CONSUMER FINANCE

Daaaad, Are We There Yet!? The *Madden v. Midland* Road Trip Continues

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No Shirt, No Shoes, No Service: NYDFS to Overhaul Mortgage Loan Servicer Business Conduct

The New York State Department of Financial Services has proposed significant changes to the mortgage servicer business conduct rules found in Part 419 of the Superintendent's Regulations.

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After eight rather unsettling years, the parties in *Madden v. Midland Funding, LLC* finally reached a settlement agreement this past March, with the class members receiving monetary damages and substantial reductions in their credit balance. What began as a minor credit card debt dispute in 2011 resulted in a bombshell decision from the U.S. Second Circuit Court of Appeals (New York, Vermont, and Connecticut) in 2015 that turned the long-standing "valid when made" doctrine on its head and triggered an avalanche of agita within the consumer lending community.

To briefly recap, *Madden v. Midland* was a usury case that arose in the U.S. District Court for the Southern District of New York in 2011 and involved a plaintiff who defaulted on credit card debt with a national bank, where the debt was subsequently sold to Midland Funding, LLC, a non-bank debt collector based in California. Midland charged the plaintiff a default interest rate that exceeded the New York state usury law limitations, the same rate that was charged by the originating national bank. The court ruled in favor of Midland, holding that the National Bank Act preempted state-specific usury claims against Midland. This holding was reversed on appeal in 2015, on the basis that the established authority of a federally chartered bank to preempt state usury laws under the National Bank Act did not extend to Midland, as a non-bank purchaser of the debt. On June 27, 2016, the U.S. Supreme Court denied certiorari, thereby allowing the Second Circuit's decision to stand as binding precedent in Vermont, New York, and Connecticut and persuasive precedent everywhere else. On remand in 2017, the District Court held that New York usury law, rather than the Delaware governing law in the credit agreement, applied to the plaintiff's claims. In rejecting the "valid when made" doctrine, the court essentially determined that non-bank purchasers of consumer debt may not be entitled to collect interest at the interest rate established by the originating entity and the originating bank may not be the "true lender or creditor" in respect of the debt.

The fallout from this decision was swift and widespread. Origination partnerships with national or FDIC-insured state-chartered banks were immediately called into question, deals were restructured, work-arounds were created, and assets held in these states were excluded from financings. None of it satisfactory and all with a fervent hope that the decision does not infect other jurisdictions.

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Congress jumped on the issue by proposing fixes in both the Financial CHOICE Act of 2017 and the Protecting Consumers Access to Credit Act of 2017. Each of these Acts attempted to codify the "valid when made" doctrine, which provides that "[a] loan that is valid when made as to its maximum rate of interest . . . shall remain valid with respect to such rate regardless of whether the loan is subsequently sold, assigned, or otherwise transferred to a third party, and may be enforced by such third party notwithstanding any State law to the contrary." The Acts were each passed by the House of Representatives but failed to receive traction in the Senate. Given the current gridlock in Washington, the prospect of passing any such legislation soon remains dim.

Where does this leave us? Unfortunately, still in limbo. The settlement doesn't preclude the ability for the principles of *Madden* to be adopted by other circuits. Further, there are other pending consumer finance lawsuits that challenge the bank partnership model and raise true lender concerns, such as Avant and Marlette, and now Capital One, which we discuss below. So we're buckled up in the backseat of this rusty station wagon, continuing to monitor these developments as they arise. ■

Big Ben, Parliament, Madden 2.0....

Well, this road trip officially stinks. Although *Madden* settled, hot on its heels is a new class action lawsuit filed on June 12 with the U.S. District Court for the Eastern District of New York, *Cohen v. Capital One Funding, LLC*. This suit claims that various Capital One-affiliated securitization entities and their related trustees violated New York's criminal usury statute by transferring credit card receivables with interest rates in excess of the state's 16 percent usury limit to a securitization trust. The plaintiffs (three Capital One credit card holders) cite the *Madden* holding to support the argument that non-bank purchasers of consumer debt from national banks are not entitled to the benefits of federal preemption under the National Bank Act, and thus national banks cannot assign their ability to charge otherwise usurious interest rates to non-bank third parties. If this lawsuit is successful, it could subject a wide range of securitized consumer debt products – including those backed by credit card receivables, auto loans, and personal loans – to regulation in the states that sit within the Second Circuit and could have an even greater chilling effect on origination volumes and consumer access to credit than *Madden* initially did, as this lawsuit shows that the anti-"valid when made" argument has legs.

In order to counteract this lawsuit and establish potential grounds for a dismissal, at least one industry group, the Structured Finance Association, is planning to ask the Office of the Comptroller of the Currency (OCC) to issue a statement confirming that under the longstanding federal preemption standard, national banks may sell or securitize the loans they originate to non-bank entities without fear of violating conflicting state laws. Such a statement would be consistent with the OCC's broad view of the preemptive effects of the National Bank Act, which was reaffirmed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. It remains to be seen whether that will have any impact on the judicial climate regarding this issue. ■

Play Nice in the Sandbox, Kids: Fostering Innovation in the FinTech Space

Financial technology is evolving and innovating at a speed that far outpaces legislative adaptation. As a result, many financial technology companies have no choice but to develop and test their products and services within existing regulatory frameworks that are often unclear, burdensome, and regressive. This can have the effect of deterring, rather than fostering, innovation.

One solution to this problem is the concept of a "regulatory sandbox." Introduced by financial sector regulators, a regulatory sandbox is a legislative framework that enables financial technology startups and other financial technology innovators and disrupters to test innovations for a limited time within a controlled environment that – although under regulatory supervision and typically limited in the scope of products and services that can be tested, both by quantity and value – is unburdened by traditional licensing and regulatory requirements. Innovators can experiment with new technologies and "work out the kinks" without incurring licensing costs and can abandon unsuccessful innovations at early stages. Regulators can learn how to effectively regulate new technologies, without diminishing consumer protection, and both sides can improve communication. Even investors benefit, as regulatory sandboxes highlight and provide insight into new technologies that investors may wish to support or that the market may wish to participate in. The Consumer Financial Protection Bureau (CFPB) proposed a sweeping regulatory sandbox at the federal level that would give FinTech companies immunity from certain state law, but this effort has been resisted by a number of Democratic state attorneys' general. Nevertheless, individual states have enacted their own regulatory sandboxes.

In March 2018, Arizona created the first regulatory sandbox in the U.S.[1] The 10-year program, which will be overseen and administered by the state's attorney general, will allow participants who offer "innovative products or services"[2] to test technologies over a two year period. At the end of the two-year period, the participant must either apply for a license to continue its service or stop offering the specific innovative product or service in Arizona, unless it applies and receives a one-year extension. Section 41-5601 of the Arizona Revised Statutes defines "innovative" as "the use or incorporation of new or emerging technology or the re-imagination of uses for existing technology to address a problem, provide a benefit or otherwise offer a product, service, business model or delivery mechanism that is not known by the Attorney General to have a comparable widespread offering in this state."[3] The sandbox limits the amounts transacted and the number of consumers using the innovation. The program will be open to financial services companies that would typically fall under the purview of Arizona's Department of Financial Institutions, including lenders, debt management companies, and mortgage brokers. The program also has a reciprocity provision that will allow Arizona participants to operate in other jurisdictions that establish similar programs, including internationally. As of May 16, 2019, the program had six participants.[4]

Wyoming enacted the Financial Technology Sandbox Act in February 2019, becoming the second state to adopt this approach. The framework is similar to Arizona's, allowing participants a two-year test period with a one year potential extension before falling under formal licensure requirements. The program will be overseen by the Wyoming Banking Commissioner and Secretary of State and will take effect on January 1, 2020. Utah followed suit in March by creating a similar program run by its Department of Commerce and allowing the same two-year testing period but with a potential six-month extension period.

States across the nation are recognizing the advantages of utilizing regulatory sandboxes and are joining Arizona, Wyoming, and Utah in enacting legislation to institute such programs. Nevada recently proposed a bill that would create the Regulatory Experimentation Program for Product Innovation, a program similar to its state predecessors.[5] The District of Columbia Financial Services Regulatory Sandbox and Innovation Council, established by the D.C. mayor earlier this year, is currently studying financial services innovation in the District, including the feasibility of implementing a regulatory sandbox.[6] And state banking regulators in New England are exploring the creation of the first regional fintech regulatory sandbox that would harmonize the regulatory regime for the sandbox across Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, and Connecticut.

Success in these jurisdictions could lead to other states making a push to create their own sandboxes. This approach to regulation fosters growth in the financial services industry concurrently with development in regulatory oversight, so that innovators can operate more efficiently, and new challengers can overcome barriers to entry. Coordination with the CFPB will also enhance future efforts to create and expand regulatory sandboxes. ■

[1] https://www.azag.gov/press-release/arizona-becomes-first-state-us-offer-fintech-regulatory-sandbox

[2] https://www.azag.gov/fintech

[3] ARIZ. REV. STAT. ANN. § 41-5601 (2018).

[4] https://www.azag.gov/fintech/participants

[5] https://www.ethnews.com/nevada-senator-wants-to-establish-state-fintech-sandbox

[6] https://disb.dc.gov/release/mayor-establishes-district-columbia-financial-services-regulatory-sandbox-and-innovation

Summer School's in Session: LIBOR 101

The London Interbank Offered Rate (LIBOR), often referred to as the "world's most important number," is a benchmark interest rate calculation that is ubiquitous as the reference rate for trillions of dollars of debt capital markets transactions, including bond issuances, loans and derivatives. Globally, it is estimated that over $350 trillion in financial arrangements are tied to LIBOR as the reference interest rate.

LIBOR is determined each banking day for five major currencies (the U.S. dollar, Swiss franc, euro, British pound sterling, and Japanese yen) with seven different maturities (from overnight to 12 months), and it is based on submissions from a panel of participating banks syndicating the rates at which these large global banks can borrow from each other on a short-term unsecured basis. LIBOR, as an average of those submitted rates, is meant to be an indicator of the health of the global capital markets. For decades, LIBOR has been the worldwide standard measure for pricing a multitude of financial products.

In recent years, however, LIBOR's reliability as a measure of the rate at which banks would transact with one another has been called into question. The interbank short-term unsecured loan market is thin and diminishing over time. The number of actual bank-to-bank transactions is dwindling, with less than $1 billion of U.S. dollar LIBOR daily interbank trading. In addition, confidence in LIBOR was further shaken by schemes, uncovered in 2012, among participating banks to manipulate LIBOR determinations for profit. The LIBOR-rigging schemes involved bankers colluding with one another to provide purported interest rate figures that did not truly reflect the rate at which banks could borrow from one another.

For decades, LIBOR has been the worldwide standard measure for pricing a multitude of financial products.

As a result of the structural weaknesses of LIBOR as a reliable reference rate, regulators in global financial centers around the world have been pushing for LIBOR alternatives. The UK's Financial Conduct Authority (FCA) has urged banks to abandon LIBOR and move to other benchmark rates, announcing that it will no longer require or encourage banks to submit rate data to determine LIBOR following 2021. In the U.S., the Federal Reserve Board and the New York Federal Reserve Bank jointly formed the Alternative Reference Rates Committee (ARRC) to identify a benchmark rate that might replace U.S. dollar LIBOR.

Alternative Benchmark Rates

The ARRC has proposed the Secured Overnight Financing Rate (SOFR), which is based on a combination of three rates for overnight repurchase transactions secured by U.S. Trea¬sury securities, as the successor to LIBOR for U.S dollar transactions. Unlike LIBOR, the determination process for SOFR, which measures the cost of overnight borrowing of cash collateralized by U.S. Treasury securities, includes actual market data. SOFR is derived from a deep and well-defined market and it is produced in a transparent manner based on verifiable data, rather than depending on es¬timates. Moreover, with the continued development of SOFR derivatives markets, market participants will be able to use SOFR to produce robust forward-looking curves for SOFR-based term rates, which will generate the predictability of future rates that is necessary for widespread adoption in the credit markets.

Reconciliation of Credit Agreements and Related Derivatives Agreements

As with the ARRC, the International Swaps and Derivatives Association, Inc. (ISDA), the leading derivatives industry trade association, is promoting SOFR as the appropriate fallback reference rate following the cessation of LIBOR. ISDA has worked in consultation with its members to identify SOFR as its preferred alternative reference rate for hedging agreements; though, there is concern that the fallback language in ISDA agreements may not align with the ARRC-proposed fallbacks for related credit agreements. A potential misalignment between loans and their respective interest rate hedges might lead to significant hedging ineffectiveness. To maintain effective hedging instruments, the related agreements must be consistent both in terms of the respective definitions of the relevant fallback rate as well as in terms of the trigger for transition to that fallback rate. ARRC's current proposal for fallback language includes a pre-cessation trigger (e.g.,, a trigger based on a public statement by the FCA that LIBOR is no longer representative); whereas, prior ISDA fallback proposals rely on a trigger that is not implicated until LIBOR permanently ceases to be published. Inconsistent fallback triggers may result in credit agreements that switch to an alternative reference rate before it has ceased to be published, while any associated hedges using ISDA's currently proposed fallback language would continue to be based on LIBOR until it is officially discontinued. In appreciation of the need to coordinate its approach with that of the approach of cash markets participants, notably the ARRC, ISDA has recently sought further consultation with derivatives industry participants to consider pre-cessation triggers for the fallback language in ISDA agreements.

Not only must triggering language be synchronized in related agreements, but the respective methods of determining the replacement benchmark itself for the cash and derivatives markets must be consistent. ISDA announced that the SOFR determination in its fallback language will utilize a compounded replacement rate calculated in arrears. If the credit markets adopt a different methodology for determining the replacement rate (e.g., a forward-looking term SOFR) instead of a compounded SOFR in arrears, there will be a mismatch between the credit instruments and their associated hedges.

Logistical Challenges of Amending Documents

As the cash and derivatives markets work to adopt a consensus replacement for LIBOR, they are also faced with the task of adequately and efficiently amending legacy agreements to effect a transition to an alternative benchmark rate as seamlessly as possible. Most loan agreements do not provide adequate fallback language in the

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event LIBOR permanently ceases to be published. Historically, loan agreements have provided for alternative rates (typically a prime-based rate or a Fed funds-based rate) to bridge a short-term gap in the availability or publication of LIBOR. These alternative rates do not provide an effective long-term replacement, particularly from a borrower's perspective, as they are typically more expensive than LIBOR and do not represent a lender's cost of funds. The current fallback rates in many loan agreements were never intended to serve as the long-term rates upon which parties transact.

The ARRC has released market consultations on potential fallback language for syndicated loans, floating rate notes, bilateral loans, and securitizations, and in April 2019, the ARRC published its recommendations of fallback language for syndicated loans and floating rate notes, based on such consultations. Even with market-standard fallback language, the amendment process presents enormous challenges. As a secured rate, SOFR is expected to be lower than LIBOR, so spread adjustments will be required, the negotiation of which may challenge otherwise straightforward loan modification negotiations for bilateral loans among sophisticated lenders and borrowers. The greater challenge, however, may be obtaining requisite consents among lenders in a syndicate, the credit agreement for which could require the approval of lenders holding up to 100 percent of the outstanding loan for any proposed modification of the method for calculating interest. In addition, many floating rate notes programs require the consent of noteholders holding 100 percent of the outstanding notes to effect amendments to interest rates. To the extent that such notes are broadly held, especially if a significant portion of the noteholders are retail investors, it is difficult to see how the appropriate modifications may be made in a timely manner, if at all.

The process for amending ISDA documents is easier than amending the LIBOR-based credit agreements to which those hedging documents relate. ISDA intends to amend certain of its standard documentation, notably the 2006 ISDA Definitions, to implement the necessary fallback language for derivatives transactions entered into after the effective date of those amendments. For existing ISDA agreements, ISDA intends effect the appropriate amendments to its documents on a market-wide basis through its protocol process. An ISDA protocol is a multilateral contractual amendment mechanism that provides an efficient and uniform means of implementing industry-wide contractual changes over a broad number of counterparties. Through the protocol process, ISDA acts as an agent for participating parties and posts the relevant protocol on its website, receives letters from participants indicating adherence to the posted protocol and updates its website with the list of all adhering parties. ISDA's protocol process seeks to eliminate the need for amendment negotiation among trading counterparties, which reduces frictions in the amendment process, but it also creates uniformity of amendments throughout the industry, so that each market participant is not left to devise its own new contract language.

Both credit and derivatives market participants must assess their LIBOR exposure and if they are parties to LIBOR-based agreements that extend beyond 2021, they must determine whether those agreements have adequate benchmark rate fallback provisions for the situation where LIBOR permanently ceases to be published. If these agreements do not have adequate fallback provisions, market participants should undertake to make the necessary amendments as soon as possible to provide for fallbacks that preserve as closely as possible the intended economics of such contractual arrangements. ■

Sweating Out the QM Patch Expiration

The "QM Patch" was enacted as a temporary provision of the qualified mortgage rule to allow Fannie Mae and Freddie Mac to exceed the qualified mortgage debt-to-income ratio (DTI) and originate or acquire mortgage loans with a DTI in excess of 43 percent. Approximately $210 billion to $310 billion of annual originations are currently protected by the QM Patch. Unless extended, the QM Patch will automatically expire on January 10, 2021, generating a significant effect on the agency and private-label securities (PLS) secondary markets and the U.S. housing market writ large. We would expect mortgage interest rates, housing prices, and the availability of mortgage credit to be adversely affected as well if there is no suitable or market-accepted replacement.

When thinking about the potential effects of the expiration, consider that it could disproportionately impact disadvantaged borrowers and borrowers in underserved communities, as they are the primary beneficiaries of the QM Patch. Another discomfiting thought is whether the market could readily absorb the shift if all these mortgage loans suddenly became available in the PLS market. But good lawyers don't just raise problems without solutions. Aside from just letting the QM Patch expire, proposed solutions include moving from a DTI analysis for QM eligibility to an average prime offer rate (APOR) analysis, which is used as a market rate benchmark against which the actual interest rate on the mortgage loan is compared, as is currently done with "QM-rebuttable presumption" mortgage loans. Another solution is to use the technology of DU/LP automated underwriting currently used by government-sponsored enterprise s (GSEs) but have the factors used in the decision set by the government regulators.

> Approximately $210 billion to $310 billion of annual originations are currently protected by the QM Patch.

As a law firm that is active in the residential mortgage-backed securities (RMBS) market, we have some anxiety about the QM Patch expiring, and while we would like to see the growth of the PLS market, we think a staggered approach to expiration might ease the overall market impact. For example, rather than allowing all $260 billion to hit the private market at once, instead, a better approach would be to step-down the DTI requirement gradually and over time. A similar approach could be considered for each of the various proposals.

The secondary market will bear most of the burden of the QM Patch suddenly expiring, and as mentioned above, there are concerns about the market's ability to absorb all these mortgage loans. Steps should be taken to address this. Expanding the RMBS market to include a public option for securitization would be beneficial to market transparency, pricing, and the secondary market. Amending Regulation AB II to reduce the currently onerous disclosure requirements could make public RMBS viable again. Additionally, completing the Structured Finance Association's RMBS 3.0 project would establish some guidance for securitization transactions and may increase the number of participants in the secondary market. Regardless, the RMBS PLS market may expect to see a significant increase in the number of transactions completed in the coming years. ■

It's Christmas in July!

Residential Mortgage Lender Survives Challenge to ATR/QM

Since the inception of the qualified mortgage rules, we have all been doing some hand-wringing over what a challenge to a lender's "ability to repay" determination could look like. Well, we can now breathe a collective sigh of relief. In what appears to be a case of first impression, the U.S. District Court for the Southern District of Ohio rejected a consumer's ability-to-repay defense that was raised to prevent foreclosure of the consumer's home. *Elliot v. First Federal Community Bank of Bucyrus*, filed on March 26, 2019, is instructive because, up to this point, there has been no defining judicial precedent interpreting the CFPB's ability-to-repay/qualified mortgage regulations since such regulations became effective on January 10, 2014.

These regulations generally require creditors to make a reasonable, good-faith determination at or before consummation of a consumer credit transaction secured by a dwelling that a consumer will have a reasonable ability to repay the loan according to its terms. The regulations provide a "safe harbor" for compliance with the ability-to-repay rules to creditors or assignees of loans that satisfy the definition of a qualified mortgage and are not higher-priced mortgage loans. They also provide a "rebuttable presumption" of compliance with the ability-to-repay rules to creditors or assignees for higher-priced mortgage loans, defined as loans with an annual percentage rate (APR) exceeding the average prime offer rate by 1.5 or more percentage points for first-lien loans, or by 3.5 or more percentage points for subordinate-lien loans.

In *Elliot*, the plaintiff was an experienced realtor in his 80s and at the time of the loan transaction in question, was separated from his spouse. The defendant bank underwrote the loan based on the terms of the separation agreement between the couple, under which the plaintiff would receive monthly spousal support in addition to his monthly job income, social security payments, and certain rental income. The bank deemed the income from these sources sufficient to support payment of the mortgage. Under the separation agreement, the plaintiff took sole title to the property that had been the couple's marital home and was the sole mortgagor on the loan.

In underwriting the loan, the defendant bank relied on the repeated assurances that the couple was committed to the terms of the separation agreement, the fact that the couple had been longtime customers of the bank in good standing, and most importantly, that the plaintiff's debt-to-income ratio was below the 40 percent threshold established by the bank and that his 660 FICO score was above the bank's minimum threshold.

After the loan in question was originated, the relationship between the couple deteriorated. In the ensuing divorce proceedings, the property was re-divided, and the plaintiff received significantly reduced spousal support. The plaintiff was also fired from his job and incurred additional debts during the divorce proceedings. As a result, the plaintiff became delinquent in his mortgage payments and ultimately defaulted on the loan. The bank then sought to foreclose on the mortgaged property. The thrust of the plaintiff's claim is that the bank failed to make a "reasonable and good faith determination based on verified and documented information" that he had a "reasonable ability to repay the loan."

The court, in rejecting the plaintiff's claim and in granting summary judgment for the defendant bank, observed that "the bank did its due diligence to confirm Plaintiff would have the ability to make the payments on his mortgage," and the fact that the parties did not adhere to the settlement agreement when opting for divorce "was not an event that was reasonably foreseeable to the bank." Notably, the court dismissed the plaintiff's assertion that the bank approved the loan in violation of Appendix Q of the CFPB's ability-to-repay/qualified mortgage regulations, which establish the standards lenders must use to calculate the borrower's total debt-to-income ratio (which cannot exceed 43 percent at the time of consummation) under the standard qualified mortgage definition. In particular, the plaintiff contended that the bank should not have considered the plaintiff's spousal support that he was receiving under the separation agreement and certain rental income as reliable sources of income under Appendix Q. The court, in refuting these arguments, ruled the bank's debt-to-income ratio determination was amply supported by the plaintiff's tax returns (which reflected the spousal support payments) and a written lease that evidenced the rental income received by the plaintiff.

In rendering its decision in favor of the defendant bank, the court ultimately permitted the bank to foreclose on the mortgaged property and collect ancillary fees (such as court costs, accruing interest, and default interest) associated with the plaintiff's defaulting on the mortgage.

The *Elliot* decision is significant because, as the first-known precedent addressing the CFPB's ability-to-repay/qualified mortgage standards, the court's ruling is inherently sensible in upholding the defendant bank's ability-to-repay and qualified mortgage determinations. The essence of the ruling is that, before making the loan, the bank possessed ample evidence to document that the loan met the CFPB's qualified mortgage criteria and that the plaintiff had the ability to make the monthly mortgage payments. The regulations require that lenders make these ability-to-repay and qualified mortgage determinations at or before loan consummation. This case confirmed that Lenders are not required to anticipate, and will not be held responsible for, unforeseen events occurring after origination that adversely impacts their initial underwriting determination, such as divorces, serious illnesses, and job losses. *Elliot* is a win for the mortgage industry that is consistent with the purpose and intent of CFPB regulations. ■

Locate Your Lemonade Stand Here: The Tax Benefits of Investing in Opportunity Zones

In enacting sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code, the Tax Cuts and Jobs Act of 2017 sought to encourage economic development and job creation in economically distressed communities that are designated as qualified opportunity zones (OZs). OZs cover approximately 12 percent of the land in the U.S., and investment in OZs offer investors specific tax benefits. An investor making qualified investments in qualified opportunity funds (QOFs) may be eligible to (i) elect to defer tax on the invested gains until the earlier of the investor's disposal of the investment and December 31, 2026, (ii) receive a basis step-up of up to 15 percent of the original amount invested, and (iii) exclude tax on the appreciation in the investment if held for more than 10 years.

> OZs cover approximately 12 percent of the land in the U.S., and investment in OZs offer investors specific tax benefits.

The Treasury has released two tranches of proposed Treasury regulations augmenting and clarifying the statutory language of Section 1400Z-2, and the IRS has released certain other guidance clarifying the rules applicable to the OZ program. The first set of regulations, released in October 2018, was generally taxpayer-friendly and made clear that the Treasury and IRS desire to make the program practical and usable for investors, business owners, and real estate developers alike. The second set of regulations, released in April 2019, reaffirmed the Treasury and IRS's stance in this respect. Although many commentators and industry participants expected a third tranche of regulations, officials have indicated that a third tranche is not planned – in hopes that investors will be willing to act based on regulations (which generally may be relied upon by taxpayers) and other guidance provided thus far.

The second tranche of regulations provided particularly favorable rules for tangible property leased by a QOF or qualified opportunity zone business (QOZB). Under the regulations, leased tangible property can be qualified ("good") property for purposes of the asset test to which QOFs and QOZBs are subject, provided that the lease was entered into after 2017, the property is used in an OZ, and certain other requirements are satisfied. Furthermore, unlike owned tangible property, the "original use" of leased tangible property need not be in the OZ, and there is no requirement to "substantially improve" leased tangible property. Even tangible property leased from a related party may be qualified property, provided that certain additional requirements, generally designed to avoid abuse, are satisfied. The flexible rules allowing for leased tangible property to be qualified property may allow for, among other things, sale-leaseback arrangements to facilitate the qualification of investments in real estate development projects or operating businesses that may not otherwise qualify for OZ benefits.

The second tranche of regulations also provided rules designed to allow investors to elect exclusion of certain flow-through gains or capital gains dividends resulting from a QOF's disposition of property following the 10-year anniversary of the investor's acquisition of its interest in the QOF. Although these rules provide much needed flexibility, investors and managers alike should still scrutinize the form of asset dispositions after 10 years, as certain forms of dispositions will trigger depreciation recapture to investors, while others will not.

Although the second tranche of regulations includes a long list of taxpayer-favorable rules, one rule viewed by many as unfavorable to taxpayers requires that 1231 "net gains" (generally defined as net gains from the disposition of property used in a trade or business) be invested during the 180-day period beginning after the year in which the gain is recognized. Thus, for example, an investor who realizes a 1231 gain in January of year 1 would not be able to make a qualifying investment of such gains until the 180-day period beginning at the start of year 2 (even if the investor knows that it will not subsequently experience any 1231 losses that would reduce or eliminate its year 1 1231 net gains). For this reason, an investment opportunity arising in June of year 1 may be missed. Notwithstanding this unfavorable rule, other rules provided in the second tranche of regulations (for example, the ability to make a qualifying investment in a QOF interest acquired on the secondary market) may allow investors structuring alternatives to fund investments prior to the 180-day period beginning in year 2 and ultimately achieve favorable results.

The regulations on OZs have been pleasantly taxpayer-friendly thus far, and investment activity in OZs has increased as a result. Taxpayers should take comfort in the stance of the Treasury and IRS on the OZ program thus far. The guidance released to date gives reason for hope that any changes to the regulations in response to comments prior to their finalization will be favorable to taxpayers and further facilitate investment in OZs. ■

MSR Valuations: More Than Just a Summertime Slump?

The Federal Reserve recently expressed concerns for a slowing economy during its June meeting, and although it left interest rates unchanged, certain of its leaders indicated that a rate cut may be on the horizon before the end of the year. As the Federal Reserve signals readiness to lower interest rates for the first time since 2008, what does this mean for mortgage servicing rights?

Mortgage servicers service mortgage loans in exchange for a fee, which is typically paid from a portion of the monthly interest payments received on the serviced loans and certain additional ancillary income. This fee is intended to cover a servicer's costs associated with various servicing functions such as processing payments of principal and interest, directing escrow funds of taxes and insurance on behalf of borrowers, and managing delinquencies and foreclosures. The contractual right to service a mortgage loan for this fee is called a mortgage servicing right (MSR).

How are MSRs valued? Not easily. Their value is derived from the net present value of the expected future cash flow of the related mortgage servicing contract, and a future stream of income can be difficult to determine. One measure commonly used to value MSRs and that is a driving factor in valuation models is interest rates and the probability of a mortgage loan prepayment resulting in termination of the servicing fees, typically as a result of a refinancing.

The value of MSRs is inversely related to interest rate movements. In a rising interest rate environment, mortgage rates increase and, as a result, prepayment speeds tend to decrease. Fewer prepayments and more certainty around continuing to receive servicing fees augments the value of MSRs. Over the past several years as interest rates have steadily climbed, MSR values have been on the rise, enhancing investor appetite for MSRs, which is also a contributing factor to the high value placed on MSRs.

Conversely, when interest rates decline, the propensity of borrowers to prepay or refinance their mortgage loans increases, thereby reducing the likelihood of future cash flows from existing MSRs and, consequently, the value of the MSRs as well. Looking back over the past 12 months, the 30-year mortgage rate peaked in November at 4.94 percent and has steadily declined since then to 3.75 percent at the end of Q2. It is no surprise then that several major MSR holders have been reporting significant drops in MSR values. This trend does not bode well for what has been, until recently, a robust market.

Earlier this month, Federal Reserve Chairman Jerome Powell indicated that the uncertain U.S. economic outlook could lead to a reduction in the Fed's benchmark short-term interest rate at its next meeting on July 30. Prognosticators are prognosticating a step-down of 25 basis points—nothing too aggressive, but headwinds for the MSR market nonetheless. Our takeaway is that, if they haven't already, MSR investors and borrowers alike should now consider building early amortization triggers into MSR financings that are based on the value of the MSR portfolio. These triggers will protect lenders and borrowers from abrupt fluctuations in MSR values and will allow for acceleration of the debt over time rather than upon a sudden decline in value. ■

No Shirt, No Shoes, No Service: NYDFS to Overhaul Mortgage Loan Servicer Business Conduct Rules

The New York State Department of Financial Services has proposed significant changes to the mortgage servicer business conduct rules found in Part 419 of the Superintendent's Regulations. The proposed changes represent the first major changes to Part 419 since its adoption nearly 10 years ago. Some of the significant proposed changes to Part 419 include:

- Adding new provisions governing affiliated business arrangements, which would include a requirement that such relationships be negotiated at market rate, restrictions on certain kick-backs, and a requirement to provide borrowers with a written disclosure of the relationship;
- Restricting a servicer from charging a property valuation fee to a borrower more than once in a 12-month period;
- Broadening a servicer's duty of fair dealing to include ability to repay requirements for loan modifications and that a servicer consider foreclosure alternatives;
- Broadening the protections available to delinquent borrowers and borrowers seeking loss mitigation assistance to more closely align with the CFPB's Mortgage Servicing Rules, including a requirement that acknowledgment notices be delivered more quickly than under the current rules and providing borrowers with additional time to accept or reject a loss mitigation offer; and
- Detailed third-party vendor management requirements, which would require a servicer to maintain policies and procedures overseeing third-party providers generally and more specific requirements for overseeing counsel and trustees of foreclosure proceedings.

The deadline for comment on the proposal was June 29, 2019. ■

Alston & Bird Launches Consumer Finance Blog

Check out our new blog, Consumer Finance ABstract, for commentary on regulatory and compliance developments affecting all areas of consumer lending, including mortgage, installment, credit card, auto, student, and peer-to-peer. The blog focuses on the regulation of consumer credit and real estate finance and the compliance challenges faced by major Wall Street financial institutions, including federal- and state-chartered depository institutions, hedge funds, private equity funds, nonbank lenders and servicers, appraisal management and title companies, and others.

Recent posts include:

- Will Maine Begin to Regulate Passive, Secondary Market Investors in Student Loan Debt?
- Appraisal Reform Act of 2019 Would Impact TRID
- Connecticut Officially Becomes an Attorney Closing State
- Will the CFPB Find Its Voice on "Abusiveness"?

QM Patch Symposium

On June 20 in Washington, D.C., SFA (formerly SFIG) and Andrew Davidson & Co. invited thought leaders, including our own Richard Simonds, to a closed-door discussion of the expiration of the QM Patch in 2021. Topics discussed included the current state of the QM and non-QM markets, how the GSEs are currently providing access to credit through the GSE Patch, concerns of current RMBS issuers and investors, and alternative proposals that would provide for additional private capital and a more level playing field while meeting the needs of borrowers currently being served by the QM rule. SFA has committed to continue working with members and stakeholders to explore paths to ensure a smooth transition for borrowers while creating a level playing field for private capital.

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