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TREASURY ISSUES REPORT REGARDING NONBANK FINANCIALS, FINTECH, AND INNOVATION – RESIDENTIAL MORTGAGE LENDING

The U.S. Department of the Treasury (the "**Treasury**") has released a fourth report in a series of reports produced in response to Executive Order 13772, available here, which sets out the Administration's seven core principles for regulating the U.S. financial system (the "**Core Principles**"). This report, entitled "A Financial System That Creates Economic Opportunities: Nonbank Financials, Fintech, and Innovation" (the "**Fourth Report**", available here) analyzes and provides recommendations for the regulation of nonbank financial companies, the fintech sector and other forms of financial market innovation through the lens of the Core Principles. Thematically, the Fourth Report primarily addresses the following two Core Principles: (1) making regulation efficient, effective, and appropriately tailored and (2) enabling American companies to be competitive with foreign firms in domestic and foreign markets.

This briefing discusses the Treasury's recommendations regarding residential mortgage lending. Specifically, the Fourth Report highlighted several areas of potential improvement for the residential mortgage industry, including adapting to the increase in non-bank participation, addressing regulatory challenges which discourage market participation or otherwise hinder the industry, and encouraging the adoption of available technological improvements.

Use of Digital Technology for Mortgage Origination

The Fourth Report identifies the existing paper-based mortgage origination system as overly costly and time consuming, and therefore frustrating for industry participants and borrowers. Currently, very few lenders use a digital technology beyond the initial loan application stage, with many reverting to a traditional paper-based process after the application is received. Despite there being a clear legal basis, both under statutory and case law, for the validity of electronic mortgages (also known as eNotes), and the use of eNotes offering significant practical benefits, the industry has not yet adopted the use of eNotes on a widespread basis.

One major hurdle identified in the Fourth Report is lack of acceptance of eNotes by major secondary market participants. Currently, Ginnie Mae and Federal Home Loan Banks ("**FHLBs**") do not accept mortgage loans with electronic signatures, and while the Federal Housing Administration ("**FHA**") accepts electronic

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signatures, it has faced practical and technical difficulties in processing and storing electronic mortgages. FHLBs do not accept eNotes as eligible collateral to secure an advance primarily because they are concerned with the diminished secondary market for eNotes noted above; and the appropriate representation in the MERS eRegistry in cases where it owns an interest in, but is not the owner of, an electronic Mortgage.

In relation to the second issue, the Fourth Report notes that MERSCORP Holdings, Inc. is working towards the addition of a "Secured Party" field to its eRegistry, which will allow increased participation from parties such as FHLBs and warehouse lenders.

The Fourth Report recommends wider acceptance and use of electronic mortgage technology by federal mortgage industry participants in order to improve the origination process. In particular, the report recommends that Ginnie Mae change its policy to accept eNotes, and that both Ginnie Mae and the FHA improve their digital capabilities and functionality with respect to digital mortgages. Further, it recommends that all states authorize the use and recognition of electronic notarizations, and that Congress consider providing a national standard for electronic notarizations.

Availability of Appraisals

The Fourth Report identifies the existing regulatory framework with respect to appraisals as outdated given advances in technology (including automated valuation models). It describes the tension in the appraisals market since the financial crisis caused by a mismatch between demand for appraisal services and the availability of independent appraisals, which is causing longer timelines and increased costs associated with mortgage origination. In response, the Treasury recommends that Congress modernize the appraisal requirements provided in Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act to, among other improvements, allow the more widespread use of technology-based appraisals when appropriate. The Treasury also expresses support for the recently updated minimum appraiser qualification standards which ease the educational requirements in order to increase the availability of licensed appraisers.

False Claims Act Enforcement Issues

The Fourth Report notes that while Treasury recognizes that enforcement of the False Claims Act (the "**FCA**") is critical to the health and stability of the mortgage industry, the reputational and financial risk associated with becoming subject to FCA enforcement has been identified as a factor in the departure of depository institutions from the origination and servicing of government-insured mortgage loans. The FCA requires that a violation be both knowing and material before sanctions can be imposed, however the U.S. Department of Justice ("**DOJ**") and the FHA and the U.S. Department of Housing and Urban Development ("**HUD**") have faced criticism for not sufficiently distinguishing knowing and material violations from clerical and other minor errors. The significant financial and reputational harms associated with being held liable for minor mistakes can be a factor in determining whether and at what price to participate in the market.

The report emphasizes that FCA enforcement should be focused on bad actors who commit knowing violations, and immaterial violations should be addressed outside of the FCA framework to mitigate the enforcement risk faced by market participants making good faith efforts to comply with FCA standards. Recognizing that increased clarity will allow institutions to better gauge their potential exposure and encourage participation, the Treasury also recommends that DOJ, HUD and FHA establish clear and unambiguous standards around the potential liabilities faced by lenders and servicers. These standards should be both with respect to what constitutes a material violation (and thus is subject to FCA enforcement), and also what liabilities each type of violation can result in. The Treasury also recommends the relevant agencies provide clear guidance for how lenders can proactively cure violations, and create transparent safe harbors for immaterial violations and violations cured in accordance with established remedies.

Inconsistent Loss Mitigation Standards

The report identifies the differing loss mitigation standards across government sponsored enterprises ("**GSEs**"), FHA, the Mortgage Bankers Association, the U.S. Department of Veterans Affairs and other market participants as a challenge for servicers, in part because managing multiple standards limits efficiencies and opportunities to scale operations. The report notes that the varying standards cause uncertainty for borrowers as well, since they often cannot know if ownership of their mortgage will change hands, resulting potentially in the application of a different loss mitigation standard.

The Treasury recommends that federally supported mortgage programs work to align and standardize their loss mitigation approaches as much as possible. While the Treasury recommends that such programs establish certain standardized parameters, such as affordability standards, the Fourth Report recommends avoiding a standardized loss mitigation approach which would prescribe any specific modification product. It further recommends that HUD review FHA servicing practices with the goal of increasing certainty and reducing regulatory compliance costs.

Support for Non-Judicial Foreclosure Laws

Another area the Fourth Report suggests the market could benefit from policy alignment is foreclosure standards. Foreclosure policies are among the most divergent state-level policies in the industry, which has proven costly for the industry since the financial crisis. The report notes that foreclosure timelines have increased across the board since the financial crisis – particularly in states with a judicial foreclosure model. The report notes that in certain judicial foreclosure states, the average foreclosure process exceeds three years, compared to an overall national average of six months in 2007. The report highlights research that the judicial foreclosure process, in addition to being costly and time consuming, tends to lead to higher rates of persistent delinquency, without improving outcomes for delinquent borrowers.

The Treasury recommends that states move away from judicial foreclosure laws, and towards a more standardized foreclosure law through the adoption of a non-judicial model foreclosure law. The report goes on to recommend that the relevant agencies and GSEs add fees and surcharges for added costs in states with longer than average foreclosure timelines.

Aligning Reporting Standards for Nondepository Financial Institutions and Monitoring Related Counterparty Risks

A recurring theme in the Fourth Report is the challenges associated with the increase in the proportion of origination and servicing activity performed by nondepository financial institutions. Since nondepositories are subject to different regulatory and supervisory standards than traditional banks, this increases counterparty risk for GSEs such as Ginnie Mae which guarantee payments on securities backed by government insured mortgages. Since much of the regulation of nonbank institutions is done at the state level, there are also inconsistent standards depending on the location of the nondepository. Another concern related to this shift is that traditional banks have more liquid assets, such as customer deposits, than nondepositories, which tend to rely on less reliable financing arrangements.

In order to mitigate this counterparty risk, the Treasury recommends that Ginnie Mae work with the Conference of State Bank Supervisors (which has already made some progress on aligning standards for supervising nonbank financial institutions), the FHFA and the GSEs to expand and standardize reporting requirements relating to the finances of nonbank counterparties. It also recommends an assessment of Ginnie Mae's operational capacity to adequately monitor counterparty risk, and consider alternative pay and staffing arrangements to enhance its ability to do so.

Conclusion

The Fourth Report identifies a number of processes and practices in the mortgage industry that would benefit from modernization and standardization. Any spotlight on these issues and constructive suggestions for how to make improvements will be welcomed by industry participants, although seasoned industry watchers are unlikely to see anything new to them in the report. Change can be slow. However, with more widespread application of technological developments and a regulatory environment that may be becoming lighter touch, the stars may be aligning to facilitate improvements that will benefit both borrowers and the mortgage industry alike.

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