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State Prudential Standards for Mortgage Servicers: “Ahead of the Curve” or “Dead Man’s Curve”?

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I was only 9 years old when Jan and Dean in 1963 released their hit song “Dead Man’s Curve.” I thought about this song when I read the Conference of State Bank Supervisors’ (“CSBS”) Proposed Regulatory Prudential Standards for Nonbank Mortgage Servicers (the “Proposal”). Published for comment on September 29 with comments due by the end of the year, the Proposal seeks to impose on US nonbank mortgage servicers many of the safety and soundness or prudential standards required of insured depository institutions by federal banking regulators. The goal, it appears, is to “get ahead of the curve” of the potential for mortgage servicer failures resulting from widespread mortgagor delinquencies. While that objective is reasonable in principle, the question is whether a state-imposed “one size fits all” financial strength requirement could cause the very mortgage servicer failures that the standards are designed to prevent.

We previously wrote a Legal Update describing the Proposal. The focus of this Legal Update is the financial strength requirements specified in the Proposal. CSBS seems to recognize that bank safety and soundness standards might not be a comfortable fit for nonbank mortgage servicers when CSBS asks interested parties, among other questions, to provide comments on a fundamental “gating” issue—namely, is the need for state prudential standards sufficiently established?

BACKGROUND

The Proposal includes minimum net worth and capital ratio requirements that in part track FHFA (the conservator and regulator of Fannie Mae and Freddie Mac) requirements, and the Proposal requirements are designed automatically to adjust as FHFA’s requirements are modified. One of the questions it asks is whether its financial strength standards should be tied to FHFA requirements.

Specifically, the Proposal would require nonbank mortgage servicers to maintain the *higher of* (1) $2.5 million net worth plus 25 basis points of owned unpaid principal balance for total 1–4 unit residential mortgage loans serviced or (2) FHFA eligibility requirements. The Proposal

would apply this methodology to all owned residential servicing rights, without regard to the terms of the servicing agreement, such as whether the servicer is contractually obligated to make monthly advances of principal and interest if the borrower does not pay. With respect to capital requirements, nonbank mortgage servicers would be required to maintain the higher of (1) net worth/total assets equal to or greater than 6% or (2) FHFA eligibility requirements. These align with FHFA’s current 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 aggregate unpaid principal balances of agency and non-agency servicing 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. This additional requirement would equal 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. This tracks FHFA’s existing requirements, although FHFA discounts the size of the outstanding balances of loans in CARES Act forbearance. Also, 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 to satisfy these liquidity requirements 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; prior to this month, this exclusion was part of the revisions to Fannie Mae’s and Freddie Mac’s financial strength requirements that FHFA proposed in January 2020 and later rescinded in June 2020 pending further rulemaking. To the surprise of the industry, Fannie Mae and Freddie Mac each announced the adoption of this exclusion on December 16, 2020, effective March 31, 2021.

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. 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.

CONTEXT

Our prior Legal Update identifies the genesis of the Proposal. While not explicitly stated in the Proposal, there appear to be two types of major regulator concerns relating to the financial strength of nonbank mortgage servicers. The first is whether mortgage servicers can meet their contractual obligations to advance principal and interest to whole loan or mortgage-backed securities holders under the terms of the relevant servicing agreements, if a substantial percentage of borrowers go delinquent and do not soon reinstate. COVID-19 exacerbated this concern this year by virtue of the statutory right of eligible borrowers to seek mortgage forbearance under either the CARES Act for government-related mortgage loans or the laws of some states for other loans.

Luckily, in light of the continuing refinancing boom, the ability of servicers under their servicing agreements to use excess custodial funds from full prepayments as an interim source of funds to make principal and interest advances materially reduced the potential hardship on mortgage servicers to meet these advance obligations. But an increase in interest rates could diminish the availability of excess custodial funds to pay for principal and interest advances. What happens if a mortgage servicer cannot come up with the funds it needs to make required advances?

The second concern is whether mortgage servicers can meet their contractual obligations under their borrowing facilities that they obtained to finance the making of advances and the acquisition and holding of mortgage servicing rights. These facilities often are secured by the mortgage servicer’s interest in all or a portion of its mortgage servicing rights, based on a prescribed loan-to-value ratio. If the value of the servicing rights declines, the servicer either has to provide additional collateral or partially prepay the loan in order to maintain the required loan-to-value ratio—a so-called ”margin call.” In a worst case scenario, the creditor could declare the mortgage servicer in default under the loan agreement and seek to seize the mortgage servicing rights, which most likely would result in a default under the agency servicing agreements. While the Proposal’s (and FHFA’s) financial strength requirements do not directly account for the financial covenants in a mortgage servicer’s borrowing facilities, the existence of the debt and the impact of margin losses would be reflected in the calculation of net worth.

In either case, a mortgage servicer’s default, under either a servicing agreement or a commercial loan agreement, theoretically could result in a mortgage servicer failure with resulting harm to borrowers. The fact that this ”parade of horribles” could occur does not mean that it is reasonably likely to occur—that either a servicer would fail or, if it did, the failure would cause widespread harm to borrowers. Indeed, Fannie Mae, Freddie Mac, and Ginnie Mae have subservicers in place to take over the servicing functions on an interim basis for servicers terminated with cause. They have utilized these arrangements for years without reports of material consumer harm.

But that does not mean that state regulators want to wait until the risk of a servicer failure eventuates to find out for sure that the likelihood and severity of consumer harm is low; it understandably wants to get “ahead of the curve.” The Proposal is designed to minimize the likelihood of a mortgage servicer’s financial failure. Yet the good faith pursuit of a worthy public policy objective does not mean the Proposal as constituted makes sense.

ISSUE

A key issue under the Proposal is whether there should be prescriptive, state-mandated financial strength requirements, and, if so, what should they be and how will they be enforced? There is nothing unique or outlandish about a state licensing authority wanting to impose financial strength standards on a licensed entity. Many state mortgage banking licensing laws already do that, although there is little history of state requirements comparable to those in the Proposal.

The bigger issue is what should those standards be? Should they equal FHFA standards for Fannie Mae or Freddie Mac approved servicers? Should they be higher than these standards? Should FHFA standards even apply for servicers who only service non-agency loans? Is there another approach to address the same concerns?

Agency Financial Strength Requirements

As noted above, agency servicers already have to meet agency financial strength requirements on net worth, capital, and liquidity. Requiring an agency servicer to meet the financial strength requirement of the agencies for which it services has a simple logic to it. But converting a contractually imposed continuing eligibility requirement into a law or regulation could cause a problem in state enforcement. Each of Ginnie Mae, Fannie Mae, and Freddie Mac has the discretion to waive or alter these financial strength requirements based on its evaluation of the relevant circumstances. This flexibility to act quickly when necessary or appropriate may take many forms and is informed by their “hands-on” knowledge of the servicer’s performance and profile to support a judgment to take a less drastic alternative than declaring default.

Depending on the final form that the Proposal might take for any particular state, state regulators may not have the same flexibility when administering fixed laws and regulations. This difference between fixed and discretionary standards could create the anomalous result of a state or states imposing administrative sanctions on a mortgage servicer for failing to meet agency financial requirements when the agency itself determined in its informed judgement not to declare a default and exercise remedies. These state sanctions could create a series of cross-defaults resulting in the failure of a mortgage servicer even though the agency itself elected initially not to declare a default under the servicing agreement.

It is hard to fathom a compelling reason for state regulators to prescribe financial strength requirements that are higher than those of Fannie Mae, Freddie Mac, and Ginnie Mae for agency servicers. One of the primary risks about which the state regulators seem to be most concerned—meeting principal and interest advance requirements in a time of high borrower delinquencies—is the very risk to which these agencies manage because they bear the direct risk of loss if a servicer fails to meet this advance obligation. Moreover, Fannie Mae and Freddie Mac are subject to their own federal supervision and examination and are subject to regulatory safety and soundness standards, and Ginnie Mae is part of a federal agency, the Department of Housing and Urban Development. Where is the data-driven analyses to support the states' exercise of different judgments about the required financial strength of mortgage servicers in connection with federally related servicing agreements?

Similarly, why would state regulators require non-agency servicers to meet the financial strength requirements of Fannie Mae and Freddie Mac, if the non-agency servicing agreements do not require servicers to advance principal and interest and servicers may not have financed their mortgage servicing portfolio? There should be a rational relationship between the state financial strength requirements and the contractual obligations and financial profile of the mortgage servicer. Such a relationship is not readily apparent in the non-agency servicing world under the Proposal. As non-agency approved servicers tend to be smaller than their approved counterparts, a "one size fits all" approach pegged to agency financial strength requirements also could have a particular adverse impact on smaller mortgage servicers, again perhaps needlessly resulting in a smaller mortgage servicer's failure by virtue of the imposition of state administrative sanctions.

An Alternative Approach

An alternative approach is to abandon a fixed quantitative formula for determining financial strength requirements and instead utilize a pure "principles-based" regulatory perspective—namely, that a mortgage servicer must meet in all material respects the financial strength requirements under the servicing agreements to which it is subject. Under this approach, a state could not impose its judgement on how much net worth, capital, or liquidity is enough or not enough or how to calculate these metrics; it could not question the determinations of the counterparties to a mortgage servicer's servicing agreements. A decision by an investor under a servicing agreement to waive a potential breach of its financial strength requirements automatically would pass-through to the state standard. A principles-based approach recognizes that the risk of a mortgage servicer's financial failure would be the direct the result of a contractual counterparty declaring a default and exercising remedies based on a servicer's inability to meet material contractual obligations.

As noted above, aside from the risk of servicer licensees failing to make principal and interest advances, state regulators also are particularly concerned about the potential for a mortgage

servicer's material losses resulting from margin calls on loans secured by mortgage servicing rights. But the impact of margin calls on a servicer's financial strength is reflected in its financial statements through a reduction in indebtedness and a reduction in cash, with any resulting changes in the servicer's net worth and liquidity. In any event, while the Proposal links a mortgage servicer's financial strength requirements to those of FHFA, secured creditors have their own financial strength requirements for their mortgage servicer borrowers. In many respects, the financial risk profile of mortgage servicers under commercial loan agreements is very much like their profile under servicing agreements with the agencies and thus serve as a "second set of private eyes" to monitor a mortgage servicer's financial profile.

First, commercial lenders impose sophisticated affirmative and negative financial covenants on its mortgage servicer borrowers in their credit agreements, including the continuing covenants to comply with state licensing laws and agency eligibility standards for financial strength. These agreements provide the creditor with robust remedies it may elect to exercise if the mortgage servicer defaults under the credit agreement.

Second, in each case, the investor under the servicing agreement and the commercial lender under the credit agreement bears the direct credit risk of loss if the mortgage servicer defaults on its contractual obligations and has a broad array of risk management controls and contract remedies to address this risk.

Third, federally insured depository institutions often serve as commercial credit providers to mortgage servicers and are themselves subject to safety and soundness standards and supervision and examination by their federal regulators. Fourth, commercial lenders have the discretion to waive, modify, or vary any of their contractually imposed affirmative and negative covenants, or elect not to declare a default and accelerate the outstanding indebtedness, based on their evaluation of the totality of the circumstances; if a state were to impose administrative sanctions on a mortgage servicer for failing to meet financial covenants in a loan agreement as to which the creditor elected not to declare a default, a series of cross-defaults could follow, resulting in the failure of a mortgage servicer.

The one problem with this approach is timing. Mortgage servicers annually upload their audited financial statements to the NMLS. A lot can happen in a year, and state regulators likely do not want to be caught "flat footed" if a licensee suffers a material adverse financial effect during the year. But that concern is easily resolved through the supervisory powers of a state mortgage regulator to request interim financial results to assess a licensee's continuing compliance with the financial strength requirements of its servicing agreements.

Collective State Action

Financial strength requirements, regardless of how formulated, could wreak havoc if the states do not act in unison. As drafted, the Proposal seemingly would permit any single state

regulator to restrict or terminate a license of a servicer that allegedly is in violation of that state’s financial requirements. Such a unilateral act likely would set in motion a series of parallel state actions, even though the investors under the servicing agreements or the commercial creditors under loan facilities formulated their own action plans to address the financial issues without declaring a default. This makes no sense and again could cause the result that the Proposal is designed to limit.

CONCLUSION

One should not blame CSBS and state regulators for wanting to get *“ahead of the curve”* in monitoring for a potential collapse of a mortgage servicer. But imposing prescriptive, mandatory financial strength requirements in a “one size fits all” manner may have an unintended material adverse effect on mortgage servicers—*a regulatory “dead man’s curve”*—particularly if the states either disregard a servicer’s contract counterparties election not to declare a default or fail to act in unison in response to a servicer’s financial hardship.