Residential Secondary Mortgage Market September 2016

« back

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Solomon Maman, *Noonan & Lieberman, Ltd.,* Chicago
312-431-1455 | E-mail Solomon Maman

The Residential Secondary Mortgage Market — Overview and Post-Crisis Developments

The financial crisis of 2007 – 2009 was a catalyst for significant change in the residential secondary mortgage market (secondary market). In the wake of the financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub.L. No. 111-203, §929Z, 124 Stat. 1376, 1871 (2010), a substantial piece of legislation that continues to reshape the financial services industry. The Dodd-Frank Act set in motion the creation of regulations that changed the types of mortgage products purchased and sold in the secondary market today and as a result directly affected the range of products funded by private investors. The financial crisis also unmasked differences in expectations concerning contractual obligations between loan sellers and investors and exposed investors to new risks to their security interests. This FLASHPOINTS provides the uninitiated financial services practitioner with a general overview of the post-crisis secondary market and discusses several developments that challenge investors in the market today.

Secondary Market Overview

The secondary market refers to the post-origination market where funded loans secured by mortgages on one-four family residential properties, including condominiums and cooperative units, are purchased and sold either as whole loans or as securities backed by pools of mortgages that collateralize residential mortgage-backed securities (RMBS). The secondary market is an essential element of the mortgage industry. The secondary market allows lenders to transfer *credit risk* and *market risk* to investors, and it provides important liquidity to lenders that allows them to continue to serve more borrowers. Credit risk is the risk that a borrower will default and the losses that result from such default. Market risk includes interest rate risk and prepayment risk. Interest rate risk is the risk that the loan rate held by the investor will fall lower than the market rate. The investor holding a long-term obligation risks making less than it could if it loaned the money at current market rates. Prepayment risk is the risk that borrowers will pay off the loan before maturity when market rates are low (which is usually when prepayment occurs), requiring the investor to reinvest the money at a lower rate. The secondary market provides liquidity by allowing lenders, through the sale of whole loans or securitization of loans, to replenish the money loaned to borrowers and reuse the proceeds to lend to new borrowers.

Central to secondary market liquidity is the securitization of RMBS, which are generally divided into three categories: (1) RMBS issued and guaranteed by Fannie Mae and Freddie Mac (the Enterprises), (2) RMBS guaranteed by Ginnie Mae, and (3) private-label RMBS (PL-RMBS). Enterprises RMBS are generally backed by mortgages that meet the Enterprises' conforming loan size limits and their respective loan products, credit, and collateral criteria. Ginnie Mae RMBS are backed by federally insured or guaranteed mortgages, such as Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA), and U.S. Department of Agriculture (USDA) loans. PL-RMBS are generally backed by mortgages that exceed the conforming loan limits (*i.e.,* jumbo loans) or loans that do not meet the Enterprises' purchase criteria and are not federally insured or guaranteed.

In the early 2000s and leading up to the crisis, the mortgage market experienced an increased flux in the origination of Alternative-A (Alt-A) and subprime loans that combined high credit risk with higher interest rates, minimal underwriting, adjusting loan terms, and prepayment penalties. The PL-RMBS market played a significant role in the growth of these kinds of loan products, which, although it may have been well intentioned, resulted in significant losses to borrowers and investors when these loans began defaulting during the financial crisis. The loan features found in loans held in pre-crisis PL-RMBS, such as negative amortization, interest only, short-term adjustable rates and balloons, and prepayment penalties, had all but disappeared following the financial crisis. The residential mortgage market became more conservative, relying almost exclusively on the Enterprises' and federally insured or guaranteed loan products. The PL-RMBS segment of the market has mostly collapsed. Whether it can rebound depends, in part, on investors' comfort level with the new legal risk involved in investing in certain mortgage products in light of the new ability to repay (ATR) requirement.

ATR-QM Impact on the PL-RMBS

The Dodd-Frank Act established a new ATR requirement and qualified mortgage (QM) standards for residential mortgages as an amendment to the Truth in Lending Act (TILA). See 15 U.S.C. §1639c. Unless exempt, a lender is now prohibited from making a residential mortgage unless it meets the ATR requirement, *i.e.,* a reasonable and good-faith determination by the lender at or before making the mortgage that the borrower will have a reasonable ability to repay the mortgage in accordance with its terms. Regulation Z, which implements TILA, establishes QM standards that, when met, create a presumption of compliance with the ATR requirement. See 12 C.F.R. §1026.43. The presumption is nonrebuttable if the loan meets the QM standard and is not higher-priced (Safe Harbor QM). See 12 C.F.R. §1026.43(e)(1)(i). Conversely, the presumption is rebuttable if the loan meets the QM standard but is a higher-priced loan (Rebuttable QM). See 12 C.F.R. §1026.43(e)(1)(ii). A Safe Harbor QM loan provides the lender a safe harbor that the ATR requirement has been met. On the other hand, a Rebuttable QM loan remains open to challenge as to whether it met the ATR requirement. Mortgages covered by the ATR requirement but that do not meet a QM standard (non-QM) and Rebuttable QM loans may be challenged for not meeting the ATR requirements within three years of origination or at any time if the challenge is brought as a defense in recoupment or setoff to a foreclosure. 15 U.S.C. §1640(k). This means that Rebuttable QM, and particularly non-QM, loans are more susceptible to losses resulting from damages and litigation costs. As violation of the ATR requirement may be asserted against assignees (*id.),* Rebuttable QM and non-QM loans carry increased credit risk to investors.

Investors in Enterprises RMBS and in Ginnie Mae RMBS are less exposed to ATR-related credit risk than investors in PL-RMBS for two reasons. First, Enterprises RMBS and Ginnie Mae RMBS are backed by mortgages that meet the QM standard. 12 C.F.R. §1026.43(e)(4) (loans that are eligible for purchase by the Enterprises and government guaranteed or insured loans are QM). (Federal agencies, such as the U.S. Department of Housing and Urban Development (24 C.F.R. §201.7), VA (38 C.F.R. §36.4300), and USDA (7 C.F.R. §3555.109) have promulgated their own QM rules.) Second, to the extent these mortgages are Rebuttable QM loans, investors are secured by guarantees provided for the RMBS by the Enterprises and Ginnie Mae respectively. The Ginnie Mae guarantee is particularly strong because it is backed by the full faith and credit of the U.S. government. The Enterprises guaranty is perceived as similarly strong due to an implicit federal guarantee of the Enterprises, which became a reality when the Enterprises were placed in conservatorship as a result of the crisis. In contrast, investors in PL-RMBS are not covered by any federal insurance or guarantee and the mortgages backing PL-RMBS are generally a small number of jumbo QM loans and an even smaller number of non-QM loans, which range in credit quality of Alt-A to subprime. These mortgage products, as explained above, carry increased credit risk. With this added credit risk, investors remain averse to the PL-RMBS market, which results in lower liquidity for such mortgage products.

Nevertheless, recent reform and initiatives may help revitalize the PL-RMBS market. A reform that became effective February 23, 2015, is the adoption of the credit risk retention rules, with their new "skin in the game" requirement for RMBS. 79 Fed.Reg. 77,602 (Dec. 24, 2014). Under the credit risk retention rules, which implement the risk retention requirement of the Dodd-Frank Act (see 15 U.S.C. §78*o*-11), the sponsor of an RMBS backed by non-QM loans is required to retain at least five percent of the credit risk in the mortgages backing the RMBS. *See, e.g.*, 12 C.F.R. §§373.3 – 373.10. The rationale behind the requirement is simple — if the sponsor retains risk exposure in the mortgages backing the RMBS, then it is incentivized to ensure that the mortgages have a low risk of default. Whether it will be effective in boosting investors' confidence in PL-RMBS remains to be seen.

Another initiative is the U.S. Department of the Treasury's request of comments from stakeholders in the private-label securitization market that was announced in February 2014 (PLS Initiative). See Press Release, *U.S. Treasury Department Seeks Public Comment On The Development Of A Responsible Private Label Securities Market* (May 26, 2014), www.treasury.gov/press-center/press-releases/pages/jl2446.aspx. The Treasury's PLS Initiative facilitated discussions among participants to improve structural weaknesses in the PL-RMBS market. See Press Release, *Remarks by Deputy Assistant Secretary Monique Rollins on Reforming the Private Label Securitization Market at the Asset Backed Securities (ABS) Vegas Conference* (Feb. 29, 2016), www.treasury.gov/press-center/press-releases/pages/jl0371.aspx. Among the participants was the Structured Finance Industry Group (SFIG), which in November 2015 introduced the third edition of its "green paper" titled *RMBS 3.0 — A Comprehensive Set of Proposed Industry Standards to Promote Growth in the Private Label Securities Market* (3d ed. Nov. 10, 2015), www.sfindustry.org/images/uploads/pdfs/RMBS_3.0_Third_Edition_Green_Papers.pdf (case sensitive). The SFIG green paper proposes standards covering (1) representations, warranties, and repurchase governance and enforcement mechanisms; (2) due diligence and disclosure data; and (3) roles and responsibilities of parties to the RMBS transaction and communications with investors. The initiative's intent was to address the legal and operational risks in PL-RMBS structures that were revealed by the crisis. SFIG, however, stressed that the proposed standards are not "one size fits all" and may not be appropriate for all transactions. Still, these initiatives may be important steps toward improving the PL-RMBS market and spurring its growth. Further, the standards proposed by SFIG may resonate beyond the PL-RMBS segment and could prompt revisions to the Enterprises' and government agencies' loan purchase agreements, as representations, warranties, and repurchases impacted the broader secondary market as a result of the financial crisis.

Impact of Statute of Limitation on Representations and Warranties

Mounting losses as a result of the financial crisis drove investors to review, or demand the trustees of RMBS trusts to review, thousands of mortgage files backing their RMBS for breaches of representations and warranties made by sponsoring entities concerning the credit quality of the mortgages. Where such breaches were found, trustees filed claims to recover hundreds of millions of dollars in investor losses from sponsoring entities.

The liability of sponsoring entities to the trust and its investors for breach of representations and warranties arises out of the mortgage loan purchase agreement (MLPA), the rights under which are generally transferred to the trust by the depositor pursuant to the pooling and servicing agreement (PSA). Many MLPAs are governed by New York law, which has a six-year statute of limitations on breach-of-contract claims. Before the financial crisis, it was generally expected in the secondary markets that a breach of loan quality representations and warranties begins to accrue, at the earliest, upon the discovery of the breach. This perception was not challenged until sponsors of RMBS, inundated with repurchase demands or putback claims, began to push back.

ACE Securities Corp. v. DB Structured Products, Inc., 25 N.Y.3d 581, 36 N.E.3d 623, 15 N.Y.S.3d 716 (2015), is a case in which the sponsor was successful. In *ACE*, the trustee sought to recover almost $330 million in losses to investors on a breach-of-representations-and-warranties claim against the sponsor of the RMBS. The breach was not discovered until the trustee conducted a re-underwriting of thousands of loans in the portfolio. The New York's highest court affirmed that the claim was barred by New York's statute of limitations. Contrary to secondary market expectation, the court held that a claim for breach of representations and warranties begins to run from the date they were made, *i.e.,* when the MLPA was executed, and not when the trustee discovered the breach. The court also rejected the trustee's argument that the cure or repurchase obligation under the PSA was a substantive condition precedent that delayed the accrual of the claims, finding it was merely a procedural prerequisite to suit and not a separate undertaking. In the wake of the decision, secondary market participants try to prolong the accrual of the statute of limitation by, for example, crafting statute of limitations tolling provisions into loan sale agreements. The effectiveness of these provisions may have taken a hit recently when a New York appellate court invalidated an accrual tolling provision in an MLPA as against public policy. *Deutsche Bank National Trust Co. v. Flagstar Capital Markets Corp.*, 36 N.Y.S.3d 135 (App.Div. 2016). The statute of limitations issue is only one of several contractual points of contention between investors and sponsors related to the MLPA and PSA that are currently being argued in the courts. *See, e.g., Nomura Home Equity Loan, Inc., Series 2006-FM2 v. Nomura Credit & Capital, Inc.,* 133 A.D.3d 96, 19 N.Y.S.3d 1, 3 (2015) (sole remedy provision case); *Morgan Stanley Mortgage Loan Trust 2006-13ARX v Morgan Stanley Mortgage Capital Holdings LLC*, 2016 N.Y. Slip Op. 05781 (App.Div. 2016) (breach of contract and negligence for breach of contractual duty to notify trustee of defective loans sold to trust).

Super-Priority HOA Liens

Secondary market investors are affected not only by new judicial interpretations of contractual provisions but also by new judicial interpretations of statutory provisions that affect investors' security interests. In a line of cases that began with the District of Columbia Court of Appeals' decision in *Chase Plaza Condominium Ass'n, v. JPMorgan Chase Bank,* *N.A.*, 98 A.3d 166 (D.C. 2014), and the Nevada Supreme Court's decision in *SFR Investments Pool 1, LLC v. U.S. Bank, N.A.,* 334 P.3d 408 (2014), *reh'g denied* (Oct. 16, 2014), the courts held the respective state homeowners' association (HOA) lien statutes, which are based on the Uniform Common Interest Ownership Act, created a "superpriority lien" with respect to unpaid HOA assessments. The statutes allowed the HOAs to foreclose such liens in a nonjudicial foreclosure and by doing so extinguish a first mortgage lien without notice to the first mortgage lien holder. Because DC's and Nevada's HOA lien statutes are based on a uniform law, versions of which were adopted in more than 20 states, the possibility that first mortgage liens in an HOA foreclosure can be extinguished has generated great anxiety among investors and government agencies that has led to legal action and lobbying efforts. See, *e.g.,* Federal Housing Finance Agency (FHFA), *Statement of the Federal Housing Finance Agency on Certain Super-Priority Liens* (Dec. 22, 2014), www.fhfa.gov/media/publicaffairs/pages/statement-of-the-federal-housing-finance-agency-on-certain-super-priority-liens.aspx; FHFA, *Statement on HOA Super-Priority Lien Foreclosures* (Apr. 21 2015), www.fhfa.gov/Media/PublicAffairs/Pages/Statement-on-HOA-Super-Priority-Lien-Foreclosures.aspx (case sensitive); American Bankers Association et al., *Statement of Principles — HOA Super Priority Liens,* www.sfindustry.org/images/uploads/pdfs/Joint_Trades_HOA_Super_Lien_Letter.pdf (case sensitive). The Nevada statute has been revised to provide a fix. See Nev.Rev.Stat. §116.31166.

However, the Ninth Circuit in *Bourne Valley Court Trust v. Wells Fargo Bank, NA,* No. 15-15233, 2016 WL 4254983 (9th Cir. Aug. 12, 2016), recently held that Nevada's HOA statute was unconstitutional because its opt-in notice scheme violated the Fourteenth Amendment's Due Process Clause. The court found that requiring the HOA to provide notice to the mortgagee only if the mortgagee affirmatively requests it unconstitutionally degrades the mortgagee's interest in the property. The decision in *Bourne Valley* could have a significant impact on HOA superpriority lien litigation, especially in states where the HOA statute has a similar notice provision.

Conclusion

Investors in the post-crisis secondary market are faced with multiple legal, regulatory, and structural challenges affecting their investments. The discussion in this FLASHPOINTS is but a sample of the issues that currently impact secondary market participants. To reduce reliance on Enterprises- and government-related mortgage products and to encourage private investment in the secondary market, additional reform is required to limit the risk to private investors and to create consumer demand for private credit products. Calls for reform of the Enterprises were made, and heard, right after the crisis, but they have stalled. Whether real substantive reform will come, only time will tell.

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