



Financial Services & Products ADVISORY ■

AUGUST 29, 2017

The New Regulatory Frontier: The Licensing of MSR Holders

by [Stephen Ornstein](#)

In the wake of the Dodd–Frank Wall Street Reform and Consumer Protection Act, few financial products are as comprehensively regulated as mortgages secured by one to four family residential properties. It seems that every aspect of the residential mortgage is highly regulated—almost proscriptively so—from the products that lenders may offer to the underwriting of the loan, not to mention the application and closing process as well as the brokerage and servicing of the loans. In addition, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (“SAFE Act”), which predated Dodd–Frank, mandates that practically anyone touching a residential mortgage loan—brokers, loan officers, lenders—be subject to broad licensing requirements in the jurisdictions where the originator makes the loan. Further, approximately a third of the states require secondary market purchasers—and in some instances sellers—of residential mortgage loans to be licensed.

In a more recent phenomenon, a growing number of states are requiring entities that purchase and hold mortgage servicing rights (MSRs) to be licensed or registered as residential mortgage servicers—even though these entities actually perform *no* servicing activities and engage in *no* consumer-facing functions. MSRs themselves are a relatively new financial product: they are basically economic rights (e.g., the difference between the economic value of the servicing and the fees paid to the third party who actually services the loans) and entitle the holder to select the third-party entity that actually services the loans.

In the eyes of these state regulators, there are two types of MSR holders: (1) persons that purchase and hold only the MSRs—and not the underlying loans—but retain third-party licensed mortgage servicers to actually perform the servicing activity; and (2) persons that purchase residential mortgage loans, servicing released, from the seller—along with the servicing rights—and similarly hire licensed mortgage servicers to perform the servicing activity.

Despite performing no actual servicing functions, why do a growing list of state regulators feel compelled to license such entities as mortgage servicers? These regulators cite the broad definition of “mortgage servicer” in their licensing statutes as justification for imposing the mandate. For example, under the Arkansas Fair Mortgage Lending Act, a license is required “to act or attempt to act, directly or indirectly, as a mortgage broker, mortgage banker, loan officer, or mortgage servicer.” “Mortgage servicer” means a person “that receives or has the right to receive from or on behalf of a borrower ... the funds or credits in payment for a mortgage loan ... or the taxes or insurance associated with a mortgage loan.”

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In New York, Section 418.3(d) of Part 418 of the Superintendent's Regulations, in part, defines servicing mortgage loans to include "a person who makes or holds a mortgage loan if such person also directly or *indirectly* is the holder of the mortgage servicing rights or has been delegated servicing functions for the mortgage loan."

In Section 36a-718(a) of the Connecticut General Statutes, "no person shall act as a mortgage servicer, directly or *indirectly*, without first obtaining a license..." In an [Interpretive Letter](#) issued by the Connecticut Department of Banking on October 1, 2014, the Connecticut banking commissioner opined that owners of MSRs are acting *indirectly* as mortgage servicers even when they contract out all servicing functions. Consequently, the commissioner asserted that "both owners of mortgage servicing rights and owners of mortgage loans for which mortgage servicing rights have been retained, who hire licensed mortgage servicers to perform the mortgage servicing necessitated by ownership, would require licensure as mortgage servicers in Connecticut, unless [otherwise] exempt from licensure..."

It should be noted that while there are a growing number of states that require holders of MSRs to be licensed, there is some confusion among state regulators in certain jurisdictions about whether licensure is in fact required. Some state regulators that just a few years ago indicated that licensure was not required have reversed course and now require MSR holders to obtain licenses. Determining state licensure is fluid and must be proactively monitored.

Further, certain state regulators are rigorously enforcing their statutes and demanding that MSR holders become licensed in their jurisdictions. MSR holders ignore these licensing requirements at their peril.

The licensing applications in most states for MSR holders are arduous and oriented for servicers, *not* for entities that conduct no actual servicing functions. In the states where MSR holders must become licensed, the applications require the representatives of the entity to answer corporate and litigation questions, and its designated officers must in certain instances respond to invasive questions about their finances, submit to background checks, and have actual experience in the servicing industry. Most of the licenses may be obtained within three to four months from submission of all the requisite information. Once obtained, however, the licenses must be renewed annually, and state regulators occasionally examine licensees.

For investors who are loath to undergo this licensing process or where licensure would be impractical (e.g., the investor will only use the acquiring entity for a short time), there are two alternatives to consider.

First, the unlicensed entity could purchase the MSRs from a counterparty and simultaneously transfer legal title to the MSRs to a Delaware statutory trust with a national bank trustee. The trustee, which acts on behalf of the trust, is arguably exempt from state licensing requirements by virtue of federal preemption and, in most instances, by explicit statutory exemption. (Alternatively, the Delaware statutory trust with the national bank trustee could be the direct purchaser of the MSRs from the seller in the transaction.) Although legal title is held by the exempt national bank trustee, beneficial or economic interest in the MSRs is retained by the beneficiary of the trust, which may be the MSR purchaser. When the investor wishes to dispose of the MSRs, it merely instructs the Delaware statutory trust with the national bank trustee to retransfer the MSRs to it before their concurrent resale to a third party or to sell the MSRs directly to the third party. This structure can be deployed quickly and is relatively inexpensive.

When is it appropriate to use a Delaware statutory trust with a national bank trustee? The arrangement should *only* be used to acquire MSR on the secondary market through an entity that will purchase the MSR once or sporadically or when that entity will only be in existence for a short period (e.g., generally less than approximately 18 months). The structure should *not* be used to originate loans, to make advances under home equity lines of credit, or to repeatedly engage in MSR trades in the same unlicensed entity over a sustained period of time.

A second alternative to licensing that investors should consider is a participation arrangement. Under this structure, investors purchase undivided ownership interests in MSR evidenced by a participation certificate. While legal title to the MSR remains with the principal (i.e., the seller of the participation interests), the certificate holders (i.e., the purchasers of the participation interests) are the beneficial owners of the MSR. Under this arrangement, the purchaser of the participation interest would generally not be subject to the licensing requirements of state statutes because it would never hold legal title to any MSR or undivided part of them but would only hold beneficial interest in the MSR. The participation structure can be easily unwound when the purchaser wants to resell its interest in the MSR to third parties.

It should be noted that these alternatives are not foolproof, and there is no guarantee that an investor will not be exposed to regulatory scrutiny. The alternatives should again be employed under special circumstances and are not an absolute substitute for obtaining the requisite licenses.

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