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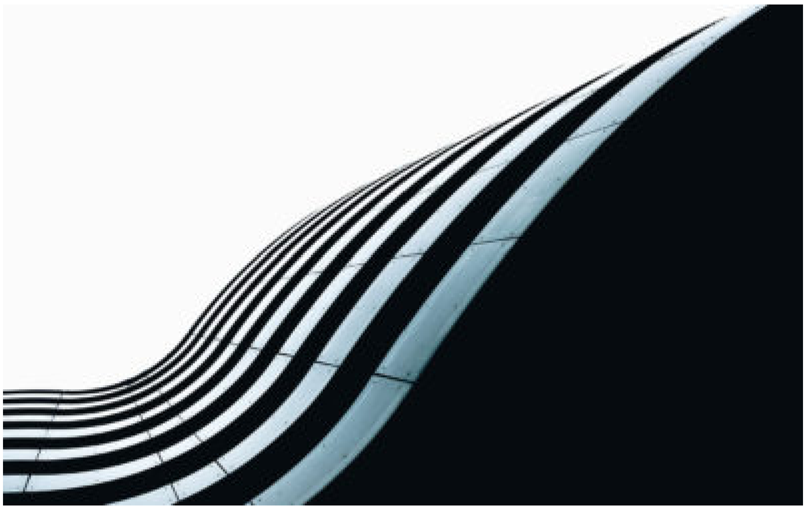

# FINANCIAL REGULATORY | Enhanced US Financial Requirements for Non-Bank Mortgage Servicers: What Doesn't Kill You Makes You Stronger?

US mortgage loan rates go up; re-financings go down, along with the amount of excess custodial funds from full prepayments to fund principal and interest servicing advances for mortgage loans in default or forbearance. Delta variant infections go up; business, income and jobs go down. Home loan delinquencies go up; servicing fee income goes down. Mortgage loan servicing advance obligations go up; servicer financial strength goes down. Required net worth, capital and liquidity requirements go up; mortgage company profitability goes down.

That's the nightmare scenario plaguing housing finance policy makers, much less the state-chartered, non-bank independent mortgage bankers they oversee. These up-and-down scenarios are not necessarily true in all cases, but the specter is enough to cause federal and state regulators to search for solutions before it is too late. Unfortunately, though, the solution of choice may actually precipitate the very downside risk it is designed to prevent. Maybe it is time to discuss more seriously whether the liquidity risk of principal and interest servicing advances in times of materially adverse economic circumstances should be borne by the government instead of by mortgage servicers, particularly in the case of Ginnie Mae.

***The Need for More Financial Strength***

The financial strength of independent, non-bank mortgage servicers has been under sharp scrutiny by the US Financial Stability Oversight Council ("FSOC"), the Conference of State Bank Supervisors ("CSBS") and the Federal Housing Finance Agency ("FHFA"), along with Fannie Mae and Freddie Mac, and Ginnie Mae. At issue is whether such mortgage servicers can withstand an adverse economic environment. But what does that really mean?

Well, counterparty risk is one type of concern for government guarantors of mortgage-backed securities. If a mortgage servicer cannot fund principal and interest servicing advances contractually required under program guidelines, the government guarantors must step in to do so. Moreover, if a mortgage servicer suddenly shuts its doors, the tasks of collecting and remitting mortgage payments, helping eligible delinquent borrowers obtain loss mitigation and pursuing foreclosure when there are no viable alternatives could wreak havoc on consumers and investors alike, unless a substitute servicer or sub-servicer seamlessly takes over. And in a really extreme case, FSOC has questioned whether the failure of one or more non-bank mortgage servicers could have an adverse impact on the financial stability of the United States—a scenario that seemingly is farfetched but nevertheless one for which FSOC has advocated advance planning to reduce the likelihood of occurring.

Heightened financial strength requirements for independent, non-bank mortgage servicers seems to be the solution of choice for policy makers these days. Fannie Mae, Freddie Mac and Ginnie Mae long have required eligible participants to meet specified levels of net worth, capital and liquidity. The CSBS recently has gotten into the fray, recommending comparable requirements for state licensing eligibility. FHFA proposed, rescinded and purportedly plans to re-propose increased financial standards. And Ginnie Mae recently issued a Request for Input on proposed increased standards, including the introduction of a highly controversial risk-based capital ratio requirement; thankfully, Ginnie Mae subsequently postponed the deadline for comments until October 8, 2021, and acknowledged its intent to pursue alignment with the related efforts of the FHFA and the CSBS. If and when alignment is achieved, at least at this point, alignment likely will require non-bank mortgage servicers to amass *more* net worth, *more* capital and *more* liquidity than required under existing standards. But could requiring *more* backfire?

### *Funding Principal and Interest Servicing Advances*

Let's start with the obvious. A third-party mortgage servicer has no beneficial ownership interest in the underlying mortgage loans that it services. It simply is a contract service provider to perform or cause to be performed the underlying mortgage servicing function for a fee on behalf of the owners of the loans and related mortgage-backed securities. An obligation to advance regularly scheduled payments of principal and interest to securities holders is part of the servicing function for Ginnie Mae/Fannie Mae/Freddie Mac securitized loans, if the borrowers fail to make such payments. In the case of Ginnie Mae, such advances must continue until the loans reinstate or the loans are repurchased from the pools, either voluntarily based on the level of delinquency or on a mandatory basis if the loans are modified in accordance with underlying Federal Housing Administration ("FHA")/Department of Veterans Affairs ("VA")/US Department of Agriculture's Rural Housing Service ("RHS") requirements. In the case of Fannie Mae and Freddie Mac, such advances must continue for a much shorter specified period of time.

Such advances in the ordinary course constitute a liquidity risk, but not an ultimate credit risk, to the mortgage servicers, because generally they have a right to reimbursement from subsequent borrower payments and/or from Fannie Mae or Freddie Mac or, in the case of Ginnie Mae, mortgage insurance or mortgage guarantee proceeds. But the source of funds to make such advances has to come from somewhere. Fannie Mae, Freddie Mac and Ginnie Mae all permit servicers to use excess custodial funds from full, voluntary mortgage loan prepayments as an interim source of funds until such prepayments must be remitted to the investor in the immediately following month. As long as refinancings continue at a torrid pace, servicers can replenish the excess custodial funds from full principal prepayments that they used to fund principal and interest advances required in one month with those collected in the next month, and so on and so on. Yet there may come a time when a steep drop-off in refinancings coupled with high levels of delinquencies due to COVID-19 or other factors will result in insufficient excess custodial funds to pay for the required advances.

Secured servicing advance financings provide a second source of funds for mortgage servicers to satisfy advance requirements. There are significant structural impediments to the availability, and that impact the cost, of such facilities, particularly with respect to Ginnie Mae. The principal impediment is the inability to fully realize on the mortgage servicing rights collateral in the case of a default under the loan agreement, based on agency restrictions. Unlike Fannie Mae and Freddie Mac, Ginnie Mae does not permit separate servicing advance facilities, only permits one financing facility per servicer that is secured by Ginnie Mae mortgage servicing rights, and provides virtually no protection for secured creditors if Ginnie Mae declares the servicer in default and seizes the servicing rights. In addition, the servicer cannot seek reimbursement for advances directly from Ginnie Mae, instead having to rely on mortgage insurance or mortgage guarantee proceeds payable by the FHA, VA or RHS.

To its credit, Ginnie Mae recognized the servicing advance conundrum for mortgage servicers after US Congress enacted the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which, among other provisions, granted borrowers who attested that they were experiencing financial hardship directly or indirectly due to COVID-19 the ability to seek mortgage forbearance for up to one year on loans sold to Fannie Mae or Freddie Mac or insured or guaranteed by the FHA, VA or RHS (defined as "federally-backed mortgage loans"). Such forbearance automatically triggered principal and interest servicing advances for insured or guaranteed loans pooled into Ginnie Mae securities and loans securitized through Fannie Mae or Freddie Mac.

Specifically, on April 10, 2020, Ginnie Mae announced the final terms of its much-anticipated Pass-Through Assist Program for Issuers ("PTAP") of mortgage-backed securities that are in need of funding for the increased amount of servicer advances due to the COVID-19 national emergency and forbearances under the CARES Act and which built upon Ginnie Mae's then existing program to assist servicers to fund advances in the wake of 9/11 and natural disasters. But, despite good intentions, the program, which Ginnie Mae structured as a program of "last resort," was lightly used. First, excess custodial funds from full prepayments discussed above lessened the need for the facility. Second, embedded in the program are significant restrictions on executive compensation and distributions while any draws remain outstanding. Third, draws under the facility mature after seven months, which is less than the amount of forbearance afforded borrowers under the CARES Act and subsequent extensions by FHA, VA and RHS. Fourth, commercial lenders under existing finance arrangements secured by a servicer's mortgage servicing rights have to agree to subordinate the priority of their security interest to that of Ginnie Mae. Last, the COVID-19 PTAP facility is documented through a "Master Supervisory Agreement"; many private commercial loan agreements make it an event of default for the mortgage servicer borrower to enter into a "supervisory agreement" with a governmental entity because such agreements typically are used by prudential regulators with supervised financial institutions that are deemed to have violated applicable regulatory requirements, creating the prospects of a cross-default and in any event a perceived badge of dishonor.

A third source of funds is the servicer's own funds, which is where the net worth, capital and liquidity requirements come into play. In an adverse economic environment resulting in high levels of borrower defaults and corresponding high levels of principal and interest servicing advance requirements, servicers may have difficulty self-funding such advances and waiting for reimbursement in accordance with agency requirements. And that's why agency alignment likely will require non-bank mortgage servicers to amass more net worth, more capital and more liquidity.

### *The Downside to "More"*

"*More*" likely comes at a cost-lower margins resulting from the cost of capital and the like and perhaps lower valuations and less interest of private capital to invest in mortgage servicers. Some mortgage servicers may not be able to meet and maintain these new requirements, thus falling out of eligibility to service agency mortgage loans and perhaps resulting in an increase in the concentration of agency servicing among fewer mortgage servicers. Those that can meet and maintain these higher financial standards presumably will be in a financially better position and, if the returns are good enough and capital is plentiful, may elect to increase their holdings. Ergo, what doesn't kill you makes you stronger. Or, at least, may make you stronger? And then again, it may make you weaker.

"*More*," however, begs the question of why mortgage servicers alone should bear the liquidity risk of increased principal and interest servicing advances in an adverse economic environment, particularly when reimbursement for advances often is prolonged. Ginnie Mae servicing is where the issue is most acute. As mentioned above, unlike Fannie Mae and Freddie Mac, there is no time limit on advancing regulatory scheduled payments of principal and interest on a pooled loan in delinquency or forbearance, unless and until the loans are repurchased based on strict Ginnie Mae guidelines and which repurchases themselves require funds available to the servicer to execute. Last year, Ginnie Mae made it even worse for servicers by imposing seasoning requirements on servicers that repurchase certain delinquent loans, reinstate the loans through options other than loan modification (even when such reinstatement is mandated by the underlying federal agency's loss mitigation waterfall of options) and then seek to re-pool the loans, thus prolonging the time it takes to recoup their repurchase funds.

### *Time for the Government to Step Up*

But there is another way than simply requiring servicers to have and maintain *more* and *more* net worth, capital and liquidity to manage the advance risk in an adverse economic environment. Ginnie Mae itself could fund principal and interest advances when certain macro-economic and other characteristics of an adverse economic environment present themselves or when, by federal legislation or executive action, borrowers are temporarily relieved from their obligations to make regularly scheduled monthly payments. Fannie Mae and Freddie Mac already cap a servicer's advance obligations for regularly scheduled payments of principal and interest on delinquent loans, without regard to the existence of adverse economic circumstances. Why can't Ginnie Mae do the same in a more limited way?

The underlying rationale for a different paradigm than exists today is that mortgage servicers are mere service providers and should not have to bear the servicing advance requirements when profound, material adverse changes occur in the economy at large, given that the servicer has no beneficial ownership of the pooled mortgage loans and the related securities. Ironically, the holders of Ginnie Mae guaranteed, mortgage-backed securities are insulated against the risk of borrower delinquencies in adverse economic circumstances, but their service providers are not. Maybe it is time to re-think the servicer's advance obligations—not whether the securities holders should receive these advances, because that might turn the market for Ginnie Mae securities upside down—but whether there should be a ceiling on the servicer's obligation to make these advances to securities holders in periods of adverse economic circumstances. In other words, while policy makers are justifiably concerned about the potential impact of adverse economic circumstances on non-bank, independent mortgage servicers, maybe they also should be looking in the mirror to find solutions.

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