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Legal Update

Treating a Nonbank Like a Bank: New Proposed Prudential Standards for Nonbank Mortgage Servicers

Should US state nonbank mortgage servicers be subject to "safety and soundness" standards of the type imposed by federal law on insured depository institutions, even though the nonbanks do not solicit and hold customer funds in federally insured deposit accounts or pose a direct risk of a government bailout? Well, state mortgage banking regulators think so. On September 29, 2020, the Conference of State Bank Supervisors ("CSBS"), an organization made up of state regulators, released proposed prudential standards for state oversight of nonbank mortgage servicers (the "Proposal").[1] CSBS pointed to a "changed nonbank mortgage market" as the driver of the proposed standards, emphasizing that nonbank mortgage servicers now service roughly 40% of the total single-family residential mortgage market. Comments from interested parties are due by December 31, 2020.

Background

CSBS correctly noted in its Proposal that there are no uniform or comprehensive prudential standards that apply to nonbank mortgage servicers. Yet, there are numerous requirements that apply to nonbank mortgage servicers, including the mortgage servicing rules promulgated by the Consumer Financial Protection Bureau ("CFPB")[2] and licensing, consumer protection and other requirements of state regulators. The Federal Housing Finance Agency ("FHFA"), as the conservator of Fannie Mae and Freddie Mac, has instituted minimum capital, net worth and liquidity requirements, and Ginnie Mae also imposes financial strength requirements, but CSBS noted that these requirements do not apply across servicers' entire portfolios. For example, FHFA requirements apply only to the portions of servicers' portfolios that consist of Fannie Mae- and Freddie Mac-owned or -backed loans. The Proposal did not mention the fact that it is reported that third-party agency servicing presently comprises over 75% of the nonbank third-party servicing market. Nor did it highlight that the private investors on whose behalf nonbank mortgage services administer non-agency loans impose their own requirements as counterparties to their servicing agreements and are the ones most likely to bear the risk of loss on the serviced loans.

The idea of "prudential" standards generally is synonymous with "safety and soundness" standards.[3] Section 39 of the Federal Deposit Insurance Act obligates the applicable federal banking agencies to prescribe for all insured depository institutions standards relating to, among others, internal controls, information systems, internal audit systems and other operational and managerial standards as the applicable agency deems to be appropriate.[4] The widely cited meaning of an "unsafe or unsound practice" is:

> Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.[5]

Interestingly, the apparent purpose does not mention protecting bank customers, but, of course, safety and soundness standards, on one hand, and consumer protection requirements, on the other hand, are not mutually exclusive. Indeed, material, persistent violations of consumer protection-related laws and regulations could pose the very type of abnormal risk of loss that safety and soundness standards are designed to prevent. But managing legal risk is one small component of much more comprehensive safety and soundness standards that apply to insured depository institutions.

This is not the first effort to apply additional safety and soundness requirements to nonbank mortgage servicers. CSBS previously issued proposed prudential standards for nonbank mortgage servicers in 2015.[6] In addition, the Housing Finance Reform and Taxpayer Protection Act of 2014, a bipartisan congressional effort to reform Fannie Mae and Freddie Mac that did not become law, would have required the creation of enhanced standards for servicers approved to service certain government-backed loans, including, among other things, standards related to the maintenance of adequate liquidity and reserves.[7] The Homeowner Mortgage Servicing Fairness Act of 2018, a bill introduced by Congresswoman Maxine Waters that also did not become law, included some safety and soundness requirements for nonbank mortgage servicers modeled on similar requirements imposed on Fannie Mae and Freddie Mac.[8] In addition, the Financial Stability Oversight Council ("FSOC") has encouraged state regulators to work to develop prudential and corporate governance standards for nonbank mortgage servicers[9] and issued guidance describing the process FSOC would follow if it were to consider making a determination to subject a nonbank financial company to supervision by the Board of Governors of the Federal Reserve System and prudential standards.[10]

Description of the Proposal

CSBS' Proposal is designed to cover nonbank mortgage servicers and investors in mortgage servicing licensed by and operating in states, but it is not intended to apply to servicers solely owning and conducting reverse mortgage servicing and it would have limited application to entities that only perform subservicing for others. CSBS does not have any regulatory authority to require mortgage servicers to follow these standards. Instead, CSBS suggests that state regulators adopt these standards by enacting laws or regulations or through other formal issuances. In many cases, the standards are somewhat vague, simply stating that a standard will align with a certain previously issued bulletin, and if states were to adopt these requirements, they may need to further develop the standards. As vague as the proposed standards may be under the Proposal, they essentially are a crude "cut and paste" of federal banking requirements. While it hasn't done it in this case, CSBS has drafted model state laws in other areas.

CSBS explained that it has monitored nonbank servicers over the past several years and is concerned about the rapid growth of nonbank servicing and the financial stability and governance of nonbank servicers. According to CSBS, the Proposal aims to provide protection for borrowers, investors and other stakeholders; enhance regulatory oversight over nonbank servicers; and improve transparency, accountability, risk management and corporate governance standards. The Proposal includes standards in the following areas:

Capital Requirements. The Proposal includes minimum net worth and capital ratio requirements that track FHFA requirements. CSBS indicated, that by leveraging existing FHFA requirements, it hopes to lessen the regulatory burden on nonbank mortgage servicers. FHFA has released heightened standards that are not yet effective,[11] and the Proposal requirements are designed to automatically adjust as FHFA's requirements are modified.

Specifically, the Proposal would require nonbank mortgage servicers to maintain the higher of (1) $2.5 million net worth[12] plus 25 basis points of owned unpaid principal balance for total 1 – 4 unit residential mortgage loans serviced or (2) FHFA eligibility requirements. CSBS noted that it would like interested parties to submit comments on whether "owned unpaid principal balanced" should include whole loans owned by the servicer or simply serviced on behalf of a whole third-party whole loan owner.

The minimum net worth requirements for subservicers that are not originators and do not own mortgage servicing rights or whole loans would be $2.5 million net worth without any additional amounts required for unpaid principal balance of subserviced loans.

With respect to capital requirements, nonbank mortgage servicers would be required to maintain the higher of (1) net worth / total assets >= 6% or (2) FHFA eligibility requirements.

If a servicer is required by Fannie Mae or Freddie Mac to maintain capital in excess of FHFA's minimum eligibility requirements, the Proposal would require the servicer to report that fact to state regulators.

Liquidity Requirements. The liquidity requirements in the Proposal also track FHFA requirements. Under the Proposal, nonbank mortgage servicers would be required to maintain liquidity at an amount that is the higher of (1) 3.5 basis points of agency servicing unpaid principal balance plus non-agency servicing unpaid principal balance or (2) FHFA eligibility requirements.

CSBS explained that because servicing loans in forbearance, delinquency or foreclosure imposes additional costs on servicers, the Proposal includes additional liquidity requirements for non-performing loans that is the higher of (1) an incremental 200 basis points charge on non-performing loans for the portion of agency and non-agency non-performing loans greater than 6% of total servicing or (2) FHFA eligibility requirements.

In addition, the Proposal would require servicers to maintain sufficient allowable assets to cover normal operating expenses in addition to the amounts required for servicing expenses. Allowable assets include unrestricted cash and cash equivalents and unencumbered investment grade assets held for sale or trade. Allowable assets do not include unused or available portions of committed servicing advance lines of credit or other unused or available portions of credit lines such as normal operating business lines.

The Proposal does not detail how the amount necessary for operating expenses should be calculated, but it would require servicers to develop a written methodology for determining and maintaining sufficient operating liquidity and maintain certain policies, procedures and plans related to operating liquidity.

If a servicer is required by Fannie Mae or Freddie Mac to maintain liquidity in excess of FHFA's minimum eligibility requirements, the Proposal would require the servicer to report that fact to state regulators.

Risk Management Requirements. Under the Proposal, nonbank mortgage servicers would be required to establish a risk management program under the oversight of the entity's board of directors that manages risks in numerous areas including credit risk, liquidity risk, operational risk, market risk, compliance risk and reputational risk.

Data Requirements. The Proposal references RESPA's Regulation X requirement that servicers maintain documents and data in such a way that they are able to compile a servicing file within 5 days that includes transaction history information, a copy of the security instrument, notes reflecting communications with the borrower, data fields relating to the borrower's loan and copies of certain information or documents provided by the borrower to the servicer.[13] This requirement already applies to most mortgage servicers, but, as CSBS notes, the requirement does not apply to small servicers, generally defined as servicers that service 5,000 or fewer mortgage loans for which the servicer is the creditor or assignee.[14] CSBS proposed to apply this requirement more broadly to nonbank mortgage servicers.[15]

Data Protection. The standards address data protection and would require servicers to have controls related to the governance of information technology and perform risk assessments as well as testing and monitoring.

Corporate Governance. Under the Proposal, nonbank mortgage servicers must establish a corporate governance framework that protects the interests of the servicer and the servicer's stakeholders.

Servicing Transfer Requirements. To address what CSBS described as widespread data quality and integrity issues in the context of servicing transfers, the Proposal includes servicing transfer requirements that align with a 2014 CFPB bulletin on servicing transfers.[16] This bulletin largely provides additional guidance on compliance with a Regulation X requirement that servicers maintain certain policies and procedures and discusses how other consumer financial laws, including other Regulation X provisions, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, and the prohibition on unfair, deceptive, and abusive acts and practices, are relevant in the servicing transfer context. Each of these laws already applies to nonbank mortgage servicers under certain circumstances, and other than stating that the standards will "align" with this bulletin, the Proposal does not explain exactly how the standards would apply this guidance. The Proposal also states that the servicing transfer requirements would align with a 2014 FHFA bulletin addressing servicing transfers.[17]

Change of Ownership and Control Requirements. Under the Proposal, nonbank mortgage servicers would be required to provide 30 business days prior notice of a change in ownership of 10% of more of a mortgage servicer. CSBS explained that the notice is designed to allow regulators to determine if additional information about a new owner is needed to evaluate whether the new owner has the financial and management capacity to operate the servicer. Note that many state licensing laws already require prior notice or prior approval of a change of control.

Complex Servicers. In addition to these requirements, the Proposal would apply enhanced standards to servicers that are deemed to be "Complex Servicers." Complex Servicers are servicers that own whole loans plus servicing rights with aggregate unpaid principal balances totaling the lesser of $100 billion or representing at least 2.5% of the total market share.[18] These servicers would be required to meet enhanced capital and liquidity standards that require the servicer's management and board of directors to develop a methodology to determine and monitor its capital and liquidity needs. Complex Servicers would also be required to engage in stress testing analysis and develop a "living will" that provides a roadmap to recovery should the servicer face significant hardship.

Commentary

It's hard to be opposed in theory to anything that is labeled as "prudential" or "safe and sound." But the question is why should state-chartered, non-depository companies be subject to regulatory requirements that historically have been reserved for insured depository institutions? What the Proposal fails to do is describe in particularity why such standards are necessary for a non-depository. There is no federal deposit insurance in play. There is little likelihood of a direct government bailout of nonbank mortgage servicers. As of yet, there is little evidence that the failure of a nonbank mortgage servicer would have a material adverse impact on the larger economy. Why a state mortgage regulator should care about the fate of a private owner of a nonbank mortgage servicer is not in all clear and appears to go beyond their statutory authority. Consumer protection is the sweet spot of state regulation of mortgage servicers, but does achievement of that goal require the type and level of standards proposed here? At best, many of these broad standards have an attenuated relationship to consumer protection. Certainly, requiring compliance management plans, much like the CFPB does, seems like a more targeted and effective approach that is consistent with their authority and likely to strengthen "safety and soundness" without imposing prudential standards.

Moreover, these financial strength requirements could make it very difficult for smaller non-agency mortgage servicers to stay in the servicing game. The impact of these requirements on small businesses is an important consideration for further review.

If government regulators truly are concerned about the health and strength of nonbank mortgage servicers, perhaps they should consider providing lines of credit or advance lines to enable servicers to advance principal and interest to mortgage-backed securities holders and taxes and insurance to third parties in respect of mortgagor delinquencies.

Conclusion

CSBS has requested comment on numerous aspects of the Proposal, including whether the need for prudential standards is sufficiently established, whether the standards threaten the viability of servicers and whether it makes sense to require Complex Servicers to comply with enhanced standards. CSBS is accepting comments through the end of the year.

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Endnotes

[1] Conference of State Bank Supervisors, "Proposed Regulatory Prudential Standards for Nonbank Mortgage Servicers," Sept. 29, 2020, available at: https://www.csbs.org/system/files/2020-09/FinalProposedPrudentialStandardsForComment-2020_1.pdf.

[2] *See* 12 C.F.R. § 1024.1 *et seq*. and 12 C.F.R. § 1026.1 *et seq*.

[3] *See* our analysis of guidance issued by US federal banking regulators on sound practices for the largest US banking organizations here.

[4] 12 U.S.C. § 1831p-1. For example, the OCC has issued various standards for safety and soundness in the form of appendices to 12 C.F.R. pt. 30. https://www.law.cornell.edu/cfr/text/12/part-30

[5] Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 and S. 3695 Before the House Comm. on Banking and Currency, 89th Cong., 2d Sess. 50 (1966); 112 Cong. Rec. 26,474 (1966) (memorandum submitted by John Horne, Chairman of the Federal Home Loan Bank Board).

[6] CSBS explained that its most recent proposal relies heavily on the 2015 proposal.

[7] Housing Finance Reform and Taxpayer Protection Act of 2014, S.1217, 113th Cong. (2014).

[8] Homeowner Mortgage Servicing Fairness Act of 2018, H.R.6102, 115th Cong. (2018). See our prior analysis of this bill here.

[9] Financial Stability Oversight Council, 2014 Annual Report, available at: https://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf. *See also* Financial Stability Oversight Council, 2019 Annual Report, available at: https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf.

[10] Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Nonbank Financial," available at: https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf. See our prior analysis of this guidance here.

[11] Federal Housing Finance Agency, "Frequently Asked Questions: Updated Eligibility Requirements for Enterprise Single-Family Seller/Servicer," Jan. 2020, available at: https://www.fhfa.gov/Media/PublicAffairs/Documents/Servicer-Eligibility-FAQs-1302020.pdf

[12] Under the Proposal, "net worth" means total equity capital as determined by generally accepted accounting principles, minus goodwill and other intangible assets (excluding mortgage servicing rights) and minus receivables from related parties and pledged assets net of associated liabilities.

[13] 12 C.F.R. § 1024.38(c)(2).

[14] *Id.* §§ 1024.30(b)(1); 1026.41(e)(4)(ii).

[15] The Proposal references both Regulation X and Regulation Z, but it only mentions specific requirements detailed in Regulation X. It is unclear which provisions from Regulation Z the Proposal seeks to apply to all nonbank servicers.

[16] Consumer Financial Protection Bureau, Bulletin 2014-01, "Compliance Bulletin and Policy Guidance: Mortgage Servicing Transfers," Aug. 19, 2014, available at: https://files.consumerfinance.gov/f/201408_cfpb_bulletin_mortgage-servicing-transfer.pdf

[17] Federal Housing and Finance Agency, Advisory Bulletin 2014-06, "Mortgage Servicing Transfers," June 11, 2014, available at: https://www.fhfa.gov/SupervisionRegulation/AdvisoryBulletins/AdvisoryBulletinDocuments/2014%20AB-06%20Mortgage%20Servicing%20Transfers%20Advisory%20Bulletin.pdf

[18] The Proposal also provides that state regulators may determine that other servicers not meeting this definition are subject to the enhanced standards.