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Mortgage Reform: Today's Vote Start of Process

What is Happening

The House Financial Services Committee begins voting today at 10 a.m. on HR 1728, which is the mortgage reform bill. Such votes tend to stretch out over more than one day.

Why it Matters

We believe the odds strongly favor enactment of mortgage reform legislation prior to the mid-term election. This legislation will set the ground rules for mortgage lending for the next generation. So it will matter to anyone involved in the mortgage origination business.

Our Assessment

This bill will make it more expensive for financial firms to originate and securitize mortgages. Yet we believe it is far more reasonable than many investors have feared and we expect lawmakers to resolve some of the industry's objections during the mark-up.

Our worry, however, is that the bill will get more radical as it moves through the full House and the Senate. This could become the vehicle to revive mortgage bankruptcy reform or to impose other consumer protection restrictions on the industry. This threat is higher than normal as few lawmakers will want to oppose mortgage reform legislation just before the mid-term election regardless of what other measures get added to it.

What the Bill Does

This is a very large bill – the official summary alone is five pages – but we summarize the key provisions below:

- **Skin in the Game.** The skin in the game requirement excludes 30-year, fixed rate mortgages. For all other mortgages, the creditor must keep at least 5% of the credit risk for each loan that is sold or transferred to a third party. The creditor also is barred from hedging this credit risk.

What it Means: This is an interesting provision and we expect Democrats to soften it during the mark up. It could benefit the portfolio lenders by making it harder for nonbanks and others to offer anything but 30-year, fixed-rate mortgages. This is because only banks and thrifts would have the capital to meet the skin-in-the-game standard. Yet it also could hurt some banks that prefer to sell their mortgages rather than keep them in portfolio. We expect the final version will give regulators discretion to modify the rule to ensure a liquid mortgage market.

- **More Rules.** Federal regulators will get more power to attack predatory, abusive or questionable mortgage practices.

What it Means: This is the danger zone as it clarifies the ability of the banking agencies to tackle mortgage practices. That means the agencies could unleash a new wave of onerous regulations. We see the risk manageable, but it is one that could rise as Obama slowly installs his own appointees at the banking agencies.

- **Underwriting Test.** For all mortgages, the lender must make a “reasonable, good-faith” conclusion that the consumer has a “reasonable ability to pay” the loan at the fully amortized, fully indexed rate based on verified data on the borrower such as the credit history and debt-to-income ratio. For refinancing, the lender also must conclude that the new loan offers a “net tangible benefit” to the borrower. Regulators will write rules to implement this provision. A 30-year fixed-rate that does not exceed an average prime rate and that lacks negative amortization or interest-only features is presumed to meet both tests. This is known as the safe harbor. The consumer may rescind loans that violate this standard and recoup legal costs if the borrower refuses to offer a free modification within 90 days of being notified of the violation.

What it means: This is an added cost for the originator and it will encourage lenders to rely primarily on 30-year, fixed-rate mortgages.

- **Assignee Liability.** If a financial firm securitizes an illegal mortgage, the firm must fix the loan within 90 days of notification or the consumer will have the right to rescind the mortgage and collect legal costs. This assignee liability stops at the financial firm. So investors and the trust are not covered. It does not authorize class-action litigation.

What it Means: This is a modest application of assignee liability which we believe will cause few disruptions to mortgage market.

- **Steering Customers.** Bars financial firms from paying different fees to mortgage brokers and loan officers based on the type of mortgage that is originated. In other words, a 30-year fixed will carry the same fee as an option ARM.

What it Means: We expect brokers will be upset, but consumer advocates contend that the higher fees for option ARMs led brokers and loan officers to steer borrowers into those loans rather than 30-year, fixed-rate loans.

- **Variable Rate Disclosure.** Lenders must notify borrowers at least six months before an introductory rate may adjust.

What it Means: This comes in response to charges that some predatory mortgages had introductory rates that change after just a few months or without any warning.

- **Escrow Rules.** Forces lenders to create escrow accounts for insurance and taxes for high-cost mortgages and requires others that opt out of escrow to get written disclosures about the importance of paying taxes and insurance.

What it Means: The Federal Reserve already has imposed similar rules. Our one worry is that it may make it tougher for lenders to impose forced-placed insurance on borrowers who let their policies lapse.

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