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PE Firms Must Tread Lightly To Cash In On Mortgage Servicing

By **Evan Weinberger**

Law360, New York (April 09, 2013, 7:46 PM ET) -- Private equity firms are inking big-ticket deals for mortgage servicing rights from banks under increasing regulatory pressure to get out of the business, positioning themselves to be big players in a potentially lucrative industry as long as they can learn to navigate a regulatory minefield that has grown more treacherous since the recent foreclosure crisis, experts say.

Mortgage servicing rights come with the baggage of the foreclosure crisis that has resulted in billions of dollars in settlement payments for banks because of robosigning and other alleged shoddy servicing practices that may have put thousands of homeowners out of their homes improperly. In response to such practices, state and federal regulators have increased their oversight over the industry.

That means private equity firms and other private entities need to prepare for increased scrutiny from regulators that are already on the lookout for problems in mortgage servicing.

“Servicing is now a heavily regulated industry, and a PE firm considering entering the market must factor in the increased cost of compliance and be prepared to make the investments necessary to address the challenges of being in that kind of environment,” said John Kromer, co-managing partner at BuckleySandler LLP.

Quicken Loans Inc. has dominated the field among privately held firms getting into the mortgage servicing industry as banks pull back, most recently purchasing a $34 billion mortgage-servicing portfolio from Ally Financial Inc. for $280 million in March. But other, more traditional private equity institutions have been moving to get involved in the lucrative, and definitely risky, space in recent years.

“Right now, there are a lot of dances going on,” said David H. Sands, the co-chair of Sheppard Mullin Richter & Hampton LLP's corporate practice group.

The force driving banks to consider selling off their mortgage servicing portfolios is the 2010 Basel III international banking agreement, Sands said.

Basel III calls for banks to hold up to 7 percent in Tier 1 capital — which is most able to absorb losses — against their risk-weighted assets. That capital would be composed entirely of common equity under the rules.

The agreement also limits the mortgage servicing rights a bank can carry to 10 percent of its Tier 1 capital, and could result in penalties for banks that do not comply by 2018.

Though U.S. implementing rules for Basel III remain incomplete, banks are starting to prepare for 2019, when the full range of regulations tied to the new capital standards are scheduled to take effect, Sands said.

“The last thing you want to do is be over or near 10 [percent] in 2017,” he said.

That has led to a flurry of transactions over the last year or so.

While publicly traded servicing giant Ocwen Financial Corp. has taken the lead in acquiring new servicing rights, Quicken and Fortress Investment Group LLC's Nationstar Mortgage Holdings Inc. and Newcastle Investment Corp. units have become involved in the industry as well, largely buying from big mortgage players like Bank of America Corp.

Getting involved in mortgage servicing means getting involved with regulators, who have taken a keen interest in the way companies collect mortgage payments and perform other servicing duties, including foreclosure prevention actions like refinancings.

While the Consumer Financial Protection Bureau has garnered headlines for its mortgage servicing rules, which largely codified a $25 billion 2012 settlement with the country's five largest mortgage servicers, states have been beefing up their oversight as well.

“You really need to have a comprehensive compliance management program, and it has to take into account all the federal, state and local laws around the country governing servicing, collections, loss mitigation and foreclosure,” Kromer said.

Private equity firms also have to make sure regulators are comfortable with them and make sure they have enough capital on hand to cover the potential for loans to go bad, Sands added.

The key to establishing a global compliance program is solid partnerships with banks giving up the servicing rights, Sands said.

Banks operating in a state can help navigate the regulatory landscape, and they have an interest in maintaining their reputation with customers so they can retain their business for other products like auto and home equity loans.

“While they don't want the servicing right, under no circumstance do they want to give up the customer relationship,” Sands said.

The other way private equity firms can keep up with mortgage servicing rules is to stay on Fannie Mae and Freddie Mac's good side. The two mortgage giants, which were saved by a government bailout in 2008 after investments in mortgage-backed securities went bad, can stop a company from servicing a mortgage if they run afoul of the firms' requirements.

With Fannie Mae and Freddie Mac owning or guaranteeing around 75 percent of all residential mortgages in the U.S., their approval carries a lot of weight.

“You conform to what they want, simply put,” Sands said.

Mortgage servicing carries other risks, including borrower default and the potential for early repayment, but private money is attracted to the potential for a big payout. As Basel III draws closer, the opportunity for deals is likely to grow.

--Editing by John Quinn and Jeremy Barker.

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