Regulation X in order to simplify and improve the disclosure requirements for mortgage settlement costs. The proposal contains the most sweeping changes to Regulation X in 20 years. The HUD states that it intends to protect consumers from unnecessarily high settlement costs by taking steps to:

- improve and standardise the good-faith estimate form to make it easier to use for shopping among settlement service providers;
- ensure that the good-faith estimate provides a clear summary of the loan terms and total settlement charges so that borrowers will be able to use it to shop among loan originators for a mortgage loan;
- provide more accurate estimates of costs of settlement services shown on the good-faith estimate;
- improve disclosure of yield spread premiums to help borrowers understand how they can affect settlement charges;
- facilitate comparison of the good-faith estimate and the HUD–1/HUD–1A settlement statements;
- ensure that at settlement borrowers are made aware of final loan terms and settlement costs

by reading and providing a copy of a closing script to borrowers;
- clarify the settlement statement instructions;
- clarify the HUD's current regulations concerning discounts; and
- expressly state when the act permits certain pricing interested members of the public.

Fannie Mae and Freddie Mac cooperation agreement
On March 3 2008 Fannie Mae and Freddie Mac entered into a cooperation agreement with the New York Attorney General's Office and OFHEO regarding an overhaul of appraisal practices for loans that the government-sponsored enterprises purchase. Fannie Mae and Freddie Mac will require sellers to warrant that all loans originated on or after January 1 2009 adhere to the new appraisal practices. Under the new standards, lenders may not rely on appraisals provided by brokers. Further, a lender may not use an in-house appraiser to conduct the initial subject property appraisal, nor may the lender use an affiliate, subsidiary or other entity owned by the lender to perform the appraisal. Lenders may use only in-house appraisers to develop or use internal automated valuation models, or prepare appraisals for transactions other than mortgage originations (ie, loan work-outs). These changes are a dramatic departure from current practice and their effect in the market will be widespread. Legal challenges to the validity of the cooperation agreement are anticipated.

The Emergency Loan Modification Act
The Emergency Loan Modification Act is a proposal being considered by the House of Representatives which aims to provide legal certainty for mortgage loan servicers by amending the Federal Truth in Lending Act. The Emergency Loan Modification Act is a streamlined version of a bill on loan modifications first proposed by Representative Mike Castle in Autumn 2007. The current version would give mortgage loan servicers a safe harbour from liability if they enter into a qualified work-out plan or loan modification that meets all the following criteria:

- It remains in place for at least five years from the date of its adoption;
- It does not provide for a repayment schedule that results in negative amortisation; and
- It does not require the borrower to pay additional points and fees.

The FHA Secure Expansion Proposal
FHA Secure was originally announced on August 31 2007 and was designed to allow borrowers facing a reset of their ARMs to refinance into FHA-insured loans. However, FHA Secure has refinanced only around 1,000 borrowers. The problem with FHA Secure is that it limits the loan-to-value ratio up to 97 per cent on loans and offers refinancing only for those in which the borrowers had a good payment history prior to the rate reset. The ASF has proposed an expansion of FHA Secure to facilitate refinancing more easily.

Developments at state level
At state level, there have been legislative efforts to strengthen lending laws across a number of jurisdictions. The overhaul of state licensing and lending compliance laws is expected to continue throughout 2008. Further, and more troubling, there has been a push from some state regulators to impede the foreclosure process. Specifically, jurisdictions including Massachusetts, Minnesota, New York and Ohio have been making it more difficult for entities to foreclose in their jurisdictions. The case of *Commonwealth of Massachusetts v Fremont Investment & Loan and Fremont General* Corporation is a prime example. On February 25 2008 the Suffolk Superior Court granted Massachusetts' motion for a preliminary injunction against Fremont General Corporation and Fremont Investment and Loan. The injunction enjoins Fremont from foreclosing on loans that are "presumptively unfair" as defined in the court's order. In reaching its decision, the court took the extraordinary step of finding that "the penumbra" of the concept of unfairness enumerated in the state unfair and deceptive acts and practices statute extends

to loans that contain certain characteristics described in the Massachusetts Predatory Home Loan Practices Act (Mass Gen Laws Ch 183C, § 1 *et seq*), even if those loans are not subject to the act. While the court's order is applicable only to Fremont, the effect is far ranging for the secondary market and it appears that the market for loans which contain these "presumptively unfair" characteristics will be sharply diminished unless the injunction is overturned.

Unfortunately, similar attempts to halt foreclosures may continue in other pro-consumer states in the near term, at least until nationwide and local foreclosure rates decrease back to there more historically normal levels.

This chapter is published to alert readers to developments in the law and not to provide substantive legal advice. Readers are urged to consult competent counsel before acting on information contained herein.