[JOINT COMMITTEE PRINT]

DESCRIPTION OF S. 2096
RESIDENTIAL MORTGAGE INVESTMENT ACT

SCHEDULED FOR A JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

AND THE

SUBCOMMITTEE ON SAVINGS, PENSIONS, AND INVESTMENT POLICY

OF THE

SENATE COMMITTEE ON FINANCE

ON MARCH 26, 1984

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet provides a description of S. 2096 (the Residential Mortgage Investment Act), introduced by Senators Packwood, Tsongas, Dodd, Hawkins, and Levin. The bill is scheduled for a joint hearing on March 26, 1984, before the Senate Finance Subcommittees on Taxation and Debt Management and Savings, Pensions, and Investment Policy.

The first part of the pamphlet is a summary. This is followed in the second part with a description of the bill and present law.

I. SUMMARY

Under present law, if an employer maintains a funded pension or welfare plan, a fiduciary of the fund is prohibited from causing the fund to engage in certain transactions with people who might have a conflict-of-interest with respect to the fund. Present law also prohibits specified self-dealing transactions by a fiduciary. The specific conflict-of-interest and self-dealing rules are provided in addition to the general fiduciary standards relating to prudence and requiring diversification of investments.

The bill would exempt certain mortgage transactions from the prohibitions against conflict-of-interest transactions. The bill would also prohibit certain interpretative or implementing administrative rules or orders. The bill would apply on the date of enactment.

II. DESCRIPTION OF THE BILL

A. Present Law

Fiduciary standards

In general

The fiduciary standards of ERISA (the Employee Retirement Income Security Act of 1974) require that the fiduciary of a pension or welfare plan meet minimum standards with respect to the handling of plan assets and that the fiduciary refrain from certain prohibited transactions involving self-dealing or conflict-of-interest. Under the Internal Revenue Code, regulatory excise taxes are imposed on a fiduciary who violates the prohibited transaction rules.

Prudence and diversification

Under ERISA, a fiduciary duties with respect to a plan are to be discharged solely in the interest of the participants and beneficiaries. ERISA provides that fiduciary duties are to be discharged for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.

ERISA requires that fiduciary duties be discharged with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. A fiduciary is required to diversify the investments under a pension or welfare plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. In addition, fiduciary duties are to be discharged under a plan in accordance with the documents and instruments governing the plan insofar as those documents and instruments are consistent with the provisions of ERISA.[1]

Employer real property

ERISA provides limited exceptions to the prudence standard in the case of certain defined contribution plans (individual account plans) that acquire qualifying employer real property or qualifying employer securities. Under ERISA, a fund may not generally hold employer real property unless it is qualifying employer real property. Parcels of employer real property qualify only if (1) a substantial number of the parcels are dispersed geographically, (2) each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use, (3) each parcel of real property is leased to one lessee (which may be an employer or an affiliate of an employer), and (4) the fiduciary

[1] ERISA section 404.

standards (other than the diversification aspects and the prohibited transaction provisions), are met with respect to the acquisition and retention of the property. Except for certain individual account plans, a plan is prohibited from acquiring qualifying employer real property if, immediately after the acquisition, the value of aggregate holding of qualifying employer real property and qualifying employer securities exceed 10 percent of the fair market value of the assets of the plan.[2]

Prohibited transactions

Conflict-of-interest rules

A fiduciary of a plan is prohibited from causing the plan to engage in certain self-dealing and conflict-of-interest transactions which are generally known as prohibited transactions. The prohibition applies if the fiduciary knows or should know that the transaction is: a direct or indirect (1) sale or exchange, or leasing of any property between the plan and a party in interest; (2) a lending of money or other extension of credit between the plan and a party in interest; (3) a furnishing of goods, services, or facilities between the plan and a party in interest; (4) a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or (5) an acquisition, on behalf of the plan, of any employer security or employer real property in violation of the special rules applicable to such transactions.

Under the Code, disqualified persons include any fiduciary, service provider, contributing employer, union whose employees are covered by the plan, certain owners of the employer, and certain persons who are related to them. Under the ERISA, the prohibited transaction rules apply to parties in interest. In addition to disqualified persons, all employees of an employer are parties in interest.

Self-dealing rules

In addition, a fiduciary with respect to a plan is prohibited from: (1) dealing with the assets of the plan in his own interest or for his own account; (2) in an individual capacity or in any other capacity, acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries; or (3) receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

Exemptions from prohibited transactions

ERISA provides a procedure under which the Secretary of Labor may grant individual or class exemptions from the prohibited transaction rules. The Secretary may not grant an exemption, however, unless the Secretary finds that it is administratively feasible, in the interests of plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. In addition, notice of the pendancy of an exemption is required to be

[2] ERISA section 407.

published in the *Federal Register*, notice is required to be provided to interested parties, and interested parties can present their views at a hearing. ERISA and the Code also provide statutory exemptions from the prohibited transaction rules. In particular, a loan to a party in interest who is a participant or beneficiary is not prohibited if it meets certain standards set forth in ERISA. One of these standards requires that the loan bear a reasonable rate of interest.

Class exemptions

Pension plans can undertake residential mortgage transactions with regard to the ERISA prohibited transaction provisions unless they involve disqualified persons (parties-in-interest). The Department of Labor has issued two class exemptions that allow plans to undertake residential mortgage transactions when disqualified persons (parties-in-interest) are involved without applying for an individual exemption.

PTE 82-87 permit plans to engage in a wide range of mortgage transactions including the issuance of commitments, receipt of fees, origination or purchase of mortgage loans and the sale, exchange or transfer of such mortgage loans. The exemption provides relief only from the conflict of interest provisions of Code section 4975(c)(1) (A)-(D) (and section 406(a) of ERISA) and only where certain protective conditions are met.

These conditions include that the decision to engage in a mortgage transaction must be made on behalf of the plan by a qualified experienced fiduciary who is independent of the parties to the transaction. Second, mortgage loans to be acquired must, at the time of origination, be eligible for purchase through an established program by FNMA, FHLMC or GNMA. Third, the terms of any loan or commitment must be at least as favorable to the plan as a similar transaction involving unrelated parties.

While PTE 82-87 deals with direct mortgage investments, PTE 83-1 deals with the operation of private mortgage pools and the acquisition and holding by plans of mortgage backed securities. The exemption provides relief for a range of transactions involving the servicing and operation of mortgage pools and for the acquisition and holding of mortgage backed pass through certificates in such pools where prescribed conditions are satisfied. Except in the situations where the pool sponsor or trustee has discretion over the plan assets invested in the pool certificates, the primary conditions to the availability of relief is that the purchase be for fair market value.

B. Explanation Of Provision

1. Exemption of certain transactions

In general

The bill would provide special rules for fiduciaries of pension and welfare funds with respect to certain transactions involving mortgages. The new rules would exempt these transactions from the usual prohibited transaction rules of ERISA and the Code relating to conflict-of-interest. The bill would not exempt the transactions from the prohibitions relating to self-dealing. Also, the bill would not affect the prudence and diversification standards of ERISA.

Under the bill, the conflict-of-interest prohibitions would not apply to an approved qualified mortgage transaction, an eligible residential mortgage loan transaction, or a rated residential mortgage transaction.

Approved qualified mortgage transaction

Under the bill, the conflict-of-interest prohibitions would not apply to a qualified mortgage transaction engaged in by a plan if the transaction received the prior approval of an independent fiduciary. The bill provides standards for determining whether an individual or an organization that serves as a fiduciary is an independent fiduciary.

Under the bill, an independent fiduciary must have expertise and experience in advising investors regarding transactions similar to transactions which the plan desires to make and to transactions to which the bill applies. In addition, under the bill, an independent fiduciary must acknowledge, in writing, to the plan that it will make decisions with respect to transactions described by the bill for which the fiduciary is acting in its capacity as a fiduciary of the plan. Finally, the bill requires that, as to a particular transaction, the independent fiduciary must not be a party-in-interest (other than in its capacity as a fiduciary of the plan).

Eligible residential mortgage loan transaction

Under the bill, the conflict-of-interest prohibitions would not apply to the purchase, retention, sale, exchange, or transfer of any interest in a residential mortgage loan if the loan is eligible for purchase by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, or any other Federal or State agency. In addition, the conflict-of-interest prohibitions would not apply to the purchase, etc., of an interest in a residential mortgage loan if the payment of principal and interest on the loan is guaranteed or insured by one of those organizations.

Rated residential mortgage transaction

The bill provides that the prohibitions would not apply to the acquisition, purchase, retention, sale, exchange, or transfer by a plan of any residential mortgage-backed security, or a participation in the security, if the security or participation bears one of the three highest ratings of a nationally recognized rating service.

2. Definitions

Qualified mortgage transaction

Under the bill, a qualified mortgage transaction is: (1) the issuance of a residential mortgage financing commitment by a plan; (2) the receipt of a fee by a plan in exchange for issuing a residential mortgage financing commitment; (3) the origination, acquisition, purchase, retention, sale, exchange, or transfer by a plan of a residential mortgage loan[3] or a participation in the loan (regardless of whether the action is taken pursuant to a residential mortgage financing commitment); (4) the sale, exchange, or transfer by a plan of a residential mortgage loan or a participation in the loan; (regardless of whether the action occurred before or after the maturity date of the loan[4] (5) the servicing or contracting for servicing of a residential mortgage loan (regardless of whether the residential mortgage loan is a part of a mortgage investment pool)[5] or a mortgage-backed security by a plan for reasonable compensation;[6] (6) the acquisition, purchase, retention, sale, exchange, or transfer, or the issuance of a commitment to purchase or sell, an interest or participation[7] in a mortgage investment pool or a residential mortgage-backed security; or (7) the formation and operation by a plan of a mortgage investment pool.

Residential mortgage financing commitment

The bill defines a residential mortgage financing commitment as a contractual obligation or option to originate, acquire, purchase, retain, sell, exchange, or transfer a residential mortgage loan, mortgage investment pool or a participation in the pool, which must be satisfied or may be exercised by a plan or a trust or other entity designed to facilitate such actions by a plan. Under the bill, the term "origination" means carrying out the process by which financing is obtained for residential dwellings.

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[3] The bill defines a residential mortgage loan as a loan secured by (1) a mortgage or deed of trust on residential property held in fee simple absolute title as security for payment of a debt, (2) the pledge of a leasehold with a term of at least 99 years, (3) the pledge of a leasehold with a term extending at least 10 years beyond the term of the mortgage, (4) a leasehold wherein fee simple, absolute title vests in the borrower by operation of law, (5) a mortgage or deed of trust secured by a condominium unit, or (6) a loan secured by a share or shares in a residential cooperative.

[4] Generally if a loan is not repaid by the maturity date it is in default.

[5] An aggregation of residential mortgage loans, originated by one or more lenders, that is established by a plan or lender, or transferred to a trustee, to create a residential mortgage-backed security.

[6] The bill specifies services that would be included as permitted services for which reasonable compensation may be provided. These specified services are collecting mortgage payments, assuring that taxes and insurance premiums for the residential dwelling units are paid, making decisions relating to foreclosures, and executing foreclosures.

[7] The bill defines a participation as an ownership interest in a residential mortgage loan, mortgage investment pool, or residential mortgage-backed security, which is held in common with another person or legal entity.

Residential dwelling

The bill defines a residential dwelling as a structure designed for residential use by one or more families.[8]

Residential mortgage-backed security

Under the bill, a security is a residential mortgage-backed security if it is (1) an interest in a mortgage investment pool that meets specified requirements, (2) an interest in a loan which is secured by a mortgage investment pool or residential mortgage-backed security and which meets those specified requirements, or (3) an interest in a debt instrument collaterized by the cash flow from a mortgage investment pool or residential mortgage-backed security.

A mortgage investment pool or loan meets the specified requirements if it (1) is held in trust or under an agreement for the benefit of security holders; and (2) is secured solely by, or represents solely interests in, residential mortgage loans, property which was used to secure residential mortgage loans and has been acquired by foreclosure, or undistributed cash.

3. Prohibited administrative activity

Under the bill, no rule, regulation, or order could be promulgated which implements, interprets, or limits the exemptions provided by the bill or the definitions of the terms used under the bill. In addition, no rule, regulation, or order could be promulgated under the provisions of ERISA or the Code prohibiting conflict-of-interest or self-dealing transactions with pension or welfare funds, or under the provisions permitting exemptions from those prohibitions, if the rule, etc., implements, interprets, or limits the term "reasonable rate of interest" with respect to a qualified mortgage transaction. Accordingly, the Secretary of Labor could not interpret the term "reasonable rate of interest" under the provisions of the Code and ERISA permitting loans to participants.

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[8] The term would specifically include (1) a detached house, (2) a townhouse, (3) a manufactured house (regardless of whether the house is considered real or personal property under State law), (4) a condominium unit, (5) a unit in a housing cooperative, (6) a unit in a multiunit subdivision (planned unit development) which is subject to recorded documents which limit the use of the unit to residential purposes for maintenance and facilities, and (7) a structure consisting of two or more residential dwelling units.

C. Effective Date

The bill would apply on the date of enactment. The bill provides that it is not to be construed as limiting or otherwise affecting the interpretation or construction of the provisions of ERISA and the Code in effect before the date of enactment. Also, the bill provides that its provisions are to be in addition to, and independent of, any other provision of ERISA.

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