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COMMENTARY

# State Regulators Propose New Prudential Standards for Nonbank Mortgage Servicers

On March 25, 2015, the Conference of State Bank Supervisors ("CSBS") and the American Association of Residential Mortgage Regulators ("AARMR") issued for a 90-day public comment period a proposed set of baseline prudential regulatory standards for nonbank mortgage servicers and a set of enhanced prudential standards for large complex nonbank mortgage servicers.[1]

CSBS and AARMR believe increased state prudential regulation of nonbank mortgage servicers would better protect borrowers, investors, and stakeholders; enhance effective regulatory oversight and market discipline; and improve standards of transparency, accountability, risk management, and governance.

The proposal marks the culmination of the work of the CSBS's Mortgage Servicing Rights Task Force, which was formed in October 2014 with regulators from several states,[2] to develop options for prudential standards for nonbank mortgage servicers. The proposal also reflects the dramatic growth in the size, complexity, and importance of nonbank mortgage servicers over the past several years. Following the housing crisis, a significant share of mortgage servicing rights ("MSRs"), particularly those for troubled and nonperforming mortgage loans, shifted out of commercial banks, which had traditionally dominated the mortgage servicing market, and into nonbank mortgage servicers. This shift was driven, in part, by increased compliance costs faced by banks that service troubled or nonperforming loans and new bank capital requirements that make it more costly for banks to retain MSRs.

While the Consumer Financial Protection Bureau ("CFPB") has responsibilities related to consumer protection for nonbank mortgage servicers, and nonbank mortgage servicers are subject to state licensing and bonding requirements, nonbank mortgage servicers generally have not been subject to the same safety and soundness standards that apply to commercial banks. Several federal regulatory agencies, including the Financial Stability Oversight Council ("FSOC") and the Federal Housing Finance Agency ("FHFA"), have expressed concerns about the lack of prudential standards, given the dramatic increase in MSRs acquired by nonbank mortgage servicers in recent years. In its 2014 Annual Report, the FSOC recommended that "state regulators work together to collaborate on prudential and corporate governance standards to strengthen these companies, in collaboration with the CFPB and FHFA, as may be deemed appropriate."[3]

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On January 30, 2015, the FHFA released a proposal to apply new minimum financial eligibility requirements to sellers and servicers that do business with Fannie Mae and Freddie Mac.[4] The FHFA's proposed financial eligibility requirements include minimum net worth, capital, and liquidity requirements. While the prudential standards proposed by the state regulators also include new minimum net worth and liquidity requirements, they are not limited to financial criteria but have a much broader application. The proposal includes a set of baseline prudential standards applicable to all state-licensed nonbank mortgage servicers in eight areas: (i) capital, (ii) liquidity, (iii) risk management, (iv) data standards, (v) data protection (and cybersecurity), (vi) corporate governance (including auditing requirements), (vii) servicing transfer requirements, and (viii) change of control requirements.

It is not clear from the proposal how or when the new prudential standards, if approved, will be made effective with respect to nonbank mortgage servicers. The state regulators are requesting public comment on all aspects of the proposed standards, and specific questions, within the 90-day comment period. All comments will be made public at www.csbs.org.

## Baseline Prudential Standards

The proposal would apply the following baseline prudential standards to all nonbank mortgage servicers regardless of asset size or complexity. CSBS and AARMR intend to leverage existing standards and generally accepted business practices.

**Minimum Net Worth Requirement**. All nonbank mortgage servicers would be required to have a minimum net worth of at least $2.5 million, plus 25 basis points ("bps") of the value of the unpaid principal balance of all loans serviced. This is the same standard proposed by the FHFA for Fannie Mae and Freddie Mac servicers. Unlike the FHFA proposal, the baseline prudential standards do not require servicers to meet a minimum capital ratio. Under the FHFA's proposal, nonbank servicers that service loans for Fannie Mae and Freddie Mac would be required to maintain a minimum capital ratio of 6 percent calculated as tangible net worth divided by total assets.

**Minimum Liquidity Requirement**. The proposed baseline liquidity standard is the same standard proposed by FHFA of 3.5 bps but would be applied to all loans serviced. Unlike the FHFA's proposal, the baseline liquidity standard does not include an additional incremental charge based on nonperforming loans. Servicers would also be required to have a methodology to determine the liquidity needs for non-servicing activities.

**Risk Management**. All nonbank servicers would be expected to have a risk management program that is overseen by their board of directors. The program should include appropriate processes and models to measure, monitor, and mitigate financial risks and changes to the risk profile of the firm and the loans being serviced. The program should be scaled to the complexity of the organization but be sufficiently robust to manage various risks, including credit risk, transactional risk, operational risk, financial risk, and affiliated/related party risk. In addition, a servicer should ensure that a risk management assessment is independently conducted on an annual basis, concluding with a formal report to its board of directors. Servicers would be expected to maintain evidence of risk management activities throughout the year, including findings of issues and the response to address those findings.

**Data Standards**. All nonbank mortgage servicers would be required to comply with the CFPB's Mortgage Servicing Rules with respect to all serviced loans, which will further the effort to implement a set of uniform minimum national standards for mortgage loan servicing.[5]

**Data Protection**. All nonbank mortgage servicers would be required to implement information technology ("IT") policies approved by their board of directors, develop an IT security risk assessment strategy, and engage in routine IT security testing and monitoring. Nonbank mortgage servicers would be expected to have strong controls over protection of customer data to mitigate cyber attacks, security breaches, and identity theft.

**Corporate Governance**. The board of directors of a nonbank mortgage servicer would be expected to establish a sound corporate governance framework, set minimum standards of acceptable behavior for employees, and establish an appropriate set of internal controls, as well as a method for independently validating the accuracy and reliability of the financial and servicing information of the firm. The proposal also provides that a servicer's internal audit requirements should be appropriate for its size and complexity. The

proposal would require all nonbank mortgage servicers to adhere to Ginnie Mae's reporting requirements, which require all servicers to have audited financial statements and audit reports conducted by an independent public accountant.[6]

**Servicing Transfers.** The proposal would include servicing transfer requirements aligned with existing guidance set forth in the CFPB's *Compliance Bulletin and Policy Guidance: Mortgage Servicing Transfers*,[7] and the FHFA's *Advisory Bulletin 2014-06: Mortgage Servicing Transfers*.[8]

**Change in Control**. The proposal would require prior notice to be provided to state regulators of a change of control of a nonbank mortgage servicer. A "change of control" would be liberally defined to include a change (i) of 10 percent or more in the ownership of a servicer, (ii) in the ability of a person or group acting in concert to elect a majority of the directors of the firm, or (iii) that results in a group that can effect a change in policy of the firm, regardless of ownership percentage.

## Enhanced Prudential Standards

For larger, more complex nonbank servicers with higher-risk profiles, the proposal would require enhanced prudential standards concerning capital, liquidity, stress testing, and recovery and resolution planning beyond the proposed set of baseline standards. According to the proposal, state regulators see a need for certain more complex firms to mitigate risk by deploying enhanced planning, modeling, metrics, and audit in these areas. Independent third-party assessments would be viewed as a key part of enhanced prudential standards. The proposal does not establish any bright-line test, such as a minimum asset threshold, for determining when a servicer would become subject to enhanced prudential standards.

**Capital Requirements**. A large, complex nonbank servicer would be expected to maintain capital standards commensurate with its overall risk profile. The management and board of directors of a large, complex nonbank servicer would be expected to develop a methodology for supporting the capital adequacy of the entire firm and the capital planning process. The methodology should be tailored to the servicer's overall risk profile, taking into account the composition of its servicing portfolio and the particular types of loans serviced. The methodology would be subject to regulatory approval and would need to be validated by an independent third party.

**Enhanced Liquidity Requirements**. The management and board of directors of a large, complex nonbank servicer should develop methodology to measure and monitor the firm's liquidity needs, including the amount of on-balance sheet liquidity required to ensure normal operations during a moderate stress environment. Large, complex nonbank servicers would be expected to maintain on-balance sheet liquidity consisting of high-quality liquid assets.[9] The methodology would also need to quantify off-balance sheet liquidity in the form of unfunded lines of credit or other sources. Any forms of off-balance sheet liquidity would have to be tested and would be subject to regulatory review.

**Stress Testing Requirements**. A large, complex nonbank servicer would be required to maintain a robust, forward-looking capital and liquidity planning process that considers the servicer's unique markets and risks. The servicer would be expected to engage a third-party vendor, experienced in validating modeling assumptions, to conduct an independent party assessment of the firm's stress testing model. The third-party vendor would be required to provide confirmation to the regulators that the servicer's stress test model is appropriate, the assumptions are valid, and the outcomes are realistic.

**Resolution Plans**. All large, complex nonbank servicers would be required to develop a living will or resolution plan subject to regulatory review, irrespective of whether they were deemed to be systemically important by the FSOC. A typical resolution plan would provide consolidated financial information; describe the firm's principal lines of business, foreign operations, and material management information systems; identify the firm's principal officers and vendors; and outline a recommended plan for purchase of servicing or the firm.

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## Endnotes

1 CSBS and AARMR Media Release, "State Regulators Propose Prudential Regulatory Standards for Nonbank Mortgage Servicers" (Mar. 25, 2015).

2 California, New York, Texas, Illinois, Massachusetts, Pennsylvania, Minnesota, South Dakota, and Washington.

3 FSOC, 2014 *Annual Report* (May 7, 2014).

4 FHFA, "Proposed Minimum Financial Requirements for Enterprise Seller/Servicers" (Jan. 30, 2015). FHFA anticipates that the proposed minimum financial requirements will be finalized in the second quarter of 2015 and will be effective six months after they are finalized.

5 CFPB, "Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X)" and "Mortgage Servicing Rules under the Truth in Lending Act (Regulation Z)."

6 Ginnie Mae MBS Guide, Chapter 3, "Eligibility Requirements—Maintaining Ginnie Mae Issuer Status." October 17, 2014.

7 CFPB Bulletin 2014-01 (August 19, 2014).

8 FHFA Advisory Bulletin 2014-06 (June 11, 2014),

9 High-quality liquid assets would be defined with reference to the banking agencies' final rule on Liquidity Coverage Ratio: *Liquidity Risk Measurement Standards*, 79 Fed. Reg. 61440 (October 10, 2014).


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