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Expect a Change to Regulation of Non-Bank Mortgage Servicers

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Last month, Citigroup announced plans to exit the mortgage servicing business and sell off a $97 billion portfolio to a non-bank servicer and transfer their remaining mortgage servicing rights (MSRs) to another non-bank servicer by early 2018. Thus continues the trend of non-bank mortgage servicers capturing more market share year after year than their bank competition. Last year, the U.S. Government Accountability Office (GAO) issued a report which emphasized the fact that the share of mortgages serviced by non-banks increased from 6.8 percent in 2012 to 24.2 percent in 2015.

Multiple factors are driving this trend. First, the cost of compliance has recently begun to grow year after year and was fueled by the formation of the CFPB and their constant rule promulgation and amendments coming at a pace that was previously unseen in the mortgage market. According to the Mortgage Bankers Association (MBA), the average cost of serving a performing loan in 2008 was $59 and a defaulted loan was $482; that cost has risen to $175 for performing loans and $2,375 for a defaulted loan in 2015. This increase has become a drag on profits for most banks. Non-bank servicers seem to be more adept at managing these rising costs, but there is a counterargument that they have not had the same level of regulatory scrutiny that the banking institutions have dealt with to date.

Section 1024(a)(1)(A) of Dodd-Frank gives the CFPB authority to supervise all non-bank mortgage servicers regardless of size, meaning they are not required to define larger participant rules as they need to for debt collection and other markets. That said, the Bureau cannot supervise everyone in the non-bank servicing space as there are simply too many participants. When the CFPB began their supervision of non-bank entities, they stated that "when considering whether and how to supervise particular non-banks, we will consider several relevant factors, including the non-bank's volume of business, types of products or services, and the extent of state oversight." Please note that at this time, non-banks only had 6.8 percent of the markets and they couldn't get to all participants. They now have more than 24.2 percent of the market and 23.6 percent of that non-bank market share is comprised of entities outside of the top ten non-bank servicers.

The largest of the non-bank servicers are on the Bureau's radar and have undergone multiple exams, but many smaller non-bank servicers have not. They adhere to the regulations, but have not yet had their compliance reviewed and tested by the CFPB. Therefore, they have not had to bear the full burden of costs facing banks including exam management, reporting and any required remediation efforts. Banks, however, are never too small to avoid regulatory supervision. If a bank is under ten billion in assets, they may avoid the supervision of the CFPB, but those supervision functions are then handled by the FDIC, the Fed or state regulators. In the case of a Non-Bank Mortgage Servicer, there is simply less regulators. The bank prudential regulators don't have the authority and not all states require mortgage servicers to register or become licensed.

The same GAO report mentioned above echoes these points and states that the CFPB does not currently have a mechanism to develop a comprehensive list of non-bank servicers and, therefore, does not have a full record of entities under its purview, going as far as to call the Bureau's oversight of non-bank lenders "***indirect***," stating that even if they did have the capacity to fully supervise all the non-bank servicers in the market, they would not know the full makeup of the market.

Another issue that is driving banks out of mortgage servicing that non-banks do not have to contend with is how a bank must value an MSR. Under the Basel III rules, a bank which chooses to hold an MSR portfolio takes a significant hit to their balance sheet. The rule permits only ten percent of a bank's common equity Tier 1 capital to be comprised of MSRs, and overage must be deducted from common equity given a risk-weighting of 250 percent.

Non-bank servicers are not currently held to these same valuation standards. A 2016 Federal Reserve Report found that "if the revised capital rule were applied to non-bank firms, the MSR treatment would likely affect non-bank activity in the mortgage servicing market. However, the deduction of MSAs from regulatory capital would prove far more consequential for non-bank servicers than the 250 percent risk weight for MSRs that are not deducted." An older report issued in 2014 by the Financial Stability Oversight Counsel (FSCO) signaled they were aware of this issue and may be contemplating a possible change. They stated "MSRs are increasingly being transferred to non-bank mortgage servicing companies. While the CFPB and state regulators have ***some*** authority over these companies, many of them are not currently subject to prudential standards such as capital, liquidity, or risk management oversight. Further, in many cases, mortgage investors' ability to collect on mortgages is dependent on a single mortgage servicing company, where failure could have significant negative consequences for market participants." The FSCO went on to state that they recommend, "in addition to continued monitoring, 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." To date, this has not occurred, but with the continuing growth of non-bank servicers, the call for more oversight will only get louder.

The CFPB is well aware of the rising increase in market share of non-bank servicers as well as the information contained in the GAO, FSOC and Federal Reserve reports. In 2016's Issue 11 of the CFPB's Supervisory Highlights, they spent the full 21 pages of the document expressing that they were concerned about the range of legal violations identified at various mortgage servicers and that remediation and improvements did not seem to uniform throughout the industry, one has to ask if this was driven by the increase in loan volume handled by non-bank servicers. Given the continued growth and calls for greater oversight, it would be prudent to expect more regulatory scrutiny from the CFPB in near future for non-bank servicers.

Baker Donelson follows developments in this space closely to keep our clients advised of any changes on the horizon. If you have any questions at all about the impact of regulations or the best practices for an exam or investigation, please contact a member of Baker Donelson's Financial Services Department.