Client Alert

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Trends in Single-Family Housing

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Rising home values in many areas of the country and improved economic data have buoyed hopes that the recession may be behind us, but no one expects an immediate return of either pre-2007 home value appreciation or the loose mortgage underwriting and servicing standards that were exposed during the housing crash. Not only have federal regulators issued numerous rules to prevent another housing-based recession, but many communities still face a daunting inventory of distressed single-family housing.

Whenever there are dramatic changes in the operations and functions of an industry, opportunities arise to take advantage of the shifting landscape. This alert briefly explores the ways investors and new market entrants are attempting to develop what is emerging as a new single-family asset class, the regulatory changes that have caused banks to retreat from participation in the mortgage servicing business, and compliance challenges for existing and new servicers.

Investing in Foreclosed Single-Family Housing

Numerous media reports late last year indicated that investment funds were being organized to acquire, rent, and dispose of distressed single-family housing portfolios in markets such as Atlanta, Miami, Phoenix, and Las Vegas. Sellers of REO ranged from the GSEs to large banking institutions to smaller financial entities. Investors in this area generally break down into two groups—those seeking to buy as many houses as possible, renovating them, if necessary, for a quick sale, and those seeking to buy homes for operation as commercial rental properties.

The first category of investors expects to take advantage of improving home values and, to a lesser extent, a potential rental income stream, until the applicable market has turned. The second group, while welcoming home price appreciation, focuses on long-term rental income and believes that the convulsions in the housing market were so severe that a significant number of Americans—either by choice or as a result of financial necessity—who previously would have chosen to buy single-family houses, will rent those houses instead from professional owners/managers. (Much more conservative underwriting standards now in place prevent many potential homeowners from qualifying for mortgage financing—even when the loan applicant can afford a higher down payment.)

Any investor looking to participate in either space must contend with a range of issues, including:

- Acquiring the right number of assets, in the right condition, with the right geographical distribution to meet investor and lender expectations;
- Analyzing local political and regulatory issues, including those relating to transfer taxes and real property code compliance;
- Managing risks associated with leasing of residential real property and related owner liability; and
- Dealing with local property managers, leasing agents, and homeowners associations.

Although the answers to these and other legal and operational issues may result in different investment strategies being pursued in various markets throughout the United States, project management standards are emerging to develop efficiencies, including standardized purchase agreements, residential leasing contracts, and property management agreements.

Transfers of Mortgage Servicing Rights

Another area profoundly affected by the housing crisis has been the mortgage servicing business. What became clear as homeowners struggled with their mortgage payments was that the current mortgage servicing system was not structured to accommodate a widespread need for “high-touch” servicing protocols. Servicers of all sizes, including banks, whose mission was geared primarily toward servicing non-delinquent home loans, suddenly found themselves overwhelmed with missed payments, requests for loan modifications, and a variety of government programs designed to offer mortgage relief.

As a result of these new obligations, and the federal government’s insistence that mortgage servicers engage in loan workout and government-sponsored remedial programs, over the past two years, GSEs and other owners of loans have required that servicing be moved to servicers with more robust infrastructure and proactive systems. (As part of this evolution in the nature of loan servicing, multi-state loan servicing settlements have resulted in new “best practices” for loan servicers.)

Depository institutions, including banks and their holding companies and affiliates, ultimately may have another reason to transfer mortgage servicing rights. Under the proposed Basel III regulatory capital reforms (the adoption of which has been delayed by U.S. regulators), the amount of mortgage servicing rights that may be applied towards a bank’s Tier 1 capital would be capped at 10% (implemented in phases over a period of years). This limitation would require banks to increase capital reserves per loan, raising the cost of running a mortgage servicing business—over and above costs associated with the additional regulatory requirements layered on by U.S. regulators (described below).

Regulatory Matters

The adoption of wholesale revisions to home mortgage origination and servicing requirements by the Consumer Financial Protection Bureau (CFPB) may effectively level the playing field between existing mortgage industry members and new entrants, because all participants will be required to develop entirely new loan origination and servicing platforms and systems at considerable cost.

After the mortgage meltdown, Congress, pursuant to the Dodd-Frank Act, charged the CFPB with revising virtually all substantive and procedural rules governing residential lending, including loan application, origination, and servicing. Most of those new requirements were adopted between January 7 and January 21 of this year, and include the following:

- RESPA-TILA Integration
- High-Cost Mortgage Amendments
- Mortgage Servicing
- Loan Originator Compensation
- Appraisals
- Ability to Repay and Qualified Mortgage Definitions
- Escrows

Mortgage industry participants will have until January 2014 to design new compliance systems (with the exception of the proposed RESPA-TILA integration amendments, which will not be adopted in final form until approximately June 2013 and may require 12-18 months to implement system design changes).

Mortgage servicing platforms and systems will be far more complex, in part due to the expected need to associate mortgage origination documentation with the loan servicing file in a manner that permits that data to be immediately available to loan servicing personnel. Potentially, the cost of legacy system redesign may be more burdensome to existing mortgage lenders and servicers than to new entrants, who may be able to develop new mortgage origination and servicing platforms designed to be in compliance with the new requirements.

Conclusion

This alert identifies potential business opportunities related to the quickly evolving mortgage marketplace. Pillsbury has extensive experience with single-family REO portfolios, the issues unique to the emerging single-family asset class, and the challenges related to the transfers of mortgage servicing rights, including the bifurcation of indemnities and special representations and warranties. Pillsbury also is qualified to provide counsel regarding the regulatory response to the housing crisis and the burdens and opportunities to be considered by owners, lenders, managers, and servicers. Of course, many of the topics discussed require additional, detailed review. We would be happy to answer any questions that might arise.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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