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Recent changes to the regulatory treatment of mortgage servicing rights ("MSR"s) for financial institutions subject to Basel III, together with political and prosecutorial pressures, have resulted in a substantial increase in incentives for financial institutions to transfer their residential MSRs. While MSRs have traded frequently in the past, the following highlights some of the current issues related to the sale and financing of MSRs in the current environment.

What is an MSR?

The term "MSR" is commonly used by market participants to describe all or some of a party's contractual rights with respect to servicing or controlling the servicing of a pool of mortgage loans, including the entitlement to receive servicing compensation. In addition, there are specific regulatory and accounting uses (discussed below). MSRs, however, are usually contingent rights that may be lost entirely if the servicer is terminated. In addition, the ability to transfer MSRs may be prohibited, severely limited or conditioned on the assumption of certain risks and liabilities. Anyone evaluating an MSR should carefully review the relevant servicing contract, which may vary considerably depending on numerous factors, including whether the loan is included in a securitization or held in portfolio.

Valuation of MSRs

It is our understanding that under GAAP, an entity is required to recognize a servicing asset (or servicing liability) "each time it undertakes an obligation to service a financial asset by entering into a servicing contract," unless such contract relates to servicing of financial assets sold by such entity in a transaction that does not qualify for sale accounting. FASB ASC 860-50-25-1. Such asset (or liability) must initially be measured at "fair value." FASB ASC 860-50-30-1. Whether servicing constitutes an asset or liability (or nothing) depends on whether "the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing." FASB ASC 860-50-30-2. While such conclusion may change if the applicable assumptions change, the asset or liability must be based on the compensation demanded by the marketplace, not the entity's own cost of servicing or even the amount that would be paid to a replacement servicer. FASB ASC 860-50-30-3 and -4. After initial measurement at fair value, an entity may elect to either amortize the servicing asset (or liability) or continue to measure at fair value. FASB ASC 860-50-35-1.

The value of MSRs related to any given pool of mortgage loans can vary considerably, depending on the characteristics of the mortgage loans and the provisions of the servicing agreement. The servicing fee on residential mortgage loans is generally a fixed fee, which is usually initially greater than the expected cost of servicing the mortgage loans. Other factors relevant to the value of MSRs are the obligations of the servicer with respect to delinquent assets (such as the obligation to advance delinquent payments of interest and principal), termination rights and default provisions, restrictions on transfer of the MSRs, and the servicer's ability to reimburse itself for out-of-pocket expenses related to servicing. In addition, the value of an MSR is sensitive to the general level of interest rates and prepayment and default rates. Given the financial crisis and delinquencies on transactions which have greatly
How Basel III Is Changing the Treatment of MSRs

Banks have traditionally been able to apply 100% of the value of MSRs to their Tier 1 capital ratios. However, under Basel III, banks will only be able to count a portion of the value of their MSRs as Tier 1 capital. Specifically, under Basel III, MSRs will be limited to 10% of a bank's common equity when calculating Tier 1 capital. Similarly, under Basel III, MSRs, together with (1) significant (more than 10%) investments in the common stock of non-consolidated financial institutions (banks, insurance companies and other financial companies) and (2) deferred tax assets that arise from temporary differences (e.g. allowance for credit losses), will be limited to 15% of a bank's common equity when calculating Tier 1 capital. Because there is considerable debate in the U.S. about the treatment of capital that is not considered loss absorbing, U.S. banking regulators may treat these assets differently when they adopt regulations implementing Basel III. While full implementation of Basel III is still several years away, if adopted without change by U.S. banking regulators, certain provisions of Basel III related to MSRs would become effective soon. Starting January 1, 2013, a bank would have to deduct the amount by which the aggregate of these three assets exceeds 15% of its common equity before deductions. The required deduction would be increased each year for five years until January 1, 2018, when a bank would have to deduct the amount by which the aggregate of these three assets exceeds 15% of its common equity after deductions. Any portion of MSRs above these thresholds that is not deducted in the calculation of Tier 1 common equity would be risk weighted at 250%, making MSRs a very expensive asset to own. If this regulatory capital "haircut" were to be implemented by U.S. banking regulators, MSRs would be less attractive for banks to hold on their balance sheets and banks might choose to retain less residential servicing and sell more to non-bank buyers, such as REITs, hedge funds and private equity firms, not subject to Basel III's more restrictive capital requirements.

Structuring an Investment in MSRs

Typically an MSR will be acquired by an entity that meets the requirements of the existing servicing contract (which may include agency, investor or rating agency approval) and has the necessary licensing, infrastructure and capacity to assume the primary servicing obligation on the mortgage loan. Alternatively, if permitted under the relevant agreement, the purchaser of the MSR may have the primary servicing performed by an affiliate or an unaffiliated party.

MSRs are typically held by large financial institutions with servicing affiliates or by companies that focus primarily on servicing. However, the expected availability of MSRs for purchase as a result of the Basel III changes have created interest in other parties who are not primary servicers and who may not have invested in this asset in the past. Even investors without a servicing affiliate may have an interest in investing in MSRs (or, more accurately, the "excess servicing fee"), although such investors would be exposed to the risk that the actual contract servicer may be terminated (or reject the contract in bankruptcy).
Investors such as REITs or funds may also be able to invest in MSRs, and additional guidance in this area is expected from the IRS soon. Structures with these types of investors need to be carefully vetted, with particular consideration for tax purposes.

The transfer of MSRs raises accounting issues for GAAP and similar rules and regulatory issues for depository institutions, including regulatory issues under the risk based capital rules. Anyone transferring MSRs and seeking to remove them from its balance sheet, especially depository institutions, needs to work closely with counsel and accountants and may need further guidance from the Federal banking agencies.

**Financing an Investment in MSRs**

MSRs are difficult to finance for a multitude of reasons. Potential lenders must address many issues, including servicer termination and bankruptcy, assignment and transfer, and other considerations. A servicer may be terminated "for cause" (due to a default) or, in some cases, "without cause" under the servicing contract. If not terminated prior to a bankruptcy filing by the servicer, the servicing contract would generally be subject to the rights of the servicer (as debtor) in bankruptcy, including the automatic stay and the right to accept or reject executory contracts. If terminated prior to bankruptcy or rejected in bankruptcy, the MSR collateral could be lost. Also, the inability of the servicer (or the lender as its assignee) to control the transfer of servicing may affect the ability of a lender to foreclose on the MSRs in the event of a default. The servicing contract related to any MSRs may be difficult to amend in order to address these concerns.

Despite these challenges, MSRs have been financed in the past, and new techniques are being developed to creatively finance them going forward. In particular, owners of mortgage loans (for example, investors in a securitization) seeking a new or better servicer may be willing to accept arrangements permitting financing of MSRs in exchange for ceding a portion of their control rights over the servicing. In the past, some issuers in RMBS securitizations included provisions in the transaction documents to permit the financing of MSRs, and so provisions exist which have been acceptable in the past to investors, trustees and rating agencies, and these types of provisions may be more common in the future. There have been some recent signs that Fannie Mae, Freddie Mac and Ginnie Mae, realizing the need for more liquidity in the market, may be more flexible in the terms of their acknowledgment agreements with lenders seeking to finance Agency MSRs.

While financing MSRs is difficult, the servicing advances that a servicer is required to make under the servicing contract have been successfully financed through secured lending and securitization structures for many years. If properly structured, such advances can be legally isolated from the servicer’s bankruptcy estate, and securities backed by such advances can be rated (increasing liquidity, reducing carry and, in some cases, improving capital treatment).

**Regulatory Issues Related to the Ownership of MSRs**

Whereas engaging in the act of primary servicing is highly regulated, the mere ownership of an MSR generally does not require licensing, as long as the holder of the MSR does not perform any actual servicing or collection functions and contractually delegates those functions to a fully licensed servicer. Recent state and local laws and regulations have placed onerous burdens on servicers in some jurisdictions, increasing the cost to service mortgage loans. As noted previously, new regulations enacted by the CFPB may also increase the cost of servicing. Compliance with these regulations may affect the value of the asset.

**Conclusion**

Owners of MSRs, investors, lenders and others interested in pursuing new opportunities in the MSR market should consider the issues outlined above. It is expected that there will be a large volume of MSRs for which financial
institutions will seek regulatory capital relief or otherwise seek to transfer servicing, and the solutions may involve significant opportunities for interested parties.

1 Uniform Commercial Code provisions may render such prohibitions ineffective for certain purposes (for example, terminating the servicer). UCC 9-4 and 9-408.

2 The following references to GAAP were based on our review of FASB ASC Topic "Transfers and Servicing" as published on the Financial Accounting Standards Board website. We are not accountants and nothing contained herein should be construed as accounting advice.

Some existing servicing agreements, but not many, contain additional incentive fees for the servicing of delinquent assets. This feature may be more common in the future, and is currently being considered by the Federal Housing Finance Authority, for example, as a new paradigm for servicing going forward.

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