

PUBLICATION

Mortgage Investors Push Congress for Aggressive Oversight, Enhanced Disclosure Under the National Mortgage Settlement

July 12, 2012

Last month, Rep. Scott Garrett (R – NJ), chairman of the House Financial Services Committee's Capital Markets Subcommittee, held a hearing on "Investor Protection: The Need to Protect Investors from the Government." The hearing's purpose was largely to highlight how, in the opinion of Rep. Garrett and mortgage investors, the National Mortgage Settlement (NMS) favors the loan servicing industry over the interests of distressed homeowners and investors in "private-label" residential mortgage backed securities (RMBS). Although mortgage investors were fully represented at the hearing by the Association of Mortgage Investors (AMI) and the Association of Institutional Investors (AII), the loan servicing industry was either not asked to testify or not allowed to do so.

The hearing reflects the increased influence of mortgage investors in Washington in response to the string of setbacks they experienced starting with the servicer "safe harbor" legislation in 2009, implementation of TARP's Making Home Affordable (MHA) loss mitigation programs and, more recently, the NMS. The hearing also demonstrates Rep. Garrett's growing effectiveness as Capitol Hill's top champion for mortgage investors, who allege that conflicts of interest in the loan modification process give servicers a distinct financial advantage over aggrieved homeowners and competing stakeholders in the housing finance sector. In May, Rep. Garrett garnered 238 votes in support of his floor amendment to the annual Justice Department funding bill that would prohibit Justice from being a party to "single or multi-state court settlement where funds are removed from any residential mortgage-backed securitization trust." Strongly supported by AMI and AII, the amendment's purpose is to prevent any future Justice Department-backed mortgage settlement agreement from being ratified without the consent of private-label RMBS investors. Although it's too early to say whether Rep. Garrett's amendment will become law, the level of floor support for the amendment in the House of Representatives has important, long-term consequences for housing finance stakeholders. Rep. Garrett is one of only a handful of candidates who might become chairman of the full Financial Services Committee in the 113th Congress should Republicans retain control of the House this coming November.

At the June 7 hearing, AMI and AII warned that servicers will implement the NMS in a way which exclusively favors the servicers' interest and the banks with which servicers are affiliated. Investors essentially argue that the NMS penalizes private-label investors for servicer transgressions popularized by the robo-signing scandal that led to the NMS in the first place. They allege that because servicers have a built-in incentive to minimize the number of principal reductions made to loans in their own portfolio due to loss recognition rules, the majority of NMS-sanctioned principal reductions will come from private-label investor-owned mortgages. The Obama Administration believes that the credit incentives contained in the NMS sufficiently incentivize servicers to first modify loans on their own balance sheets before modifying private-label owned loans. (For example, the NMS provides a \$1.00 servicer credit for every \$1.00 of principal write-down in servicer-owned portfolios compared to the \$0.45 servicer credit for write-downs in investor-owned portfolios.) Hearing witnesses, however, cite statements by Housing and Urban Development (HUD) Secretary Shaun Donovan that the \$25 billion NMS could produce as much as \$32 billion in homeowner relief, an amount achievable only if servicers write down \$22 billion in private-label RMBS loans, according to at least one interpretation of Secretary Donovan's statement. Investors are urging the official NMS monitor, former North Carolina banking commissioner Joseph A. Smith Jr., to impose additional disclosure requirements on servicers that would allow investors to better track the amount of principal reduction coming from servicer-owned portfolios compared to

private-label investor-owned portfolios and the extent to which servicer-owned second liens are modified by servicers who are also responsible for servicing private-label investor-owned first liens secured by the same property.

It is unclear if enhanced disclosure under the NMS sought by investors will result in increased liability for servicers for purported violations of servicer-investor RMBS Pooling and Servicing Agreements (PSAs). That's because stakeholders appear to be divided over whether the "servicer safe harbor" contained in Section 201 of the Helping Families Save Their Homes Act of 2009 applies to NMS-sanctioned loan modifications. (The safe harbor was created to facilitate loan modifications under TARP's Home Affordable Modification Program by holding servicers harmless from investor lawsuits for violating PSAs.) Investors cite a March 12 HUD fact sheet as evidence that NMS-sanctioned loan modifications by servicers must comply with PSAs, thus impairing servicers' ability to claim safe harbor protection in discharging their obligations under the NMS. However, the consent judgments entered pursuant to the NMS seem to suggest otherwise. According to one sample consent judgment, "The servicing standards and any modifications or other actions taken in accordance with the servicing standards are expressly subject to, and shall be interpreted in accordance with.....Section 201 of the Helping Families Save Their Homes Act of 2009."

Whether the servicer safe harbor issue becomes an obstacle to implementing the NMS is not known. The United States currently has over \$10 trillion in outstanding mortgage debt. Of that amount, \$5.4 trillion is held by Fannie Mae and Freddie Mac, \$3.6 trillion by banks in their own portfolios and \$1.5 trillion in first lien mortgages owned by private-label RMBS investors. Although investors technically own the fewest mortgages, to the extent that servicers are exposed to PSA-based claims brought by investors, the NMS may run additional risks previously unknown to the loan servicing industry.

Ultimately, full economic recovery and a stable housing market will likely minimize current legislative conflict among housing advocates, consumer groups, loan servicers, mortgage investors and their respective allies on Capitol Hill. For the time being, however, previously unorganized private-label RMBS investors will continue to marshal their resources, push for greater servicer disclosure and aggressively monitor how the NMS and federal loan servicing standards are implemented. Nor will they hesitate to leverage whatever influence they have developed in Washington in recent years to ensure their interests are sufficiently protected, regardless of the outcome of the November elections.