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Client Alert

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FHFA Announces Minimum Capital and Liquidity Requirements for Non-Bank Servicers

On January 30, 2015, the Federal Housing Finance Agency (FHFA) proposed new minimum financial eligibility requirements for non-bank sellers and servicers of mortgage loans to Fannie Mae and Freddie Mac (the GSEs). The proposed minimum financial requirements include net worth, capital ratio, and liquidity criteria for the non-bank mortgage firms and are an attempt to curb perceived risks to the GSEs, and ultimately the tax payers, amidst a post-financial crisis industry shift that has resulted in non-bank mortgage firms playing an expanded role in mortgage servicing. The proposed requirements, which are set forth in more detail below, are open for public comment, expect to be finalized by mid-2015, and will take effect six months from the date they are finalized. With the private securitization market still recovering from the financial crisis, almost all residential mortgage loans that originated in the United States are sold to the GSEs or U.S.-owned Ginnie Mae. As a result, these new requirements will affect almost all non-banks that are active in the mortgage market.

The Changing Landscape of the Mortgage Servicing Industry Post-Financial Crisis

Banks historically dominated the mortgage servicing industry due to their roles as loan originators and aggregators, their access to cheap capital, and their desire to benefit from favorable regulatory and U.S. accounting treatment given to mortgage servicing rights, or MSRs. But during the financial crisis, the mortgage servicing industry's customer service standards and foreclosure practices became the subject of countless news stories, Congressional hearings, lawsuits and regulatory actions. Banks have paid billions of dollars in legal and regulatory settlements and have spent millions of dollars updating internal policies and procedures to comply with the terms or conditions of consent orders and new servicing standards. In addition to rising litigation and compliance costs, banks now are facing regulatory changes that make holding MSRs on their books cost-prohibitive despite their value under U.S. accounting rules, their use as a natural hedge against rising interest rates, and their impact on banks' mortgage origination businesses. The passage of the capital standards adopted in the U.S. pursuant to the Dodd–Frank Wall Street Reform and Consumer Protection Act as set under the Basel III international capital accords eliminated the favorable treatment of MSRs, which previously could comprise up to 50% of a bank's Tier 1 capital. Now faced with the increased regulatory, legal, and reputational risks of operating in the post-financial crisis environment, many banks are feeling pressure to exit the mortgage servicing business or decrease their mortgage servicing portfolios.

At the same time, large non-bank mortgage servicers have seen this post-crisis landscape as an opportunity to gain market share in the industry by purchasing MSRs at distressed prices, implementing cost-cutting measures to reduce servicing costs, and creating new financial products to fund servicing operations. With banks no longer the only big players in the business, this industry shift has caught the attention of federal and state regulators and has raised concerns over a lack of prudential regulatory standards for mortgage servicers. The FHFA's inspector general raised concerns in the 2014 FHFA Office of Inspector General Audit Report (the "FHFA

Report") about the rapid growth in non-bank servicers, noting that the three largest tripled in size since 2012 and are, in some cases, using short-term financing to fund their expansion. Similar concerns were raised in the 2014 Annual Report of the Financial Stability Oversight Council, which noted that MSR holdings of non-bank servicers increased by $806 billion to $1.7 trillion from 2012 to 2013. The FHFA Report focused on the quick growth of non-bank mortgage servicers, especially in the area of servicing non-performing loans. This concern also was raised in the 2014 Annual Report of the Financial Stability Oversight Council published in May. According to the Urban Institute and Mortgage Bankers Association, the annual cost for servicing such loans in 2013 was $2,357 per loan. With Fannie Mae's three largest non-bank servicers overseeing 13 percent of its loans as of September 2013, including 32 percent of delinquent debt, there are concerns that the rapidly expanding non-bank servicers may not be adequately capitalized to handle such large volumes of non-performing mortgage loans. In addition, nine out of Fannie Mae's top 20 servicers were non-banks at the end of 2013, accounting for 28 percent of loan volume or 3.6 million loans with approximately $600 billion in unpaid principal balances, according to the FHFA Report. Similarly, seven out of Freddie Mac's top 20 servicers were non-banks, accounting for 15 percent of loan volume or 1.3 million loans with approximately $230 billion in unpaid principal balances. And at the state level, the New York Superintendent of the Department of Financial Services, for example, has been speaking out about the quick growth of large non-bank servicers and subjecting non-bank servicing acquisitions to greater scrutiny. In addition, on October 22nd, 2014, the Conference of State Bank Supervisors announced it had formed a Mortgage Servicing Rights Task Force to examine and enhance state-level prudential standards for non-bank mortgage servicers with which the FHFA has been assisting by providing the task force with data and input. With the FHFA's announcement last week, it is now becoming apparent that this shift will affect how the mortgage servicing industry is regulated in the future.

The FHFA's Proposed New Rules

As noted above, banks historically dominated the mortgage servicing industry. Since banks are heavily regulated on either the federal or state level and subject to stringent capital and liquidity rules, no stand-alone capital and liquidity requirements exist for the mortgage servicing industry generally. Although non-bank mortgage firms must comply with state regulations and now, along with their bank peers, are subject to oversight by the Consumer Financial Protection Bureau, much of the oversight is consumer-focused and little attention has been given to capital adequacy, liquidity needs, or risk management. With the industry shifting increased market share to large non-bank mortgage servicers, the FHFA's proposal attempts to address a perceived regulatory gap. Although the FHFA's power to regulate stems from its oversight of the GSEs, the rules will ultimately impact most, if not all, mortgage servicers, since 47 percent of mortgages sold to Fannie Mae in 2013 and 20 percent of loans sold to Freddie Mac during the same period were sold by non-bank mortgage firms.

The standards will establish minimum capital ratio and liquidity requirements for any non-bank servicer who services loans sold to the GSEs equal to at least six percent of the servicer's total assets. In addition, non-bank servicers also will have to hold liquid assets equivalent to at least 0.035 percent of the loans they oversee for the GSEs or Ginnie Mae. This amount could increase by a rate of 200 basis points of the total of non-performing GSE and Ginnie Mae servicing assets in excess of six percent of the servicer's total in unpaid principal balances if the non-bank servicers own, or service, many delinquent loans due to the high costs of servicing non-performing loans. The delinquency statistics for the servicer's total GSE and Ginnie Mae servicing portfolio must be certified quarterly by the servicer's Chief Financial Officer.

Allowable assets for liquidity purposes include the following: cash and cash equivalents (unrestricted); available for sale or held for trading investment grade securities, including GSE or Ginnie Mae MBS, obligations of the GSEs, and U.S. Treasury obligations; and any unused or available portion of committed servicing advance lines. The available amount used for servicing advance lines must be certified quarterly by the servicer's Chief Financial Officer.

In addition, all entities selling or servicing loans for the GSEs will need to have a net worth of at least $2.5 million plus 0.25 percent of the value of the unpaid principal balance of all loans they service. This will increase the amounts currently required by the GSEs because the percentage is based off all loans serviced and not just loans serviced for the GSEs.

For those currently approved non-bank GSE servicers that are unable to meet, or have not met, the new requirements upon the effective date of the final rule, the GSEs will have the discretion to take appropriate action, including termination of the servicer. Exceptions to the requirements will be at the GSEs' discretion and may be considered if there is tangible evidence support, such as a guarantee by a parent company.

The Impact of the Proposed Rules

Although the proposed rules will apply to all sellers and servicers of mortgage loans to the GSEs, the impact will be felt, if at all, by non-bank mortgage firms, as banks are already subject to more stringent capital and liquidity requirements under existing banking regulations. Of the non-bank servicers, it is unclear the extent to which the new rules will impact the largest players. For them, it may mostly slow down the rate at which they have been acquiring large servicing portfolios. For smaller non-bank players, it seems the impact would be the greatest, even though they pose the least overall risk to the soundness of the GSEs or the financial markets, in general.

The greater effect most likely won't be as a result of the rules themselves, but rather the continued momentum of agencies working together on the state and federal level to ensure proper capital, liquidity, and risk management tools are in place for all bank and non-bank firms that are critical players in the financial markets. As new regulations and requirements continue to shape the mortgage industry landscape, market participants continue to respond to such changes by taking advantage of perceived opportunities, weighing the costs of continued participation, and finding ways to reduce compliance and operational costs.

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