THE CONFERENCE OF STATE BANK SUPERVISORS
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FINAL MODEL STATE REGULATORY PRUDENTIAL STANDARDS FOR NONBANK MORTGAGE SERVICERS

2021

Non-Depository Supervisory Committee

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Requirements

The Final Model Standards contain “requirements” or standards for compliance. Each requirement is codified into model language for uniform adoption by individual states. See Codification of Requirements for State Adoption – Model Law or Rule (pg. 24). As stated above, the requirements in this model set of standards constitute policy and do not impose any immediate requirement on nonbank mortgage servicers.

Applicability – Exclusions

The Final Model Law or Rule applies to any servicer defined as a covered institution. Coverage or applicability is intended to apply at the servicer or licensed entity level rather than to other corporate entities of or within a family of companies (e.g., a holding company or affiliate of the servicer).

Specific exclusions from coverage include not-for-profit mortgage servicers or government housing finance agencies. The financial condition requirements do not apply to servicers solely owning and/or conducting reverse mortgage servicing, or the reverse mortgage portfolio administered by forward mortgage servicers otherwise covered.

Financial condition requirements for subservicers are limited under the FHFA eligibility requirements due to the lack of owned servicing. For example, net worth add-on and liquidity requirements apply only to UPB of servicing owned, thereby limiting the financial requirements for subservicers, and servicers who own MSRs and also subservice for others. However, the base capital and operating liquidity requirements as well as the corporate governance requirements apply to subservicers.

Financial Condition

Under financial condition, the supervisory areas of capital and liquidity, align with FHFA’s eligibility requirements. However, the capital and liquidity requirements of the Final Model Standards apply FHFA’s requirements to a broader set of servicing by including non-agency servicing (in other words, applicable to all servicing unless otherwise specified).

Generally Accepted Accounting Principles (GAAP): All financial data necessary for compliance with the financial condition requirements must be determined in accordance with GAAP.

Capital and Servicing Liquidity

The Final Model Standards for capital are based on FHFA eligibility requirements for enterprise single family seller/servicers[13] and currently require the following:

Tangible net worth: Total equity less receivables due from related entities less goodwill and other intangibles[14] less pledged assets.

Minimum capital:

- Minimum net worth of $2.5 million.
- Tangible net worth divided by total assets $\geq$ 6%.

For nonbank owners of MSRs, there is an additional net worth requirement of 25 basis points of UPB for total loans serviced, excluding reverse mortgage servicing, subservicing for others, and "interim" [15] servicing.

Special note: In practice, the minimum capital ratio is calculated based on a GAAP as well as a non-GAAP basis, the latter reflecting allowable, documented GSE removals for assets and liabilities associated with items such as reverse mortgages, subservicing contracts, rights to MSRs, seriously delinquent loans in Ginnie Mae MBS and optional early buyout balances and securitized loan balances where only a residual interest is owned.

Liquidity

The following important terms are applicable to the liquidity standards:

- *Servicing liquidity[16] or liquidity:* The financial resources necessary to manage liquidity risk arising from servicing functions required in acquiring and financing MSRs, hedging costs (including margin calls) associated with the MSR asset and applicable financing facilities, and advances or costs of advance financing for principal, interest, taxes, insurance, and any other servicing related advances.
- *Operating liquidity:* The funds necessary to perform normal business operations, such as payment of rent, salaries, interest expense and other typical expenses associated with operating the entity. Consideration for operating liquidity must include an

[13] https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/2015-FAQs.pdf
[14] For purposes of this calculation, other intangibles exclude the value of MSRs whether pledged to secure financing or not.
[15] "Interim" means the period of time in which an originator is responsible for servicing the loan prior to sale of the loan and the associated MSR.
[16] State regulators refer to servicing liquidity to differentiate this type of liquidity from operating liquidity. FHFA draws no distinction between servicing liquidity and operating liquidity. Therefore, the terms servicing liquidity and liquidity have the same meaning. At times, these standards use the term servicing liquidity to draw a clear distinction from operating liquidity.

understanding of increases in operating needs due to changing economic climate or other stresses impacting servicer operations.

- *Allowable assets for liquidity:* Assets that may be used to satisfy the liquidity requirements include unrestricted cash and cash equivalents and unencumbered investment grade assets held for sale or trade (agency MBS, obligations of GSEs, U.S. Treasury obligations).

Consistent with FHFA, state regulators limit the allowable financial resources that may be used to satisfy liquidity requirements to high quality liquid assets. State regulators also recognize that servicer advancing obligations differ by investor, which could have a significant impact on required resources to meet those advancing obligations. While not a formal component of the liquidity calculations, differences in advancing obligations at individual servicers may be evaluated and taken into consideration by state regulators as part of the overall financial condition review.

Special note: Consistent with Fannie Mae, Freddie Mac and Ginnie Mae, allowable sources of liquidity shall not include unused/available portions of committed servicing advance lines of credit or other unused/available portions of credit lines such as normal operating business lines.[17]

Minimum Servicing Liquidity Requirements

State regulators base the minimum servicing liquidity requirement on the current eligibility requirements established by FHFA[18] but apply these calculations to the total owned servicing portfolio. Currently, the base servicing liquidity requirement is set at 3.5 basis point of total servicing UPB, excluding subservicing for others and reverse mortgage servicing.

Servicing loans in forbearance, delinquency or foreclosure imposes additional costs on servicers and thus requires additional financial resources to cover these costs. Accordingly, the Final Model Standards align with FHFA's current eligibility requirements for enterprise single family seller/servicers, which includes an incremental non-performing loan (NPL) [19] charge to enhance the sensitivity of liquidity requirements to portfolio performance. Due to the incremental nature of the charge, as the volume of NPLs increase, so too do the servicer's liquidity requirements.

The current incremental NPL Charge required by FHFA is 200 basis points charged on NPLs greater than 6.0% of total servicing UPB, excluding Subservicing for others and reverse

[17] As announced by Fannie Mae and Freddie Mac at the direction of FHFA. The respective announcements can be found at the following links:
https://singlefamily.fanniemae.com/news-events/announcement-svc-2020-08-servicing-guide-update and
https://guide.freddiemac.com/app/guide/bulletin/2020-48

[18] https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/2015-FAQs.pdf.

[19] Loans 90+ days delinquent and in foreclosure.

mortgage servicing.

As discussed under Summary of Process and Review of Comments (pg. 7), the NPL charge effectively requires servicers to hold more liquidity as the rate of delinquency in their portfolio increases. Many argue that the result is pro-cyclical or has the effect of requiring more liquidity when the servicer is least able to do so (i.e., at times when revenues may be falling, and servicing costs are rising). The NDSC agrees with this observation; however, the Final Model Standards are intentionally aligned with FHFA's current requirements for consistency across government agencies, versus taking a counter-cyclical approach of requiring servicers to build liquidity reserves when performance is on a more positive path with increasing revenues and profitability. Again, the NDSC has determined that alignment with the federal agencies is the most appropriate course of action at this time, however, the NDSC intends to continue close engagement with the federal agencies and remains receptive to amendment when and if a change in requirements is deemed appropriate.

The Final Model Standards require that management maintain written policies and procedures implementing the minimum servicing liquidity requirements. Such policies and procedures must include a sustainable written methodology for satisfying the servicing liquidity requirements. Written policies and procedures memorialize management's attention to this crucial responsibility and provide reference points for state examiners in reviewing servicer compliance.

Requirements for Maintaining Appropriate Levels of Operating Liquidity

Operating liquidity are the funds necessary to perform normal business operations beyond the servicing liquidity requirements. All servicers must maintain sufficient Allowable Assets for Operating Liquidity in addition to the amounts required for minimum servicing liquidity to cover normal or non-servicing related operating expenses and general business risk (as described above). All servicers must have in place sound cash management and business operating plans that match the size and sophistication of the institution to ensure normal business operations. Management must develop, establish, and implement plans, policies, and procedures for maintaining operating liquidity sufficient for the ongoing needs of the institution. Such plans, policies and procedures must contain sustainable, written methodologies for maintaining sufficient operating liquidity.

Written methodologies should at a minimum include the following factors:

- Servicer business model
- Composition of portfolio
- Allowable Assets for Liquidity
- Average monthly operating expense need

- Excess funds after coverage of monthly servicing expenses available to cover operating expenses

Corporate Governance

Corporate governance refers to the structure of the institution and how it is managed. It includes the corporate rules, and the practices and processes used to oversee and manage the institution. Corporate governance dictates how its board of directors and management balance responsibilities to shareholders, the public, regulators, and its own employees.

Board of Directors

The board of directors is responsible for establishing a sound corporate governance framework to protect the financial, reputational, cultural and strategic interests of the institution and the institution's stakeholders and set minimum standards of acceptable behavior for employees. The board of directors must also establish an appropriate set of internal controls, as well as a method for independently validating the accuracy and reliability of the financial and servicing information of the institution. Accurate and reliable information is necessary to monitor compliance with prudential standards, evaluate emerging risks and file an accurate Mortgage Call Report.

Special Note: Filing an accurate and timely Mortgage Call Report is an existing requirement of state law that is fundamental to state regulators' ability to determine compliance with these standards.

Institutions must establish a formal board of directors responsible for ensuring the responsibilities in the Final Model Standards. For institutions that are not approved to service loans by Fannie Mae, Freddie Mac or Ginnie Mae or where these federal agencies have granted approval for a board alternative, an institution may establish a similar body (referred to in these standards as the board of directors) constituted to exercise oversight and fulfill the responsibilities below. The board of directors is responsible for:

- Establishing a written corporate governance framework, including appropriate internal controls designed to monitor corporate governance and assess compliance with the framework.
- Monitoring and ensuring institution compliance with the corporate governance framework and the Final Model Standards.
- Accurate and timely regulatory reporting, including the Mortgage Call Report.

Internal Audit

Internal audit is an independent assessment and evaluation of the institution's internal controls, including financial condition controls and requirements and management responsibilities in performing sound risk management and corporate governance. The internal audit should ensure institution compliance, accurate financial controls, and reporting, and assist in maintaining effective and efficient institution operations. The internal audit identifies problems and recommends corrective action to senior management and the board of directors.

The board must establish internal audit requirements that are appropriate for the size and complexity and risk profile of the servicer, with appropriate independence to provide a reliable evaluation of the servicer's internal control structure, risk management and governance.

External Audit

Audited financial statements by an independent public accountant provide a transparent third-party evaluation of the reliability and accuracy of management's presentation of a company's financial position and results of operations and highlight potential areas of risk. This not only provides reliable data for calculation of the financial requirements in the Final Model Standards but also provides independent evidence of the financial adequacy of the servicer.

For external audit and financial reporting, certain Ginnie Mae reporting requirements will be used to meet the external audit standards.[20] The requirements include audited financial statements and audit reports conducted by an independent public accountant including:

- Annual financial statements that must include a balance sheet, statement of operations [income statement] and cash flows, including notes and supplemental schedules and be prepared in accordance with GAAP.
- Assessment of the internal control structure.
- Computation of tangible net worth.
- Validation of MSR valuation and reserve methodology, if applicable.
- Verification of adequate fidelity and errors and omissions insurance.
- Testing of controls related to risk management activities, including compliance and stress testing, where applicable.

[20] "MBS Guide. Chapter 3: Eligibility Requirements – Maintaining Ginnie Mae Issuer Status." Ginnie Mae, October 2014. Available at: http://www.ginniemae.gov/doing_business_with_ginniemae/issuer_resources/MBSGuideLib/Chapter_03.pdf.

Risk Management

Nonbank mortgage servicers face multiple risks which need to be appropriately managed through a variety of market and economic cycles. The ability of the servicer to internally measure, monitor and mitigate risks inherent to servicing is a prudent business practice and will help increase the servicer's financial strength.

Risk Management Program

All servicers must establish a risk management program under the oversight of the board of directors that identifies, measures, monitors, and controls risk sufficient for the level of sophistication of the servicer. The risk management program must have appropriate processes and models in place to measure, monitor and mitigate financial risks and changes to the risk profile of the servicer and assets being serviced. The risk management program must be scaled to the complexity of the organization, but be sufficiently robust to manage risks in several areas,[21] including, but not limited to:

- *Credit risk:* The potential that a borrower or counterparty will fail to perform on an obligation.
- *Liquidity risk (including servicing and operating liquidity)*: The potential that the servicer will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding or that it cannot easily unwind or offset specific exposures.
- *Operational risk:* The risk resulting from inadequate or failed internal processes, people and systems or from external events.
- *Market risk:* The risk to the servicer's condition resulting from adverse movements in market rates or prices.
- *Compliance risk:* The risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations or other supervisory requirements applicable to the servicer.
- *Legal risk:* The potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions or adverse judgments can disrupt or otherwise negatively affect the operations or condition of the servicer.
- *Reputation risk:* The risk to earnings and capital arising from negative publicity regarding the servicer's business practices.

[21] Definitions for the risks identified are derived from the Commercial Bank Examination Manual of the Federal Reserve System. https://www.federalreserve.gov/publications/files/cbem.pdf

Risk Management Assessment

A risk management assessment must be conducted on an annual basis concluding with a formal report to the board of directors. Evidence of risk management activities throughout the year must be maintained, including findings of issues and the response to address those findings.

Authority

Model Law Sec. 500 – Authority (pg. 29) establishes commissioner authority to adopt rules and conduct examinations, investigations and enforcement. Specific language for these parts should be drafted by states to conform with the legislature's grant of authority. In situations where these standards are adopted as rule rather than law, this subsection of Sec. 500 may be unnecessary.

The Final Model Standards are applicable to all servicers meeting the de minimis cut off, regardless of size, complexity, business model or institutional risks. In certain situations, a commissioner or other agency head may determine independently or through a multistate review that exceptions to the standards are necessary for effective or efficient supervision of individual servicers or the industry. Such necessity may include situations where specific servicers exhibit extremely high or low levels of risk or where the economy, environment or society have experienced extraordinary events. These situations may warrant controls or supervisory attention for servicers above or below the specific requirements of these standards, or a temporary suspension of the standards or part of the standards pending the resolution of an event.

Where standards are increased for a particular servicer, state supervisors should provide notice to the servicer through a formal administrative undertaking that explains the nature of the risk identified, the authority for any modification of the requirements and the ability for the servicer to contest the modification.

In situations where servicers exhibit extremely low levels of risk (e.g., insufficient servicing volume to justify the burden associated with the standards) the state supervisor, following review and determination, may exempt such servicers from some or all the requirements of the standards.

Additionally, severe economic, environmental, or societal events (such as the Covid-19 pandemic) may warrant a temporary suspension of part of these standards. In such situations, commissioners or agency heads need the flexibility and authority to act appropriately and in the best interests of consumers, the industry and the public.

Sec. 500 c. of the Model Law or Rule, Authority to Address Risk as Necessary (pg. 29), is intended to provide commissioners or agency heads with the flexibility and authority to respond appropriately to individual servicer or industry needs.