Info-Pro
Lender Services

REAL ESTATE TAX MONITORING AND REGULATORY COMPLIANCE

The following whitepaper was written by
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commissioned by Info-Pro Lender Services.

Godfrey & Kahn has provided high-level service and creative legal solutions to its clients for nearly 60 years. The firm's Banking and Financial Institutions Team has practical hands-on experience and knowledge about the financial services industry, uniquely positioning its attorneys to offer legal advice to banks, trade groups and other industry-related companies on regulatory matters, mergers and acquisitions, capital raises, financings, new products and services, executive compensation, and strategic planning.

Disclaimer

The information in this white paper is a summary of legal and regulatory principles. It is not to be construed as legal advice. Individuals should consult with legal counsel before taking any action based on these principles to ensure their applicability in a given situation.

The considerations for engaging any particular service or service provider are unique to each financial institution. Godfrey & Kahn does not generally recommend or endorse, and is not recommending or endorsing, any specific service or service provider. Any decision to engage a particular service or service provider should be made in accordance with the financial institution's established policies and procedures for vendor management.

Originating loans secured by real estate is a complex business, and it has become even more challenging on both the commercial and consumer side given regulatory expectations stemming from the recent financial crisis. Issues regarding collateral valuations, borrower financial condition, and other post-closing loan administration policies and procedures have become "hot topics" in regulatory examinations. One loan administration practice that is important to get right is real estate tax lien monitoring. If done properly, it can protect financial institutions from both legal risks and regulatory scrutiny.

As with many types of activities, institutions have the option to either conduct their real estate tax monitoring function internally or outsource it to a third party provider. Outsourcing may improve efficiency and reduce costs for some institutions. However, regardless of an institution's decision, gaining an understanding of the legal and regulatory framework that governs real estate tax monitoring responsibilities is a prudent step to take in evaluating risk and developing best practices. What follows is a summary of the legal and regulatory framework that establishes your institution's responsibility to monitor real estate taxes.

Lien Issues

Allowing real estate taxes to go unchecked can lead to lien priority issues, which can directly impact your institution's bottom line. In Wisconsin, the mortgages made in favor of banks, credit unions and certain other types of financial institutions enjoy super-priority status.[1] This means that a mortgage made in favor of a bank will take priority over most other liens (e.g., construction liens), even if the other liens predate the bank's mortgage. There are, however, a few exceptions to the super-priority status afforded these mortgages, one of which is tax liens filed after the recording of the institution's mortgage.[2]

[1] Wis. Stat. § 706.11.
[2] Id.

Subsequently recorded real estate tax liens have the following effects:

> 1. They cloud title to property;
>
> 2. They provide yet another party authority to foreclose on the property (note, the foreclosure action by the holder of the real estate tax lien will not extinguish the institution's mortgage); and
>
> 3. Functionally, they potentially reduce the proceeds the institution will receive upon liquidation of the property.

The third effect, above, merits further explanation. Let's assume that a bank has a mortgage on a piece of property, that piece of property is also subject to a subsequently recorded real estate tax lien, and the bank's borrower has defaulted on the loan for which the piece of property serves as collateral. When the bank forecloses on the borrower, the bank's foreclosure action will not extinguish the real estate tax lien (i.e., the real estate tax lien will continue to encumber the property after the bank has acquired title to the property). When the bank finds a buyer for the property, the buyer's financier invariably will require that any tax liens be satisfied at or prior to the closing of the sale. To ensure the sale closes, the bank will have to pay the past due real estate taxes. Had the bank monitored the real estate taxes on the property in the example above, it would have given itself an opportunity to pay the real estate taxes and roll the payment into the principal balance of the loan, at least preserving the possibility of recapturing the advance through a deficiency judgment.

Regulatory Expectations

Safety and Soundness

Failing to adequately monitor real estate taxes may lead to consequences under safety and soundness guidelines. For example, Section 39 of the Federal Deposit Insurance Act[3] directed the Federal banking agencies to issue safety and soundness standards for all insured depository institutions. The standards, which were issued as interagency guidelines in July of 1995, require insured depository institutions to, among other things, "establish and maintain a system…to identify problem assets and prevent deterioration in those assets."[4] In other words, under the safety and soundness guidelines, institutions are required to implement systems designed to protect the value of assets.

[3] 12 U.S.C. § 1831p-1.
[4] 12 C.F.R. Part 364, Appendix A, Section II(G).

Past due real estate taxes negatively affect the value of an institution's assets in two ways. First, tax liens impair the value of the loan's underlying collateral, adversely impacting the institution's ability to recover any possible losses on the loan. Second, it is generally known that past due real estate taxes are often indicative of a borrower that is experiencing financial difficulties, and because a borrower's creditworthiness is a factor in the value of the loan, it follows that past due real estate taxes on property that secures a loan often result in a decrease in the value of the loan. In light of the foregoing, institutions should have in place a system to prevent the accumulation of past due real estate taxes on the collateral that secures the loans in the institution's loan portfolio.

The penalties under the safety and soundness guidelines for failing to implement a system that protects assets can be serious. For example, regulators may, under certain circumstances:

> 1. Require the institution to prepare and submit a compliance plan to the regulator that details how the institution will correct the deficiency[5];
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> 2. Issue an enforcement order against the institution[6]; or
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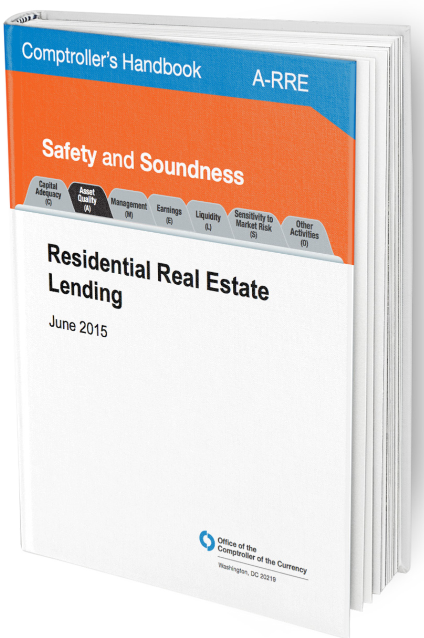
> 3. Assess civil money penalties against the institution and/or any individuals who participated in the institution's noncompliance.[7]

Regulatory Guidance



In addition to general safety and soundness guidelines, at least one federal banking regulator has specifically addressed real estate tax monitoring in public guidance. In its handbook, entitled "Residential Real Estate Lending," the Office of the Comptroller of the Currency (the "OCC") provides that national banks should monitor the payment of real estate taxes to ensure that their liens are not compromised by any liens from unpaid real estate taxes.[8] We note that the OCC's directive applies equally to loans for which the institution maintains an escrow account and to those without.

[5] 12 U.S.C. § 1831p-1(e).
[6] 12 U.S.C. § 1831p-1(e)(2).
[7] 12 C.F.R. § 308.305(b).
[8] OCC Handbook, "Residential Real Estate Lending," June 2015, page 26.

While on the topic of escrow accounts, it is worth mentioning that the implementing regulations of the Real Estate Settlement Procedures Act ("RESPA")[9] require institutions that maintain escrow accounts for the payment of real estate taxes, insurance, etc. to pay the real estate taxes in a timely manner.[10] Examiners are directed to review lending institutions' loan servicing-related practices and policies to determine whether they comply with applicable law.[11] Institutions whose loan servicing-related practices and policies do not comply with applicable law may be subject to regulatory criticism. This is yet another reason why accurately compiling real estate tax information is an important function for banks and credit unions.

Regulatory Criticism

Failing to monitor real estate taxes may lead your regulator to criticize your lending operations. As an example, pursuant to the uniform rule on real estate lending standards, banks must "adopt and maintain written policies that establish appropriate limits and standards for extensions of credit secured by liens on or interests in real estate."[12] There are several operational components of a real estate lending program that must be addressed in a lending policy, one of which is "loan administration procedures for real estate portfolios."[13] Examiners are directed to review the lending policies of a bank during the course of the bank's examination to determine if the policies are consistent with safe and sound lending practices and applicable law.[14]

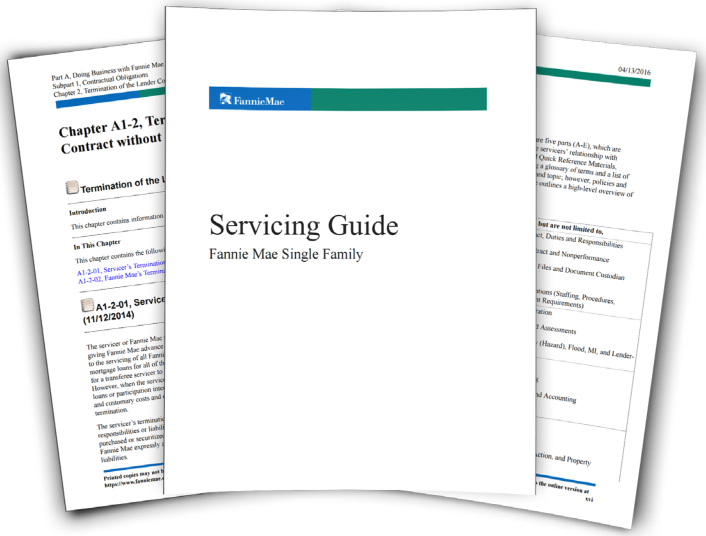
From what we have seen, examiners are not shy about critiquing institutions with regard to their loan administration procedures. In particular, we have recently seen a specific example of a regulator focusing on real estate tax payment oversight. In evaluating the effectiveness of an institution's real estate tax payment oversight program, examiners will typically review, among other things, (1) the level of unpaid real estate taxes on the collateral for the institution's loan portfolio and the institution's efforts to resolve the unpaid taxes, and (2) the protocol(s) the institution has in place for

[9] 12 C.F.R. Part 1024.
[10] 12 C.F.R. § 1024.17(k).
[11] See supra footnote 8, pages 105-106.
[12] 12 C.F.R. Part 34 (National Banks); 12 C.F.R. Part 208 (State Member Banks); and 12 C.F.R. Part 365 (State Non-member Banks)
[13] Id.
[14] Id.

monitoring the payment of real estate taxes.

As mentioned above, examiners may criticize an institution for failing to timely pay real estate taxes on behalf of borrowers in accordance with the requirements of RESPA. Additionally, because a borrower's failure to pay real estate taxes can signify cash flow problems for the borrower, examiners will be quick to note a high level of unpaid real estate taxes in the institution's loan portfolio and to criticize the institution for failing to adequately manage the high level of unpaid taxes.

GSE Expectations



Neglecting to monitor real estate taxes may adversely affect a servicer's business relationship with government sponsored enterprises like the Federal Home Loan Mortgage Corporation (i.e. Freddie Mac) and the Federal National Mortgage Association, colloquially referred to as "Fannie Mae." Servicers of loans held by Fannie Mae, for example, are subject to the directives set forth in Fannie Mae's Servicing Guide.

Pursuant to the Servicing Guide, a "servicer must protect Fannie Mae's lien and the property securing the mortgage loan by [(1)] maintaining accurate records on the status of…real estate taxes; and [(2)] ensuring the timely payment of taxes…and related charges."[15] Noncompliance with the directives set forth in the Servicing Guide may result in Fannie Mae taking a range of possible actions against the servicer to remedy the servicer's noncompliance. For example, Fannie Mae may (i) terminate its business relationship with the servicer, (ii) assess a compensatory fee or a make whole payment on the servicer,[16] or (iii) require the servicer to repurchase the loan or indemnify Fannie Mae for any losses or damages.[17] As you can imagine, the election by Fannie Mae to exercise any of its remedies described above could have a material adverse impact on a servicer's revenue.

[15] Fannie Mae Servicing Guide, Section B-1-01: Administering an Escrow Account and Paying Expenses (March 9, 2016).
[16] Fannie Mae Servicing Guide, Section A3-1-01: Maintaining Eligibility.
[17] Fannie Mae Servicing Guide, Section A1-3-02: Fannie Mae-Initiated Repurchases, Indemnifications, Make Whole Payment Requests and Deferred Payment Obligations.

Outsourcing

As mentioned at the beginning of this article, institutions have the option to outsource their real estate tax monitoring function. If an institution chooses to outsource, care should be taken to select a vendor with experience providing this service to other regulated financial institutions. Institutions should also understand that they will ultimately bear regulatory responsibility for vendors' performance, so they will need to conduct adequate due diligence and monitoring on the provider as well as follow regulatory guidelines regarding third party vendor relationships.

Conclusion

The repercussions for inadequate real estate tax monitoring practices can be significant. Institutions should understand the risks associated with real estate tax monitoring and implement policies and procedures to ensure accuracy and timeliness of tax information in order to mitigate risk. If outsource this function is deemed to be appropriate for the institution, adequate time and effort should be given to researching, selecting and monitoring the right service provider.

ABOUT INFO-PRO

Info-Pro Lender Services

Info-Pro Lender Services offers a variety of products that would complement the product mix credit unions are looking to achieve. Their primary services include real estate tax monitoring, escrow processing, flood determination, homeowners insurance monitoring services.

Info-Pro already uses technology that this paper has proven as crucial to staying competitive in today's marketplace. Some examples of this technology include systems to identify delinquent taxes, a successful track record working with the Loan Origination Systems, and the ability to reduce foreclosure risks and audit problems.

The Info-Pro Advantage feature offers the combination of passionate customer service and unmatched technology to protect your financial portfolio.

For more information, visit www.info-pro.com.
Contact Info-Pro Lender Services at 888-393-0393 or info@info-pro.com.