Bloomberg Law

BNA's
Banking Report™

Reproduced with permission from BNA's Banking Report, 109 BBR 1458, 10/30/2017. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Acquiring Excess Servicing Fees for Mortgage Loan Servicing Rights

BY LAURENCE PLATT AND JON VAN GORP

Is it possible for an investor to participate in the economics of agency residential mortgage servicing rights (MSRs) without being an approved holder of MSRs?

Acquiring excess servicing fees (ESF) is one way that investors are exploring to accomplish this objective. While an investor may not need to be approved as a servicer or issuer by the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal National Mortgage Association (Fannie Mae) or the Government National Mortgage Association (Ginnie Mae) (collectively, the Agencies) to acquire ESFs, the Agencies nevertheless impose various restrictions on the issuance, purchase, sale, and financing of ESFs.

The focus of this article is creating and selling ESFs from Agency servicing agreements as a method of financing the origination and acquisition of MSRs. Currently, Agency MSRs make up a majority of the residential mortgaging servicing market as measured by outstanding loan balance. The remaining portion of the residential mortgage servicing market comprises the so-called ''private label'' market, which is structured in much the same way as Agency servicing agreements and therefore creates a parallel opportunity for the creation of ESFs. Similarly, MSRs can be financed by loans secured by MSRs. These secured servicing finance facilities in many ways resemble ESF transactions because, among other reasons, when Agency MSRs are involved, the related Agency must consent to a pledge of the MSRs in order for the lender to have a valid security interest in the MSRs. Readers who understand the process for creating and funding ESFs from Agency servicing agreements will be a long way towards understanding private label ESFs and loans secured by Agency MSRs even though these topics are beyond the scope of this article.

Laurence E. Platt is a partner in Mayer Brown LLP's Financial Services Regulatory & Enforcement practice. Based in Washington, D.C., he can be reached at lplatt@mayerbrown.com.

Jon Van Gorp is co-leader of Mayer Brown LLP's Structured Finance and Capital Markets practices. Based in Chicago and New York, he can be reached at jvangorp@mayerbrown.com.

What is an ESF?

An ESF is a portion of the contractual mortgage servicing fee that exceeds a mutually agreed-upon base amount that is reasonably necessary to be retained by the owner of the servicing rights to enable it to discharge its servicing obligations in accordance with applicable laws, agency guidelines and prudent servicing standards.

Before discussing the structure of an ESF, it is worth examining the nature of mortgage servicing rights. Mortgage servicing rights are created whenever a new mortgage loan is originated and represent a contract right to administer the mortgage loans or related mortgage-backed securities on behalf of the owner of the loan or the securities. The mortgage servicing fee represented by a mortgage servicing right is a contractual amount of the interest rate payable by the borrower that is earmarked as compensation to a servicer who is servicing the related mortgage loan. Because these mortgage servicing fees are in excess of the cost of performing the servicing, the rights to service the loans have a current value which is roughly equal to the net present value of the difference between the contractual

servicing fee and the cost to service over the expected duration of a mortgage loan.

This is why mortgage servicing rights trade in the market for a positive price and it is why they are reflected on the books and records of a servicer as an asset, the value of which is periodically updated to reflect changes in underlying valuation assumptions, particularly the duration of the related mortgage loans. For example, when interest rates rise, so does the value of mortgage servicing rights because mortgage loan durations extend in a rising interest rate environment. The opposite effect is experienced by owners of mortgage servicing rights in a declining interest rate environment because mortgage loan durations decrease as a result of loan refinancing activity.

Because of the way that mortgage servicing rights are traded in the marketplace, a mortgage servicer is effectively required to prepay for its right to receive servicing fees over time should it perform its obligations as servicer. This model has from time to time come under scrutiny as it is believed to be an economic barrier to entry for new and capable market participants.

There are few other examples in the world of vendor service contracts where the vendor is required to effectively cash-collateralize its obligation to perform. This model faced scrutiny following the credit crisis of the last decade when many servicers lobbied the Agencies to adopt a pay-as-you-go model where an up-front payment would not be required to acquire mortgage servicing rights. This so-called fee-for-service model was eventually rejected after several rounds of comment and debate in favor of the traditional approach of servicers purchasing mortgage servicing rights to acquire the right to service for the contractual servicing fees.

The rejection of the fee-for-service model in favor of the traditional model drove servicers to become more creative about financing the up-front payment. The ESF market developed as a result of those efforts. Transferring the ESF for value was a way for servicers to economically bifurcate the financial ownership of servicing from the platform-level components of developing and managing a successful mortgage servicer. For many servicers with limited capital, this was essential to their growth and profitability because without scale and leverage, mortgage servicing is a challenging business.

''Owning'' an ESF does not represent an ownership interest in the servicing agreement or in the underlying mortgage loans. Rather, it represents an interest in the servicing fee income as and when received by the servicer. Generally speaking, the excess servicing strip is intended to leave enough of a base servicing fee behind with the sponsoring servicer so that it still has a profit-making incentive to perform its servicing obligations.

If servicing fees are not received by the servicer, such as when a borrower does not make regularly scheduled monthly mortgage payments, there is no excess to be paid to a holder of ESFs. Much like the economics of an interest-only strip, the ESF effectively evaporates if the mortgage loan prepays and the related servicing fee is no longer payable.

Similarly, if the investor terminates the servicing agreement with or without cause, then the holder's interest in the servicing fees payable under the terminated servicing agreement expires as well, except perhaps for any interest in a termination fee payable by the investor in the case of termination without cause. If the loan is repurchased from a Ginnie Mae pool based on the delinquency status of the loan or to modify the loan in accordance with FHA loss mitigation rules, the resulting right to Ginnie Mae excess servicing fees generally would terminate as well.

Why do the Agencies Restrict the Sale of ESFs?

The Agencies' treatment of interests in ESFs arose out of their treatment of security interests in residential mortgage servicing rights. Approximately 25 years ago, each Agency for the first time publicly promulgated its respective version of a master form Acknowledgment Agreement (AA). While the problem the AA sought to address was a simple one, the solution was perhaps less so: under what conditions should a loan servicer be permitted to grant a security interest in MSRs to a financing source?

Why the resistance? The Agencies did not want to deal with third parties that claimed to have an interest in an Agency-approved servicer's MSRs. The rights of a third party to the servicing, if and when the Agency terminated the servicing rights based on the servicer's breach of the Agency servicing agreement, was a particular concern. They feared that the third party would claim that the Agency did not have sufficient cause to terminate and seek to intervene to prevent the extinguishment of the third party's derivative rights to the MSRs as collateral for its financing.

In addition, the agencies did not want to deal with third parties for which it had no contractual privity or relationship when the third party sought to foreclose on its interest in the MSRs and cause the transfer of the MSRs away from the approved servicer, particularly if the servicer challenged the propriety of the foreclosure. There was no room for a third party in the context of a servicing agreement between two parties.

The first AAs issued in 1991 by Fannie Mae and Freddie Mac and shortly thereafter by Ginnie Mae represented the culmination of extensive negotiations with the industry through the Mortgage Bankers Association. While each Agency has issued variations to its respective form over the years, the construct remains basically the same. They preapprove the grant of a security interest to a third party, and then address what happens to that interest if there is a default under either the servicing agreement with the applicable Agency or the loan and security agreement with the third party. With a few tweaks, the form AA is also used by each Agency to approve ESF arrangements.

The evolution of AAs has been a priority for the mortgage servicers because of the capital required to continue to aggregate mortgage servicing rights. As a result, they have continually pressed the Agencies to be more accommodating to the comments of their financing sources and ESF buyers. They view this as an essential component to their continued economic viability and stability.

The Agencies have an interest in achieving this result as well. Despite not being persuaded to move to a fee-for-service model, which was advocated by many mortgage-servicers, the Agencies are keenly aware of the systemic risks, the volatility and other challenges associated with owning mortgaging-servicing rights. Creating ways to facilitate a robust ESF market through effective AAs not only promotes the growth and devel-

 COPYRIGHT © 2017 BY THE BUREAU OF NATIONAL AFFAIRS, INC. BBR ISSN 0891-0634

opment of mortgage servicers but it also is an effective hedge against economic factors that may put a mortgage servicer out of business when it is otherwise performing its loan-servicing functions at a high level.

How Do the AAs Work?

All but one of the Agencies prohibit the grant of a security interest in their MSRs or the sale of an ESF without prior written approval. Failure to obtain approval would be a violation of the related servicing guide allowing the related Agency to exercise remedies up to and including termination for servicer non-compliance. Ginnie Mae presently does not require prior approval of a pledge or sale of ESFs, presumably because, in its view, the transaction does not represent the conveyance of an interest in the servicing rights themselves. The consequence of that, however, is that Ginnie Mae does not recognize the interests of, and will not otherwise deal with, the investor, unless the investor elects to execute an AA.

Each Agency evidences approval through the execution of the master form AA, which the Agency may execute in its sole discretion. While Ginnie Mae does not limit the purposes for which an AA may be executed, Fannie Mae and Freddie Mac both do. Freddie Mac, for example, limits the use of proceeds for which an AA is required: (a) to fund servicer's purchase of additional mortgage servicing portfolios; (b) to provide collateral for servicer's warehouse lines of credit; (c) to effect servicer's purchase of a mortgage banking company or (d) to fund servicer's working capital consistent with its residential mortgage business operations. Fannie Mae does not explicitly include working capital as a permitted purpose but does permit funding-required servicing activities, which arguably is the same thing.

Generally speaking, each form AA evidences the applicable Agency's approval of the pledge or transfer of MSRs or ESFs, as applicable. No Agency obligates itself to execute an AA with a secured party or an ESF investor. Moreover, Ginnie Mae only permits a single AA to be in effect at any one time and does not distinguish between a security interest in advances and a security interest in the MSRs. Fannie Mae and Freddie Mac, on the other hand, may permit more than one AA based on discrete pools of MSRs or advances. Each Agency will review the underlying documents as a condition to their potential approval.

The AAs basically divide the world into halves. The first half is what happens if there is a default under the secured party's loan and security agreement, and the second half is what happens if there is a default under the Agency servicing agreement. A key concern of the secured party is whether it can realize on its collateral if the servicer defaults on its contractual obligations under the loan and security agreement.

What Are the Rights of the Owner Under the AA?

While Article 9 of the applicable version of the Uniform Commercial Code may address how to foreclose on a contract, which is a ''general intangible'' in UCC parlance, the secured party's right to replace the servicer is not self-executing. The counterparty to the servicing agreement has some say on who is the servicer. In the case of Agency-servicing agreements, the Agency has no other contractual relationship with the secured party that would enable the secured party to replace the servicer with a new servicer of its choice. The AA addresses this problem by authorizing the secured party to seek to transfer the servicing rights to another approved servicer in accordance with standard Agency procedures if the servicer defaults under the loan and security agreement with the secured party and does not cure the default.

The servicer is required under the AA to waive any right to contest the secured party's claim of a default and request for transfer of the servicing. The servicer always can contest the default as being between it and the secured party, but the Agency will not get in the middle of that dispute. It is authorized by the servicer under the AA to rely on the secured party's request for a transfer of the servicing without any requirement to look behind the request and determine its validity. The foreclosing secured party, however, is required to comply with the Agency's standard procedures for servicing transfers.

This means that any such transfer cannot be done overnight, and the Agency has to approve both the transferee and the timing of the transfer and may impose conditions on the transfer in the ordinary course. There are not many differences among the three AAs on this point, although Ginnie Mae provides for the optional preapproval of a backup servicer.

What is the Seniority of Agencies' Interests Under the AAs?

All of the Agencies view their interests in the MSRs as senior to any interest and require the secured party to acknowledge that its interest is subordinate to the senior interests of such Agency. Each can terminate the servicing agreement in accordance with its established guidelines. The secured party agrees that it may not interfere with or challenge the termination. At the point of termination by the Agencies, the Agencies differ somewhat as to what extent they will continue to recognize any interest of the secured party to the MSRs.

Ginnie Mae is the least favorable to the secured party. Post-termination, it gives the secured party the right to cure a monetary default by the prior servicer, but the secured party must elect to cure the monetary default within one business day. For non-monetary defaults, there is no cure right. If the monetary default is cured, then the secured party may cause the immediate transfer of the servicing rights to itself if it is an approved issuer or a preapproved backup servicer. If the monetary default is not cured, or for other defaults for which the secured party has no cure rights, the secured party's security interest in the servicing rights automatically is extinguished and Ginnie Mae assumes no contractual obligation to pay any amounts to the secured party, including reimbursement for subsequently collected advances.

While the Ginnie Mae standard may be the least favorable of all three Agencies, it represents an improvement from prior Ginnie Mae AAs, which required the secured party to cure monetary defaults by a prior servicer. As a result, very few, if any, deals were done with AAs from Ginnie Mae. The revised form effectively gives secured parties a right to make this decision at the

line of scrimmage. At the time a monetary default arises, the secured party can ascertain the magnitude of cure and, if it is too expensive, simply forgo its right to cure and by doing so forfeit its rights in the related MSR.

Unlike Fannie Mae and Freddie Mac, Ginnie Mae is exempt from the U.S. Bankruptcy Code. Bankruptcy courts have no jurisdiction to impair Ginnie Mae's unfettered right to seize the servicer's Ginnie Mae servicing rights upon a voluntary or involuntary filing of the issuer for bankruptcy, free and clear of any third-party security interest or other purported interest, and the security interest will have no continuing property interest in the MSRs.

Fannie Mae and Freddie Mac each permit the secured party to cure the default and take over the MSRs when the Agency terminates the servicer for cause and seizes the servicing rights. They provide a longer cure period than Ginnie Mae, but differ in the length of time within which a cure may be elected. Following the seizure of the MSRs, the two Agencies immediately transfer the servicing to an interim servicer while the secured party determines whether to cure the default and the Agency decides whether to sell the servicing to another approved servicer or retain the servicing for its own account.

If the Agency decides to sell, it commits to give the secured party the net sales proceeds up to the secured party's interest, after deducting amounts due from the terminated servicer, the Agency's costs and expenses to sell and prepare for sale and amounts projected by the Agency that may become due by virtue of breaches of selling representations and warranties and covenants. Freddie Mac qualifies this obligation to pay over net sales proceeds to the secured party in circumstances where it sells the servicing to a purchaser that assumes the original selling representations and warranties and responsibility for past servicing errors.

If the Agency decides to retain the servicing, Fannie Mae, but not Freddie Mac, commits to give the secured party an amount equal to the appraised market value of the servicing up to its interest, net of comparable costs and expenses. In either case, the secured party bears the risks of deduction from sales proceeds of all of the amounts due or projected to be due by the terminated servicer to the Agency, regardless of whether the pledged collateral represents only a portion of the servicing of the terminated servicer.

Do the AAs Treat ESFs Differently than Security Interests?

It is easy enough in an AA to search and replace "grant of a security interest in MSRs" with "sale and transfer of an ESF," and by and large that is what the Agencies have done. There are key differences, however. The first and most important difference relates to the willingness of the Agencies to approve an ESF arrangement in the first place. Because there is a concern on the part of the Agencies that the actual sale and transfer of an interest in the servicing fee income may make it more likely that they will face a third-party claim if they terminate the servicing, potential investors should not assume that Fannie Mae and Freddie Mac will approve of an ESF arrangement.

On the one hand, they understand the need for liquidity that state-chartered, non-depositories have with respect to their servicing asset, but Fannie Mae and Freddie Mac zealously protect their superior interests in the MSRs. Furthermore, even if Fannie Mae or Freddie Mac were to approve of an ESF arrangement, their approval may come with conditions. For example, if the servicing strip is too large, the Agencies may be concerned that the retained portion of the ESF is insufficient to provide a profit-making incentive to perform its servicing obligations and avoid for-cause servicer terminations.

This is a particularly important issue in the default servicing context where the task of servicing, particularly on government insured loans, is labor-intensive and costly. As a practical matter, this usually means that no more than 50% of the servicing fee can be structured as an excess servicing strip. Some servicers conduct stress tests to determine if it will have sufficient income to fund its default servicing operations with reduced servicing fees based on a range of default assumptions, because regulators may question the reasonableness of the approach even if there are no express regulatory limitations.

Conclusion

Many investors who do not want to be licensed holders of mortgage loan servicing rights have looked at ESFs as a means of participating in the economics of mortgage servicing without the direct expenses and potential legal liabilities associated with holding servicing rights. Given the indirect nature of the interest, though, it is important for investors to realize what they do not have just as much as what they do have when acquiring an ESF.

Like the underlying servicing rights, an ESF can evaporate as a result of prepayments or termination of the related servicing agreement, but the holder of the ESF is at least one step removed from the control of the servicing asset. Yet, despite the risks involved, partnering with a quality servicer can provide the classic win-win for both sides, enhanced liquidity for the approved servicer, and a unique alternative investment for the ESF holder.

 COPYRIGHT © 2017 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0891-0634