



## Finance/Financial Services & Products ADVISORY ■

**FEBRUARY 8, 2015**

### Non-Agency Residential Mortgage Loans in 2014: A Survey of Legal Issues Affecting the Market

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The year 2014 was a landmark for the non-agency residential mortgage market, as a large amount of regulatory uncertainty was lifted. Final rules were implemented for qualified mortgages, and the Securities and Exchange Commission (SEC) came out with releases on Regulation AB II and risk retention. Real estate owned (REO)-to-rental continued to be an active part of the market. The eminent domain issue disappeared as a major concern. There was a substantial uptick in merger and acquisition activity for loan originators.

Much work remains undone. The Structured Finance Industry Group (SFIG) continues its work on its initiative RMBS 3.0. The Department of the Treasury is working on its own benchmark for residential mortgage-backed security (RMBS) transactions. While Regulation AB II does not yet apply to privately placed securitizations, the sword of Damocles is still hanging over the RMBS market and may drop at any time.

The future is unclear, but 2015 market trends indicate that non-qualified mortgage (“non-QM”) will be the buzzword of the year (and even “non-prime non-QM”), as “REO-to-rental” has been the buzzword in years past. How originators, investors, servicers and securitizers originate, sell, service and securitize this product on a meaningful scale will be the biggest issue facing the market. Will the product include stated income? How will credit standards be stretched under the new format?

Because QM = QRM (more or less), we feel that risk retention will lead the non-QM market towards non-bank entities that can retain the risk. For this product, we expect that mortgage REITs will end up investing in risk retention, as they are currently doing in the QM market. However, we may see more flexibility in structure and variety in the market, with different types of investors buying different types of non-QM product.

The other expected buzzword, at least towards the middle of the year, will be the “due diligence rule,” which initially was barely noticed as part of the nationally recognized statistical rating organizations (NRSRO) release, but which becomes effective June 15, 2015. There remains a large amount of uncertainty, which will need to be resolved.

In 2015, we expect that QMs and the jumbo prime market will continue to stumble along, with complex and lengthy securitization documents and very little delinquency to show for it. We hope that a new market standard can be created by SFIG or otherwise, perhaps one that is a little more streamlined, user-friendly and consistent across the market. If not, covered bonds, with their simpler conceptual structure, may be the wave of the future if legislation is ever passed.

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## Qualified Mortgages

On January 10, 2014 the Final Qualified Mortgage Rule (the "QM Rule") took effect, requiring creditors to make a determination that each consumer will have a reasonable ability to repay (ATR) their mortgage loan according to its terms. The release of the QM Rule was a watershed moment in the history of mortgage origination, as it sought to remove many origination practices and loan products that were viewed as no longer desirable in light of our experience in the financial crisis.

To comply with the QM Rule, each lender must verify consumer assets, employment and income and calculate that a borrower can repay the loan based on a fully indexed, fully amortizing payment and with a debt-to-income (DTI) of 43 percent or lower, with certain exceptions. Creditors must consider and verify eight ATR factors at a minimum:

1. Current or reasonably expected income or assets, other than value of dwelling;
2. Current employment status, if creditor relies on employment income;
3. Monthly payment on the covered transaction;
4. Monthly payment on any simultaneous loan the creditor knows or should have known about;
5. Monthly payment for mortgage-related obligations;
6. Current debt obligations, alimony and child support;
7. Monthly debt-to-income ratio or residual income; and
8. Credit history.

There is significant liability for failing to meet the ATR, including actual damages (such as a lost down payment on a property), statutory damages of up to \$4,000, all fees and up to three years of finance charges (on an average loan of \$200,000 at 4.5%, approximately \$25,000), court costs and reasonable attorney's fees. Most significantly, an ATR violation may be made against any creditor, assignee or holder of a residential mortgage loan, and a consumer can assert an ATR violation as a defense to a foreclosure (by recoupment or set-off) without regard to the three-year statute of limitations. So, there is assignee liability and extended opportunity to challenge a foreclosure for the life of the loan.

QM loans must provide for regular periodic payments (balloons are only permitted in limited circumstances by smaller rural lenders). No toxic features such as negative amortization, interest-only or a loan term exceeding 30 years. Total points and fees cannot exceed 3 percent of the total loan amount for loans of \$100,000 or more, with greater limits for smaller loans. Maximum DTI is 43 percent, subject to a temporary exemption for certain agency loans.

The QM Rule has significantly changed mortgage origination practices, as lenders are reluctant to originate outside of the rule. There has been significant discussion about whether or not lenders should originate non-QM loans. While many investors have expressed an interest in non-QM product, it remains to be seen whether or not a fulsome market will be created over the coming years.

## QRM and Risk Retention

The adoption of the Credit Risk Retention Rule issued by six federal regulators on October 21, 2014, as mandated by Section 941 of the Dodd–Frank Act, creates a number of difficulties for the emergence of a viable, broad-based, non-qualified mortgage market. The final rule is effective February 23, 2015. Asset-backed securities (ABS) collateralized by residential mortgages are required to comply beginning on December 24, 2015, and compliance with the rule with regard to all other classes of ABS is required beginning December 24, 2016. Under the risk retention rules, a sponsor of a securitization (or originator) of RMBS that are not backed solely by qualified residential mortgages must retain a collective retained interest in the securitization of not less than 5 percent. Subject to certain exceptions, the rules prohibit the sponsor from helping or transferring this retained interest. For RMBS, we expect that the retained interest will be in the form of a vertical or horizontal slice of the securities issued; the other options do not seem appealing under current market conditions.

For securities backed entirely by residential mortgages, the prohibitions on transfer or sale (without the requisite risk retention) would expire beginning five years after the date of closing, if and when the unpaid principal balance (UPB) of the mortgages has been reduced to 25 percent of the UPB at closing, but in no event later than seven years after the transaction closes.

Under Dodd–Frank, a QRM could be no broader than a QM, and in earlier proposals, the QRM contained a number of additional criteria not found in QMs, such as a 20 percent down payment and front- and back-end DTI requirements. Fortunately, with certain exceptions, in the final risk retention rule, the six regulators aligned the QRM with the QM. Nevertheless, under these rules, in order for a securitization pool to qualify for the QRM exemption from risk retention, the residential loans in the pool must exclusively consist of QRMs and not be currently more than 30 days past due.

Although the risk retention rules permit the sponsor and the originator to allocate the 5 percent retained risk between each other, few parties except for real estate investment trusts (REITs), certain hedge funds with long lives and depository institutions will be able to hold such retained risk. Therefore, parties will have an enormous incentive to originate loans that meet the criteria of a QRM. Furthermore, while these rules apply only to securitizations and not to transactions involving the sale of whole loans, many originators will not want to stray from the parameters of the QRM criteria because they will want to ensure that their loan product is ultimately eligible for securitization.

Despite these significant complications, we are still likely to see an emergence of a niche market of non-QMs/non-QRMs arising from the acute credit needs of the residential mortgage markets with hedge funds, certain banks and REITs leading the way. Unless the implementation of the risk retention rules is delayed, however, the universe of creditors making non-QMs/non-QRMs is likely to be limited in a way that restricts the flow of credit.

The primary problem with the market currently, which will not be changed by risk retention, is selling the AAAs, which on a percentage basis of the aggregate pool of mortgage loans, including non-QM and non-QRM mortgage loans, are expected to be in the 90 percent range. A bigger challenge for the RMBS market isn't finding buyers for the subordinate classes, but creating a world where institutional investors are comfortable buying the highly rated product. We envision a very bifurcated world of investors going forward with the risk retention rules, not between QRM and non-QRM RMBS, but between AAA investors and the subordinate investors. If so, we're not exactly sure what risk retention and QRM has established or what favors it has done for the market.

## Regulation AB II and the NRSRO/Due Diligence Rule

One of the most surprising events of 2014 was the release of Regulation AB II after years of waiting and considerable doubt about when it would ever be released. The second surprise, however, was just how little effect the passage of Regulation AB II had on the existing RMBS market, as the SEC has determined, at this point, not to apply the disclosure rules to private placements. In fact, other than one almost side comment related to Schedule AL and the Consumer Financial Protection Bureau (CFPB) resulting in some concern and a project, led by the Securities Industry and Financial Markets Association, to address certain privacy issues, there have been no market changes. Regulation AB II was limited to public transactions, and since no public transactions are currently being done (generally being viewed as too onerous, even prior to the considerable additional requirements of Regulation AB II), the end result for RMBS (and notably not for other asset classes) is nothing has changed. In the future, if Regulation AB II applies to private transactions, then there are many disclosure rules that will need to be complied with, many of which are unclear or burdensome. However, the additional requirements, which apply solely to public transactions, are considerable, and it seems highly unlikely that even if the public disclosure rules are applied to the private market that anyone will want to issue public RMBS.

Notwithstanding Regulation AB II, two efforts are worth mentioning in the RMBS securitization market to create standardization. One is the entirely worthy efforts of SFIG in a number of areas to create model standards (through its initiative called RMBS 3.0), and another is a recent initiative by the Department of the Treasury to create a benchmark for RMBS securitization. At this point, it is unclear what impact these efforts will have on the current RMBS market, which is very inconsistent in its procedures and approach, particularly with respect to the independent review of breaches of representations and warranties.

At the same time Regulation AB II was released, the even lengthier NRSRO release was promulgated by the SEC. This contained certain provisions on the disclosure of due diligence results through public filings and on Rule 17g-5 websites for access to the rating agencies. This rule becomes effective June 15, 2015, and is currently of great concern to the RMBS market as well as other asset classes. We direct you to our [previous advisory dated September 18, 2014](#), but none of the issues raised have reached any resolution in the market.

Regardless, the performance of newly issued jumbo prime RMBS has been pristine, with almost no delinquencies for issuances since 2009. Most of the issues that have arisen on recent issuances relate to prepayment speeds rather than credit.

## Developments in Mortgage Servicing: The ECOA Valuation Rule

Effective January 18, 2014, the Consumer Financial Protection Bureau (CFPB)'s Equal Credit Opportunity Act (ECOA) Valuations Rule, amending Regulation B and implementing the ECOA, requires a creditor to provide an applicant a copy of all appraisals and other written valuations developed in connection with an application for credit that is secured by a first lien on a dwelling. While the Valuations Rule clearly applies in the origination context, it also may apply to loss mitigation activities. In fact, the CFPB has stated in its Small Business Compliance Guide that the Valuations Rule applies to "[l]oss-mitigation transactions, such as loan modifications, short sales, and deed-in-lieu transactions, if they are credit transactions covered by Regulation B."<sup>1</sup> Whether the Valuations Rule applies to a given transaction turns on whether there has been an "application" for an "extension of credit" under existing Regulation B.

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<sup>1</sup> See Consumer Financial Protection Bureau, "Equal Credit Opportunity Act (ECOA) Valuation Rules Small Entity Compliance Guide," (Jan. 13, 2014) available at: [http://files.consumerfinance.gov/f/201401\\_cfpb\\_compliance-guide\\_ecoa.pdf](http://files.consumerfinance.gov/f/201401_cfpb_compliance-guide_ecoa.pdf) (page 10).

- **Application** – Regulation B defines “application” as “an oral or written request for an extension of credit that is made in accordance with procedures used by a creditor for the type of credit requested.” 12 C.F.R. 1002.2(f). “Applicant” means “any person who requests or who has received an extension of credit from a creditor, and includes any person who is or may become contractually liable regarding an extension of credit.” 12 C.F.R. 1002.2(e).
- **Credit** – Regulation B defines “credit” as “the right granted by a creditor to an applicant to defer payment of a debt, incur debt and defer its payment, or purchase property or services and defer payment therefor.” 12 C.F.R. 1002.2(j). An “extension of credit” includes “the granting of credit in any form (including, but not limited to, credit granted in addition to any existing credit or credit limit; credit granted pursuant to an open-end credit plan; the refinancing or other renewal of credit, including the issuance of a new credit card in place of any expiring credit card or in substitution for an existing credit card; the consolidation of two or more obligations; or the continuance of existing credit without any special effort to collect at or after maturity).” 12 C.F.R. 1002.2(q).
- **Loan modifications as “extensions of credit”** – In explaining how it arrived at the final version of the Valuations Rule, the CFPB refers to Federal Reserve Board (FRB) guidance depicting how a loan modification application can be considered an “application” for an “extension of credit” under Regulation B.<sup>2</sup> Considering a Home Affordable Modification Program (HAMP) modification, the FRB guidance indicates that during a “HAMP trial period plan or modification, the servicer extends the right to defer payment of a debt by capitalizing accrued interest and certain escrow advances, reducing the interest rate, extending the loan term, and/or providing for principal forbearance.”<sup>3</sup> The FRB found these actions to be “the granting of credit in any form.”<sup>4</sup>
- **Short sales and deeds in lieu may be “extensions of credit”** – A short sale occurs when a homeowner sells the home for less than the balance remaining on the mortgage. In a deed-in-lieu transfer, a homeowner transfers ownership of a mortgaged property directly to the mortgage owner in exchange for release of a mortgage and subsequent payments. Depending on the content of the agreement between the lender and borrower, a borrower may enjoy reduced or suspended monthly payments and other advantages during the short sale period, or in the context of a deed in lieu, until the transfer is completed. A borrower’s communication about entering into loss mitigation could be the making of an “application” under Regulation B. Moreover, while short sales and deeds in lieu are generally considered the settlement of a debt, the settlement may constitute an extension of credit. For example, during the marketing period of a short sale, the borrower and lender may agree to suspend regular monthly payments; such temporary forbearance may be understood as a “deferral of payment” under Regulation B. Similarly, borrowers and lenders may agree not to suspend payments but to reduce them, which also may be a “deferral of payment” under Regulation B. Moreover, a short sale or deed-in-lieu transfer agreement that extends the servicer’s right to pursue the borrower personally for the outstanding amount after the sale or transfer might be considered the “deferral” or “postponement” of the debt.
- **Requirements of the Valuations Rule** – If a valuation is obtained in connection with a first-lien loan, a “creditor”:
  - Must notify an applicant of his or her right to receive a copy of all written appraisals of the property within three days of receiving an application;

<sup>2</sup> See Bureau of Consumer Financial Protection, Disclosure and Delivery Requirements for Copies of Appraisals and Other Valuations Under the Equal Credit Opportunity Act (Regulation B) Final Rule, 78 Fed. Reg. 7216, 7223 FN 31 (Jan. 31, 2013).

<sup>3</sup> See Bd. of Governors of the Fed. Reserve System, CA Letter 09-13 “Mortgage Loan Modifications and Regulation B’s Adverse Action Requirements,” (Dec. 4, 2009), available at: <http://www.federalreserve.gov/boarddocs/caletters/2009/0913/caltr0913.htm>.

<sup>4</sup> *Id.*

- Must provide an applicant a copy of each appraisal and other written valuation developed in connection with an application for credit promptly upon completion or three business days prior to loan consummation (for closed-end loans) or account opening (for open-end loans), whichever is earlier;
  - May permit an applicant to waive the timing requirement for providing a copy of the appraisal or valuation materials unless otherwise prohibited by law (but still must provide the copy no later than at consummation or account opening); and
  - Must not charge a borrower for a copy of any appraisal or written valuation, but may charge an applicant a reasonable fee to recover the cost of the appraisal or valuation.
- **Valuation is more than an appraisal** – The CFPB considers “any estimate of the value of a dwelling developed in connection with an application for credit” to be a “valuation.” This includes not only appraisals but also automated valuation models (AVMs) and broker price opinions (BPOs). The CFPB recognizes that “many documents prepared in the course of a mortgage transaction may contain information regarding the value of a dwelling, but are not themselves an appraisal or other written valuation,”<sup>5</sup> and to that end, the Valuations Rule provides examples of what the CFPB considers to be “valuations” and “documents that discuss the valuation of the applicant’s property” but which are not considered valuations.

It may not be the case that all loss mitigation activity is subject to the Valuations Rule. For example, a private short sale agreement that specified no change in the mortgage payments might not entail an application for “credit.” In fact, CFPB guidance states that whether a loss mitigation measure triggers the Valuations Rule’s requirements is a case-by-case determination, not an automatic assumption. Nonetheless, given the risk of CFPB enforcement and the potential for civil penalties and assignee liability under the ECOA, understanding the application of the Valuations Rule in the loss mitigation context is significant.

## Mortgage Servicing Transfers: A Significant Concern to the CFPB

*The following is an excerpt from an Alston & Bird advisory originally published on October 7, 2014. The full advisory is available at <http://www.alston.com/advisories/CFPB-mortgage-servicing/>.*

On August 19, 2014, the Consumer Financial Protection Bureau (CFPB or Bureau) issued a new compliance bulletin and policy guidance, Bulletin 2014-01, (the “bulletin”), putting mortgage servicers on notice of the CFPB’s heightened scrutiny of mortgage service transfers. The bulletin supersedes the CFPB’s prior guidance found in CFPB Bulletin 2013-01, released in February 2013, and warns that additional guidance may be forthcoming. That may be because of high volume of servicing transfers continuing to occur from banks to nonbank servicers in light of BASEL III limitations. The new bulletin outlines areas of particular interest to the CFPB in servicing transactions, which the CFPB defines to cover transfers of servicing rights and transfers of servicing responsibilities through subservicing or whole loan servicing arrangements.

More specifically, the bulletin:

- Provides the CFPB’s recommended pre- and post-servicing transfer policies and procedures to facilitate the transfer of information during servicing transfers;
- Identifies the applicability of other servicing rules to transfers as well as protections of other laws that should be addressed in policies and procedures;

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<sup>5</sup> 78 Fed. Reg. 7216, 7237 (Jan. 31, 2013).

- Highlights policies and practices that will draw scrutiny from the Bureau;
- Lists topics that the CFPB will generally request information in, if the Bureau decides to review a transfer; and
- Does not require advance CFPB approval of a transfer unless other restrictions apply (such as a consent order).

In light of the bulletin, servicers need to be aware of the following:

- The CFPB will carefully scrutinize pre- and post-servicing transfer policies and procedures to determine whether servicers, in particular servicers engaging in high-value transfers, are complying with the new servicing rules;
- With high value servicing transfers, servicers should consider implementing a written mitigation plan to minimize compliance risks; and
- Servicers should ensure that they have in place a strong Compliance Management System to identify and mitigate compliance risks and ensure compliance with the myriad consumer laws applicable to servicing.

Given the continuing high volume of servicing transfers and the attendant risks to borrowers, the CFPB has been closely monitoring servicing transactions. While the bulletin covers a number of regulations relevant to servicing transfers, it focuses on revised Regulation X, which implements the Real Estate Settlement Procedures Act that took effect January 10, 2014. The provisions of Regulation X at issue are found in 12 C.F.R. § 1024.38 and require servicers to, among other things, maintain policies and procedures that are reasonably designed to achieve two objectives: (1) the accurate transfer of mortgage servicing information; and (2) the proper evaluation of loss mitigation applications from borrowers.

The accurate transfer of mortgage servicing information is governed by Regulation X as well as many other consumer financial laws and regulations (such as the Fair Credit Reporting Act and the Fair Debt Collection Practices Act). Servicers must be careful to comply with all of the foregoing regulations and statutes (and, of course, those not stated but nonetheless could be deemed an “unfair, deceptive, abusive act or practice” or UDAAP). Failure to do so will invite CFPB scrutiny, and the CFPB will take appropriate supervisory or enforcement actions to address violations and seek all appropriate corrective measures, which could prove quite costly to servicers.

## CFPB's Proposed Changes to the Mortgage Servicing Rules: The Devil is in the Details

The following is adapted from an Alston & Bird advisory originally published on December 19, 2014. The full advisory is available at <http://www.alston.com/advisories/CFPB-proposed-Changes/>.

On November 20, 2014, the Consumer Financial Protection Bureau (CFPB) proposed amendments to its Mortgage Servicing Rules (Proposed Rule) in nine key areas: successor in interest, delinquency, information request, force placed insurance, early intervention, loss mitigation, periodic statements, small servicers and payment processing.

By way of background, in January 2013 the CFPB promulgated the Mortgage Servicing Rules to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act and to establish national standards for the mortgage servicing industry. Those rules took effect January 10, 2014, governing nine major topics<sup>6</sup> delineated in Regulation X promulgated under the Real Estate Settlement Procedures Act (RESPA) and Regulation Z under the Truth in Lending Act (TILA).

The 492-page Proposed Rule would make both significant and technical changes to the Mortgage Servicing Rules. If adopted, the new regulations would:

- Apply the Mortgage Servicing Rules to successors in interest who acquire an ownership interest in the property, irrespective of whether the successor has assumed an interest in the mortgage loan;
- Add a general definition of "delinquency";
- With regard to loss mitigation:
  - Require servicers to apply the procedural loss mitigation requirements more than once in the life of the loan;
  - Require servicers to dismiss a foreclosure sale if the servicer or its foreclosure counsel do not comply with the dual tracking requirements;
  - Clarify the application of the loss mitigation procedures and timelines during the transfer of servicing; and
  - Amend the requirements for collecting and evaluating loss mitigation applications;
- Narrow the scope of the exemption from the early intervention requirements for borrowers in bankruptcy and borrowers who have exercised their cease communication rights under the Fair Debt Collection Practices Act (FDCPA); and
- Require servicers to send periodic statements to borrowers in bankruptcy.

If promulgated, a final rule would take effect 280 days after publication in the *Federal Register*. However, the periodic statement provisions applicable to bankruptcy would take effect 365 days after publication in the *Federal Register*. Comments on the Proposed Rule are due by March 16, 2015.

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<sup>6</sup> Those nine topics are (1) periodic billing statements (TILA); (2) interest rate ARM adjustments (TILA); (3) payment crediting and payoff statements (TILA); (4) force-placed insurance (RESPA); (5) error resolution and requests for information (RESPA); (6) general servicing policies and procedures (RESPA); (7) early intervention (RESPA); (8) continuity of contact (RESPA); and (9) loss mitigation (RESPA).

Since the initial publication of the Mortgage Servicing Rules, the CFPB has issued three amendments and signaled that it would continue to issue proposed updates. Additionally, the CFPB has issued several bulletins and other interpretative guidance on issues of heightened concern, such as the intersection of the Mortgage Servicing Rules and other federal laws (such as the Federal Bankruptcy Code and the Fair Debt Collection Practices Act), vendor management, servicing transfers (with a particular focus on the impact to borrowers in default and the handling of loans mid-stream in the modification process) and how servicers handle successors in interest.

The CFPB's detailed proposal reflects its priority to understand the intersection of the Mortgage Servicing Rules with bankruptcy law and the FDPCA, how servicers handle successors in interest and borrowers impacted by a transfer of servicing and other implementation issues raised by servicers. While the Proposed Rule goes into granular detail, many questions, both large and small, remain unanswered, and new ones are likely to emerge as servicers face the daunting task of determining how to implement these rules if finalized. Alston & Bird strongly encourages servicers to accept the CFPB's invitation to provide comments on the Proposed Rule. We would be delighted to assist in reviewing or preparing comments to submit to the CFPB.

## Proposed Reforms to Safe Harbor Protections

The year 2014 raised the specter of changes to the Bankruptcy Code's safe harbor provisions that, if enacted, could have a significant and adverse impact on financial institutions and other participants involved in the residential mortgage market in the coming years.

Enacted in 1982, the safe harbor provisions of the Bankruptcy Code afford certain financial contracts and creditors special treatment under the Bankruptcy Code by exempting such creditors from the automatic stay, the bankruptcy court's avoidance powers, the normal scope of setoff and the normal treatment of ipso facto clauses upon the bankruptcy of the debtor counterparty. Since their inception, these provisions have gradually expanded to reflect the legislative intent to protect the financial markets against the market fallout that can result from a major bankruptcy. In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) considerably liberalized the safe harbor provisions to include, among other things, qualified financial contracts involving mortgage loans and mortgage-backed securities. Since then, the U.S. credit markets have enjoyed increased access to credit under these revised safe harbor provisions.

Following the financial crisis, many economists, legal scholars, regulators, legislators, lawyers and others have worked to deconstruct the catalysts of the crisis in order to develop safeguards against another similar occurrence. One theme that has emerged is the theory that the safe harbors actually helped to accelerate the crisis and spread systemic risk, instead of mitigate systemic risk and promote liquidity, which is the very problem the protections and BAPCPA were enacted to address. Because of the perceptions that the current Bankruptcy Code, as amended by BAPCPA, has created inequities among different creditor constituencies and exacerbated the financial crisis, there now seems to be a growing movement to revise the Bankruptcy Code.

A number of white papers and scholarly essays have been written on this theme and recommend a material curtailment of the safe harbors.<sup>7</sup> Indeed, one such proposal, published in *The Business Lawyer* last year, calls for a significant narrowing of the safe harbors to protect only those repurchase agreements and securities contracts with respect to highly liquid securities, such as U.S. treasuries and Ginnie Mae securities.<sup>8</sup> Contracts for all other collateral, such as mortgage loans, interests in mortgage loans, mortgage-backed securities, equities, bonds and agency securities not backed by the United States' full faith and credit, would be excluded from safe harbor protections.

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<sup>7</sup> See, e.g., Edward R. Morrison, Mark J. Roe & Hon. Christopher S. Sontchi, "Rolling Back the Repo Safe Harbors," *The Business Lawyer*, Vol. 69, No. 4 (August 2014); Thomas Jackson & David Skeel, *Transaction Consistency and the New Finance in Bankruptcy*, 112 Colum. L. Rev. 152 (2012); Stephen J. Lubben, *Repeal the Safe Harbors*, 18 Am. Bankr. Inst. Rev. 319 (2010).

<sup>8</sup> Morrison, *supra* Note 1.

These proposals have crystallized in the recent American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the "ABI Commission") Final Report and Recommendation issued on December 8, 2014 (Final Report), which is intended to guide federal legislators to enact changes to the Bankruptcy Code. The ABI Commission, composed of many well-respected restructuring practitioners, including two of the original drafters of the Bankruptcy Code, was formed in 2012 to evaluate the effectiveness of the current Bankruptcy Code in light of the expansion of the use of secured credit and distressed-debt markets. The recommendations in the Final Report arise from the ABI Commission's concern that BAPCPA expanded the safe harbors beyond their original aim of promoting market liquidity and stability, and instead encouraged runs on the market and accelerated contagion during the crisis.

The most significant (and alarming) proposal in the Final Report is the recommendation to roll back the safe harbors to the pre-BAPCPA definitions of repurchase agreement and securities contract, which would restrict the safe harbors only to securities and obligations that are guaranteed by the U.S. government. Alternatively, at a minimum, the ABI Commission proposes to eliminate the safe harbor protections for committed mortgage loan repurchase agreement facilities that essentially function as mortgage warehouse facilities. This proposed change would remove safe harbor protection from a vast swath of the current financial market and would likely mean a drastic market shift.

Other important proposals set forth in the Final Report that could impact safe harbored transactions and other financial contracts include:

- **Clarifying protections for settlement payments.** Under Section 546(e) of the Bankruptcy Code, the safe harbor protections currently apply to "settlement payments" and effectively prevent a debtor-in-possession from bringing a fraudulent transfer claim, even against insiders of the debtor, unless the transfer or payment was made within two years before bankruptcy and with the actual intent to hinder, delay or defraud creditors. Some have argued that in its current state, Section 546(e) applies to settlement payments made to beneficiaries of leveraged buyouts and other similar transactions, even if the securities were privately issued. The ABI Commission believes this is contrary to legislative intent because the safe harbor protections are meant to insulate the securities transfer system rather than privately issued securities transactions. As a result, the ABI Commission proposes excluding settlement payments in prepetition transactions in which some or all of the debtor's assets are being used to facilitate the transaction, such as leveraged buyouts. Section 546(e) would continue to protect settlement payments for publicly issued securities, securities purchases and sales, securities loans, margin loans and other transfers and transactions that are currently protected by this section.
- **Exclusion of supply contracts from safe harbor protection.** Some courts, but not all, provide safe harbor protection to contracts for the physical supply of goods used, traded or produced by the debtor, including contracts for the supply of gas or electricity. The ABI Commission proposes to forbid such protections and make it clear that safe harbors do not apply to physical supply contracts.
- **Greater clarity on the measurement of damages.** Section 562 of the Bankruptcy Code currently provides for the use of "commercially reasonable determinants of value" to govern the measurement of damages following a rejection, liquidation, termination or acceleration of a qualified financial contract, but the Code does not define such term nor does it prescribe a valuation methodology. In 2011, the U.S. Bankruptcy Court for the District of Delaware presided over whether a commercially reasonable determinant of value in the context of a safe harbored transaction is limited to market value or sale value and held that a discounted cash flow analysis could be appropriate in certain circumstances.<sup>9</sup> In order to bring more certainty to the analysis, the ABI Commission proposes to define

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<sup>9</sup> *In re Am. Home Mortg. Holdings, Inc.*, 411 B.R. 181 (Bankr. D.Del. 2009), *aff'd* 63 F.3d 246 (3d Cir. 2011).

“commercially reasonable determinants of value” as those determinants of value that are specified in the contract, provided they are not manifestly unreasonable. If adopted, this would mean that contractual provisions defining these measures would ordinarily be respected. However, if a contract was silent on the issue or if the contract provided a methodology that was manifestly unreasonable, the ABI Commission proposes that assets should be valued on the earliest date following the triggering event on which market prices are available.

- **Rendering “walkaway clauses” unenforceable.** “Walkaway” clauses operate to eliminate the benefit of a financial contract to the defaulting party, even if the defaulting party is still in the money, by extinguishing the defaulting party’s entitlement to payments owed to it by the non-defaulting party as of the defaulting party’s insolvency. Under the current Bankruptcy Code, such clauses are enforceable. The ABI Commission proposes to conform the Bankruptcy Code to the Federal Deposit Insurance Act and the Dodd-Frank Act’s Orderly Liquidation Authority standards by including a definition of “walkaway clauses” that is consistent with other federal law and rendering such clauses unenforceable in qualified financial contracts.

Consequently, although merely proposals at this time, the ABI Commission’s recommendations may lead to amendments to the Bankruptcy Code that would undoubtedly increase borrowing costs, result in the abandonment or restructuring of mortgage loan warehouse programs and significantly reduce available credit in the mortgage industry, all of which could have ripple effects throughout the market and at the consumer level. We will be closely monitoring these developments as they unfold.

## Mergers and Acquisitions

The year 2014 brought a boom in mergers and acquisitions in the residential mortgage market, with nearly twice as many mortgage-related mergers and acquisitions as 2013. The majority of these mergers and acquisitions involved small- to medium-sized mortgage lenders, allowing such lenders to both take advantage of economies of scale and increase their retail lending business, but some transactions also involved small- to mid-sized banks and REITs.

This spate of mergers and acquisitions was fueled by regulatory changes and market shifts. Because of rising costs due to regulatory changes in the mortgage market and decreased originations, lenders needed to sell more mortgages to make the same profits as they made in 2013. The mergers and acquisitions that took place this year allowed lenders to capture more customers, geography and product lines, while at the same time decreasing operating costs by consolidating back office functions and staffing.

Among the more notable transactions, loanDepot.com, LLC, the nation’s second largest nonbank consumer lender, announced plans to acquire Massachusetts-based originator Mortgage Master, Inc.; New Penn Financial, LLC, a Pennsylvania-based mortgage lender, acquired Shelter Mortgage Company, LLC, a Milwaukee-based lender; Guild Mortgage Company, a San Diego mortgage banking company, acquired both Northwest Mortgage Group, an Oregon originator, and Comstock Mortgage, a Sacramento-based independent mortgage banking company; Caliber Home Loans, Inc., of Texas acquired Cobalt Mortgage, a Washington-based privately owned retail mortgage lender; and RPM Mortgage Inc., a private mortgage lender, announced that it was acquiring Regency Mortgage Corporation, a retail mortgage lender based in New England and Florida.

During 2014, there were also many mergers and acquisitions between small- to mid-sized banks, with some of that activity spilling over into the mortgage arena. Some banks expanded their mortgage operations by purchasing mortgage companies or agreeing to new lending relationships with mortgage companies. For example, the Bankers Bank acquired two mortgage banking services firms in Kansas, and Mutual of Omaha Bank established a correspondent lending relationship with Guild Mortgage, allowing its customers to access all of Guild’s mortgage products.

Finally, REITs also entered the fray. ZAIS Financial Corp., a REIT, acquired GMFS, LLC, a privately owned mortgage originator with a 29-state footprint in the southern U.S.

After witnessing this increase of mergers and acquisitions, some economists and mortgage consultants have predicted that 30 percent of all mortgage lenders could disappear by mid-year 2015 due to either merger or failure. Time will tell if this prediction is correct.

## **Conclusion**

As can be seen, 2014 was a watershed year in the history of residential mortgage finance. More regulations were passed than would be ordinarily expected in a full decade.

A lot remains to be digested, and some areas of regulation are still unresolved, but overall the biggest surprise was that all of these regulations had a surprisingly small impact on the RMBS market. Origination standards had tightened so much after the financial crisis that the changes from QMs had very little impact. QRMs did not have a loan-to-value ratio requirement and was virtually the same as QMs, so the impact on the market was negligible. Regulation AB II has resulted in no real change in the RMBS market, which was completely private anyway. There were a number of changes in mortgage servicing, and the mergers and acquisitions market was surprisingly active.

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Alston & Bird has attorneys involved in every aspect of residential mortgage loans. If you have any questions about any of the following aspects of residential mortgage loans, please contact the individuals below.

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