

A Breakdown Of Freddie Mac's New Servicer Custody Rules

By **Eric Edwardson** (May 3, 2023, 3:52 PM EDT)

Residential mortgage servicers are obligated to indemnify Freddie Mac for a loss of funds in custodial accounts or delays in access to the funds in custodial accounts, even when they comply with all of their obligations to Freddie Mac, based on Freddie Mac Bulletin 2023-10, issued on April 12.

The bulletin is an apparent response to recent bank failures, and — in less of a surprise — also includes new standards for eligible banks and rules for the titling and use of clearing accounts.

The new standards are effective immediately, however, and therefore may require prompt action, depending on whether or not a servicer's accounts already meet the new requirements.

The bulletin addresses a few topics of interest, but this discussion centers on the new custodial account requirements.

Interestingly, the bulletin doesn't contain any detail regarding the new requirements, stating only that "[w]e are updating our Custodial Account requirements, including the acceptable risk thresholds for Eligible Depositories, Servicer's use of custodial clearing accounts and the timing of deposits to custodial clearing accounts and Custodial Accounts."

The bulletin then simply cites the sections of the guide that have been revised. In order to see what the new standards are, a servicer must go to the sections of the guide and determine what's been changed. The bulletin does not say anything about the new servicer indemnification obligation.

New Requirements for Eligible Depositories

In the revisions to Section 8302.5 of the guide, Freddie Mac added the following requirements for each custodial account depository to Freddie Mac's existing in-house tolerance standards:

- It must be rated as "well capitalized" by its federal or state regulator.
- If it has assets of \$30 billion or more, it must have either: A short-term issuer rating by S&P Global of "A-3" or better or, if no short-term issuer rating is available by S&P, a long-term issuer rating of "BBB-" or better by S&P; or a short-term bank deposit rating by Moody's Corp. of "P-3"



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or better or, if no short-term bank deposit rating is available by Moody's, a long-term bank deposit rating of "Baa3" or better by Moody's.

- If it has assets of less than \$30 billion, it must have either a 125 or better bank safety rating issued by IDC Financial Publishing Inc.; or a C+ or better KBRA Financial Intelligence score issued by Kroll Bond Rating Agency LLC.

The new language also requires the servicer to monitor the depositories' continued compliance with these ratings. That contrasts with Freddie Mac's approach to its existing in-house tolerance standards. Freddie Mac commits itself to notify servicers if a depository falls below those in-house standards.

It's possible that many or most depositories used by servicers already meet these requirements, and funds won't need to be moved at this time.

If not, however, a servicer is technically out of compliance today, since these added requirements were made effective immediately.

It seems unrealistic to expect servicers to immediately move their custodial accounts, so we presume Freddie Mac will allow servicers a reasonable amount of time to make any changes in a prudent manner.

New Requirements for Clearing Accounts

In Section 8302.6 of the guide, Freddie Mac added a new requirement for titling of clearing accounts, if used. It says that a servicer must title the account to indicate it is custodial in nature, and the title must specifically include the language "for the benefit of the Federal Home Loan Mortgage Corporation."

The guide did not contain any titling requirement for clearing accounts prior to these revisions.

These requirements may present some operational difficulties. To the extent that a clearing account is commingled with payments from borrowers on Fannie Mae or other loans, it's not clear how this titling requirement can be reconciled with the fact that not all funds will be held for Freddie Mac.

In addition, some depositors and their banks struggle with titling requirements in other settings because of system limitations — for example, limits on the number of characters that can be in an account title — and Freddie Mac's very specifically required title language may be hard to accommodate.

As with the new depository requirements, since this requirement is immediately effective, every servicer using a clearing account technically may be out of compliance today, but Freddie Mac would presumably allow some time for changes.

In addition, Section 8302.10 of the guide now requires servicers that use a clearing account to deposit borrower payments on the same day as they are received. As a practical matter, this may not change much for servicers.

Both before and after the recent changes, the borrower payments need to be in the Freddie Mac custodial account within one business day of receipt, so if a servicer is using a clearing account, it may have already been depositing the funds on that schedule.

New Servicer Indemnification Obligations

The most troubling new requirement regarding the custodial accounts has nothing to do with the mechanical servicing operations, but rather appears to be a bold reallocation of the risk of bank failures to servicers. The additions to Section 8302.3 of the guide include the somewhat shocking statement that:

Even if the Servicer has complied with all Guide and Purchase Document requirements, Servicer agrees to indemnify and hold Freddie Mac harmless for any loss of funds deposited in a Custodial Account and any damages Freddie Mac suffers because of delays in obtaining the funds from a Custodial Account.

By this statement, Freddie Mac appears to be making the servicers a backstop to banks. While it is true that a servicer selects the depository to hold custodial deposits, Freddie Mac imposes the eligibility requirements for banks to hold custodial deposits — requirements that Freddie Mac has strengthened under the bulletin.

Given that servicers really just are service providers, the logic of making servicers bear the risk of loss due to a failure of a bank that Freddie Mac otherwise approves to hold custodial accounts is not readily apparent and raises questions of fundamental fairness.

Key Takeaways

The new requirements present a mixture of near-term and longer-term takeaways.

In the near term, servicers will want to check the location and titling of their Freddie Mac accounts. These are relatively straightforward requirements, but since they are effective immediately, they require prompt attention.

The first thing Freddie Mac servicers should do is review the ratings of the depositories holding their custodial accounts to confirm compliance with the new requirements. It's likely that most — or perhaps all — banks currently used by servicers meet the requirements, but it should be easy to quickly confirm.

The next near-term step for servicers is to check the titling used on their clearing accounts, assuming they use one. It also should be easy to change the title on the account if needed.

Whether it can be changed to precisely comply with the new requirement may be a more difficult question, however. If a servicer's or its depository's systems prevent the use of the full required title due to character limits on account titles, the servicers could consider an abbreviated version that conveys the substance of the requested language, at least in the short term.

The new rating requirements for custodial account depositories also necessitate some longer-term actions. Servicers are responsible for monitoring the continued compliance of their banks with these requirements.

Whereas the servicers previously could rely on Freddie Mac to tell them when a depository failed to meet Freddie Mac's requirements, now a part of that job will fall to servicers, who will need to create procedures for ongoing compliance monitoring.

By contrast, the new indemnification obligations don't require any immediate action. They do, however, merit some thoughtful evaluation of the new potential risk presented by that obligation.

Since Freddie Mac may seek to hold servicers liable for loss of funds or delay in access to funds, even when the servicers meet all their obligations to Freddie Mac, servicers need to consider whether it's possible to manage or mitigate that risk.

Monitoring of ratings may help with that, of course, but even full compliance with those obligations can't eliminate the risk of unexpected bank failures. Servicers may need to come up with their own method for evaluating and monitoring depositories.

It doesn't seem fair that servicers should need to do this, given the existing regulatory and Freddie Mac expertise dedicated to the task, but that is the situation as long as Freddie Mac intends to maintain this indemnification requirement and put servicers in the position to backstop the risk.

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