THE WATERING DOWN OF FEDERALLY RELATED TRANSACTIONS

BY JOHN RUSSELL

What exactly is a "federally related transaction (FRT)"? Wait, that's not the right question. Let's start here: What is NOT an FRT?

An FRT is not a mortgage loan insured by the Federal Housing Administration (FHA). It's not lending underpinned by the Department of Veterans Affairs (VA) home loan program. It certainly isn't a loan that is sold to a Government-Sponsored Enterprise (or GSE), like Fannie Mae or Freddie Mac. Just considering a loan for sale to those two entities is enough to fall outside the scope of an FRT. And, of course, any loan beneath the $250,000 appraisal threshold amount.

Now that we've clearly stated what does NOT constitute an FRT, let's answer the original question: An FRT is a mortgage loan whose total amount is above the $250,000 threshold, is not insured or guaranteed by a federal agency, and is not sold or contemplated for sale to a GSE such as Fannie or Freddie.

That doesn't sound very "federally related," does it? And more to the point, how many of these loans exist in the mortgage lending marketplace? The short answer to the second question is between 8-12% of all mortgage activity falls within the contours of an FRT. So, what happened to the federal nexus with FRTs in the first place?

To answer that, one must look at the implementing regulations promulgated in 1994 by the federal banking agencies. Those rules created a number of exemptions from the definition on an FRT. These exemptions were created to address lenders concerns about duplication efforts when originating

loans which were both considered FRT's. The intent was to meet the original definition and requirements of either a federal insurance or guaranty program for those of the secondary market as set by the GSE's.

The exemptions help make clear that when an agency or GSE have its own robust appraisal requirements, those would be controlling as they were (and still are) considered similar to the obligations imposed under Title XI of FIRREA.

As recently as 2010, the federal banking agencies emphasized that the 1994 exemptions only cover those transactions that otherwise meet the insurer/guarantor/GSE underwriting and appraisal requirements. This clears up the point of the 1994 regulations – exemption does not mean waiver but instead means a replacement regime exists that is no less rigorous than what Congress contemplated in Title XI in the first instance and can stand in the place of Title XI obligations.

No matter the intent of the federal banking agencies, though, there are unintended consequences that come with the 1994 exemptions. For starters, numerous state laws that followed FIRREA's passage rely in part or in whole on the definition of an FRT to define who must have a license or certification, as well as the scope of a state's enforcement program. Which definition is controlling for these purposes: The original definition as passed by Congress in 1989, or the one with exemptions under the 1994 regulations? This confusion has led state regulators to ask for clarification surrounding the matter, so they can either continue with their program as designed or go to their legislature and seek the necessary technical corrections.

But the more troubling consequence of the 1994 exemptions is that they give federal agencies and, more pointedly, the GSEs a disproportional amount of control over appraisal requirements for their purposes. In acting with FIRREA and in the wake of the savings and loan debacle of the 1980's,

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Congress made two clear declarations to the lending community. First, that the value of the property on which they were making loans needed to be a primary factor in a lending decision, and not a secondary paper for the file. Second, appraisals had to be performed by qualified professionals who followed standards. Even with the more recent housing finance crisis of the mid-2000's, we are seeing a move by the GSEs to eliminate appraisals on a range of purchase money and refinance mortgages. Loans that are likely to fall within what Congress originally intended to capture as an FRT, but that was carved out in 1994.

Time will tell if this pivot winds up being a fulcrum for the next housing finance meltdown. But one thing is clear: The appraisal requirements that Congress intended to impose on mortgage lenders with FIRREA simply don't exist anymore, between the watering down of the FRT definition and, just as critically, the fivefold increase in the appraisal threshold amount. By letting those with a direct financial interest in the transaction have the latitude to rewrite the rules as they see fit for business purposes, we lose sight of the very safety and soundness principles that are supposed to undergird the mortgage lending market in the first place. Not to mention the fact that buying a house is the single largest investment most Americans will ever make.

Conversations on finding the healthy middle ground on appraisals are happening in Washington with growing regularity as we try to get out of the constant regulatory/deregulatory swings that come with the boom-bust nature of the housing market. It's clear from any perspective that, as currently constituted, the definition of FRT simply does not reflect the majority of the mortgage lending environment and recent regulations essentially allowed the fox to watch the henhouse regarding valuations and prudent lending decisions.

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