

SECTOR COMMENT

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RMBS - US

Lack of Diligence For TRID Compliance Violations Exposes Future GSE Credit-Risk Transfer RMBS to Some Incremental Losses

Executive Summary

The Federal Housing Finance Agency's (FHFA) directive to the government-sponsored enterprises (GSEs) [Fannie Mae](#) and [Freddie Mac](#) not to conduct loan-level reviews for technical compliance with the Consumer Financial Protection Bureau's (CFPB's) [TILA-RESPA Integrated Disclosure Rule](#) (TRID rule) exposes future GSE credit-risk transfer (CRT) transactions to the risk of some incremental losses for lender compliance violations. We expect overall losses on these transactions owing to TRID violations to be fairly small, despite our expectations that the frequency of violations will be high, at least initially. Furthermore, lender representations and warranties (R&Ws) and the GSEs' ability to remove defective loans from the transactions will likely mitigate some of these losses. While the CFPB has indicated that it will be lenient on lenders that make a good faith effort to comply with the rule, such guidance does not protect against borrower claims.

By contrast, future private-label residential mortgage-backed securities (RMBS) will be less exposed to these risks because private-label issuers are conducting thorough third-party due diligence for the loans that they purchase. Furthermore, while the due diligence feedback loop is enabling lenders who sell to private-label issuers to cure TRID violations and fix flawed processes, lenders who sell only to the GSEs do not directly benefit from this feedback and may be slower to improve processes.

GSE due diligence will not detect TRID compliance violations

A lack of transparency regarding how many loans in future GSE-sponsored CRT transactions will contain material violations of the TRID rule will be a credit negative for these transactions. Both Fannie Mae and Freddie Mac have stated that they will not conduct routine post-purchase loan file reviews for technical compliance with the TRID rule during a transitional period, a move that comes at the direction of the FHFA. The GSEs did not specify how long the transitional period would last, but during this time TRID-related checks will be limited only to whether the lender used the correct forms and will not verify whether or not the information on the forms is correct. After the transitional period, the GSEs will consider whether to begin such reviews. TRID applies to loans whose borrowers have submitted applications on or after 3 October 2015.

Merely checking that the correct forms are included in the loan file will not identify incorrect information on those forms, which could violate the rule. Such violations could cause losses on loans backing GSE CRT transactions if borrowers successfully claim TRID violations as a defense to future foreclosures or if attorneys bring class action lawsuits within the first year after loans close.

GSE-owned loans will have exposure to TRID violation claims

Loans purchased by the GSEs will likely have a high frequency of TRID compliance violations. Feedback from third-party review (TPR) firms has revealed a [very high frequency](#) of TRID compliance violations in the first pipeline of residential mortgage loans from various lenders that they reviewed. Although the loans subject to these reviews are typically sold to aggregators looking to include them in private-label RMBS or other non-GSE trades, we have no reason to believe they are not indicative of the wider market, including loans originated for sale to GSEs. So far none of the GSE CRT transactions have included loans originated after TRID's effective date.

The CFPB has issued [informal guidance](#) to reassure lenders that initially it will be lenient in enforcing the TRID rule and that government agencies, as well as the GSEs, will not check for technical compliance with the rule or enforce repurchase remedies against a lender making good faith efforts to comply. Such assurances will not protect against claims made by borrowers, however, which are beyond the CFPB's purview.

Losses owing to TRID violations will only affect future GSE CRT transactions that have "actual loss" structures. Since April 2015 for Freddie Mac ([STACR 2015-DNA1](#)) and October 2015 for Fannie Mae (CAS 2015-CO4) all CRT transactions have had "actual loss" structures, meaning that bondholders bear losses based on the actual losses that the loans incur. If the GSEs were to structure future deals like the earlier Structured Agency Credit Risk (STACR) debt notes and Connecticut Avenue Securities (CAS) deals, in which bondholders bore losses according to a fixed formula regardless of a loan's actual loss, bondholders would not suffer losses from TRID violations.

Losses owing to TRID violations will be fairly small

Unlike damages for violating predatory lending laws, which could cause losses to a securitization transaction in excess of the loan's balance, damages for TRID violations are less significant because the rule caps them to a fairly small amount and their occurrence will depend on a number of conditions. For individual claims, TRID limits potential damages to statutory damages of up to \$4,000, actual damages and borrower attorney's fees and court costs. Furthermore, borrowers can receive only one set of damages on a loan, even if there are multiple TRID violations.

A transaction will only realize losses owing to TRID violations if numerous conditions occur. For defensive actions, losses would occur only if: (1) the borrower defaulted and the loan went to foreclosure, (2) the borrower successfully asserted a TRID violation as a counterclaim permitted under state law, (3) the loan contained a TRID violation that carries assignee liability (a subset of all potential TRID violations), (4) the TRID violation is one that carries statutory damages (a subset of TRID violations that carry assignee liability) or the borrower is able to prove actual damages (unlikely), and (5) investors are not otherwise made whole through enforcement of R&Ws or removal of the loan from the transaction.

Until courts or the CFPB further clarify the issues, there is some uncertainty surrounding which potential TRID violations carry assignee liability and which of these carry statutory damages. The potential violations that carry statutory damages bear more risk because the borrower need not prove harm to win them. Actual damages are less of a risk because borrowers would need to prove that their reliance on the erroneous information caused them harm, which historically has been near impossible.

Class action lawsuits and rescission defenses are two other potential scenarios in which a CRT transaction could bear losses, yet we think the risk of each is fairly low. TRID permits class action lawsuits during a loan's first year and assignees could be liable for violations, as would the lender that committed them. The risk to a CRT transaction is low because TRID limits class action damages to the lesser of \$1 million or 1% of the lender's net worth, plus attorney's fees and court costs. This amount is insignificant compared to the extremely large loan pools backing CRT transactions. Furthermore, the lender, and not the CRT transaction, would likely bear the damages. If the lender is out of business, the GSEs could remove the loans from the pool.

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Rescission actions could cause larger losses on the related loans, but their likelihood is small. A borrower would be permitted to rescind a loan for up to three years and cause the transaction to forfeit all of the interest and costs the borrower paid if certain key disclosures on the TRID forms, such as the annual percentage rate, the finance charge, the amount financed, the total number of payments, the payment schedule, or certain prepayment penalty disclosures, were erroneous. However, we think rescission actions would be uncommon because a borrower would need to pay off the loan's principal balance to rescind the loan. Furthermore, if the GSEs become aware of any such action, they would likely seek indemnification from the lender for breach of R&Ws or remove the loan from the pool.

Remedies will likely mitigate some losses owing to TRID violations

Bondholders in CRT transactions would not bear losses owing to TRID violations if the GSEs become aware of the violations and decide either to pursue remedies against the lenders for breaches of R&Ws or to remove the loans from the pool. Although the GSEs do not have procedures in place to test all defaulted loans for violations of applicable laws and regulations in STACR and CAS transactions,¹ the GSEs' oversight of loan liquidations will likely lead to the discovery of TRID violations that cause loan losses. The GSEs require servicers to report detailed information itemizing collections and expenses for each loan liquidation. If a TRID violation causes a reduction of expected loan proceeds, the servicer will report it, the GSEs believe. If the GSEs determine that the violation is a material underwriting defect, they will likely take actions to make the transaction whole, either by seeking reimbursement from the lender for breaching R&Ws and passing such reimbursement to the transaction (Fannie Mae)² or removing the loan from the reference pool at par and separately seeking redress from the lender on its own behalf (Freddie Mac).

Despite these potential investor protections, some uncertainty remains as to how effectively these protections will work in actual practice given the newness of the TRID rule. Our two main questions are whether GSE oversight will, in fact, lead to the discovery of each TRID violation that causes a loss, and, if informed, whether the GSEs will deem such violations as material underwriting defects worthy of taking action to compensate the transaction.

Private-label RMBS will be less exposed to TRID violations than will GSE CRT transactions

As long as private-label RMBS issuers continue to do 100% due diligence, it is likely that their transactions will not include loans with material TRID violations. [Agate Bay Mortgage Trust 2016-2](#) was the first private-label RMBS deal to include loans subject to TRID. While the pool did include some loans with TRID violations, the TPR review indicated that they were not material.

On the other hand, GSE-sponsored CRT transactions will likely include loans with material TRID violations because there is no post-closing TRID review and the pre-transaction due diligence typically consists of only a small loan sample relative to the entire pool.

Furthermore, lenders that sell only to GSEs will not benefit directly from the feedback that TPR firms hired by private-label RMBS issuers provide, and thus they may be slower to cure violations or flaws in their own TRID disclosure processes. Nevertheless, even these lenders will likely benefit from some industry-wide process improvements, such as fixes to third-party vendor systems, implemented in response to TPR feedback.

Endnotes

- [1](#) However, at least one CRT transaction that we rated, the Freddie Mac Whole Loan Trust 2015-SC02 transaction, is an exception. This transaction does require a third party to test all seriously delinquent loans for breaches of R&Ws.
- [2](#) If the lender is bankrupt and unable to reimburse the transaction at the time that Fannie Mae identifies a material underwriting defect, Fannie Mae will likely remove the loan from the reference pool at par and the investors will suffer no loss.

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