Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
WASHINGTON, DC

Proposed New Federal Agency to Regulate and Backstop Mortgage-Backed Securities*

Raymond Natter

June, 2013

Draft legislation is currently circulating in Washington to create a new federal agency to regulate and backstop mortgage backed securities. The draft bill is attributed to Senators Corker and Warner. It has not yet been formally introduced, and could undergo changes before it is formally submitted in the Senate. However, even though it is not an official document, it does reflect one model for the future of mortgage-backed securities, and therefore may be of interest to those involved in mortgage finance.

Under this draft, a new system would be established to provide for the securitization of "eligible mortgages." These mortgages will be used to collateralize "covered securities" that are to be issued by "approved issuers," and insured by the Federal Mortgage Insurance Corporation (FMIC), a new independent agency of the Federal Government. The underlying mortgages have to be serviced by an approved mortgage servicing company, subject to standard servicing agreements developed by the FMIC.

In order to obtain FMIC insurance, private sector entities would have to be willing to take a minimum "first loss" position in connection with the securitization. In other words, if the underlying mortgages begin to default, the initial losses would be absorbed by these private sector companies until the number of mortgages in default becomes so large that the FMIC backstop guarantee must be used to protect investors.

The bill also abolishes the FHFA and transfers its functions to the FMIC on the "transfer date," which is one year after the date of enactment. The FMIC would replace the FHFA as the primary regulator of the Federal Home Loan Banks, and of the Enterprises: Fannie Mae and Freddie Mac. The Enterprises would be liquidated not later than five years after the date of enactment. The current multi-family line of business conducted by the

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

Enterprises would be transferred to the FMIC. The housing goals for the Enterprises (but not the FHLBanks) are repealed.

Eligible Mortgages

An "eligible mortgage" is a 1-4 family mortgage that has been originated in compliance with the CFPB's "ability to repay" rule, and has a maximum original principal obligation that does not exceed specified limits. In the first year after enactment, the maximum loan limit for a single family home would be the lesser of 115 percent of the median single-family house price in the area or $625,000. The permissible size of the loan would be reduced every year until it reaches $417,000 in the sixth year after enactment.

Eligible loans may not have a loan-to-value ratio in excess of 80 percent, after including all junior liens, unless the amount of the loan that is in excess of 80 percent is protected by private mortgage insurance provided by an approved mortgage insurance company. A cash down payment of at least five percent is also required. Other terms and conditions may be established by the Director of the FMIC, such as escrow requirements, the definition of a default, and the amount of any delinquency penalty.

Covered Security

A "covered security" is a mortgage-backed security that is collateralized by eligible mortgages, is issued pursuant to a standard form risk-sharing agreement developed by the FMIC, and that is subject to FMIC insurance protection that is purchased by an approved securities issuer.

Approved Securities Issuer

An approved securities issuer is an entity that has been approved by the FMIC to issue covered securities and to purchase FMIC insurance on that portion of a covered security for which private market holders have not assumed the first loss position. The FMIC must approve an application by a Federal Home Loan Bank to become an approved issuer. The FMIC is to establish minimum standards for issuers, including both technical capabilities, financial resources, and character and fitness of proposed management officials. No approved issuer may obtain FMIC insurance if it would result in that issuer having in excess of 15 percent of the total covered securities market.

The Federal Mortgage Insurance Corporation

The legislation establishes the Federal Mortgage Insurance Corporation as an independent agency in the Federal Government. The purpose of the FMIC is to foster, support and carry out activities to provide liquidity and the availability of mortgage credit and to protect the taxpayer from having to absorb losses during periods of economic stress. The FMIC may not engage in mortgage origination. The management of the FMIC is vested in a five member board, headed by a “Director” who will serve as the Chairman of the board.

Private Sector Must Take First Loss Position

The FMIC is required to develop, within five years, standard credit risk-sharing structures and arrangements under which the private sector entities will assume the first loss on covered securities insured by the FMIC. The first loss position must be adequate to cover losses that might be incurred as a result of economic conditions that are consistent with the economic conditions (including home price declines) that occurred in the United States during moderate to severe recessions during the last 100 years. The structures and arrangements must involve pools of mortgages that are geographically diverse and represent a diverse set of borrower characteristics. In no event may the first loss protection be less than 10 percent of the principal or face value of the covered security. The FMIC must ensure that the structures allow lenders of all sizes and from all geographic locations to have equitable access to secondary mortgage market financing.

Mortgage Insurance Fund

The FMIC will insure the payment of principal and interest on that portion of a covered security for which private entities have not assumed the first loss position. The full faith and credit of the United States stands behind this guaranty.

A Mortgage Insurance Fund (Fund) will be administered by the FMIC. Insurance fees are deposited into the Fund. The FMIC has the fiduciary duty to ensure that the Fund remains financially sound. The Fund is solely available for carrying out the FMIC’s functions under the bill. The Fund is to maintain a balance equal to 2.5 percent of the outstanding principal balance of insured covered securities, or a higher amount as determined by the FMIC.

The FMIC is to charge insurance fees, to be determined in its discretion, in order to maintain the required Fund balance and to fund the operations of the FMIC. In establishing the fees, the FMIC must consider the expected operating expenses, the risk of losses to the Fund, the economic conditions affecting mortgage markets, and any other factor the FMIC determines appropriate. Fees have to be uniform for all institutions purchasing FMIC insurance, regardless of size or location.

Uniform Securitization Agreements

The FMIC will develop uniform securitization agreements for covered securities. The agreements are to cover pooling and servicing, representations and warranties, indemnification and remedies, and the qualification and duties of the trustees. The agreements may provide for the transfer of servicing rights only if such transfer is determined to be in the best interest of the investor, as calculated on a net present value basis. Factors to be considered are the financial history and condition of the servicer, the risk presented by the servicer to the FMIC Fund, and other standards developed by the Director.

Databases

The FMIC is required to develop a database that identifies and tracks if a junior lien has been placed on a property securing an eligible mortgage. The senior lien holder must be notified of the new lien. The database will also notify both lien holders of the monthly performance on the loans.

The FMIC will also establish a loan level database on all eligible mortgages that includes loan characteristics, borrower information, and identification of the mortgaged property, the identities of the parties, appraisal data, and various other information. The FMIC will determine the manner and format for making this data publicly available.

Restriction on Second Loans

With respect to any home that is serving as the security for an eligible mortgage, a second lien that results in a combined loan-to-value ratio in excess of 80 percent is not valid or enforceable unless the new creditor has first obtained the approval of the creditor of the senior eligible mortgage.

FMIC Mutual Securitization Company

The FMIC is authorized, in its discretion, to establish the FMIC Mutual Securitization Company to develop, securitize, sell and otherwise meet the issuing needs of credit unions and banks with less than $10 billion in total assets.

Before making any insurance commitment, the FMIC must ensure that private market participants that hold a first loss position in a covered security have sufficient capital to cover their risk-sharing obligation.

Private Mortgage Insurance

The FMIC is to establish minimum standards for approved private mortgage insurance companies. These standards must include a determination if the insurer has sufficient capital to cover the first loss that would occur if there was a nationwide 30 percent decline in housing prices. The FMIC is to establish an application and approval process for private mortgage insurance companies. The same private insurance company may not provide insurance for individual loans that are originated with a loan-to-value percentage that is less than 80 percent, and also assume a first loss position with respect to a covered security.

Mortgage Servicers

The FMIC is to develop standards for mortgage servicers to administer "eligible mortgages." These standards are to include the establishment of foreclosure loss mitigation and foreclosure prevention programs that may be required by the FMIC and the advancement of principal and interest to investors when borrowers are delinquent (until the property has been liquidated).

The FMIC will establish an application process, and is to approve servicers that meet the prescribed standards. Approvals may be revoked by the FMIC for cause. Security holders in a first loss position may petition the FMIC to change servicers.

Electronic Registration of Eligible Mortgages

The FMIC is to establish an electronic registry system for eligible mortgages that collateralize FMIC insured securities in order to automate, centralize, standardize and otherwise improve the process of tracking changes in servicing rights and beneficial ownership interests.

Exemption from Risk Retention

Covered securities are exempt from the risk-retention requirements of the Dodd-Frank Act, as are securities issued, guaranteed or purchased by any institution subject to the supervision of the FMIC (including the Federal Home Loan Banks).

Abolishment of FHFA

One year after the date of enactment, the FHFA is abolished and its powers and duties transferred to the FMIC.

Raymond Natter is a partner with the law firm of Barnett Sivon & Natter, P.C.