Acquisition of Mortgage Banking Assets

TRANSFER OF OWNERSHIP AND SERVICING

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Mortgage banking companies in the United States have experienced a surge in business and profits within the last year as the result of savings and loan institutions foundering and a dramatic drop in the interest rates for fixed rate mortgages. Despite a slowdown in purchase financing, lower interest rates and a need by consumers for liquidity have led to a strong interest in refinancing. As a result, there has been an increase in investment in smaller independent mortgage banking companies by entrepreneurs eager to take advantage of the increased profits.

For most investors, the quickest way into the industry is to purchase an existing mortgage company with ongoing business. The primary benefit in purchasing an existing company is that the company will have the approvals and authorizations (collectively referred to as "Approvals") which permit the company to sell and service mortgage loans to and on behalf of the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Government National Mortgage Association ("Ginnie Mae") and to originate Federal Housing Administration (FHA) and Veterans Administration ("VA") loans.

The alternative is to form a new corporation and obtain new Approvals, a process which can often exceed six months. In the investor's rush to capitalize on the investment opportunity, however, the investor must be careful not to jeopardize loss or suspension of any of the Approvals of the existing mortgage company, as this could have a significant negative impact on or even prove fatal to the company. The first part of this article briefly discusses ways in which an Approval might be lost or suspended as a reult of a transfer in ownership and the precautions to take to minimize this risk. The second part of this article summarizes the procedures to follow in buying and selling servicing portfolios to assist the new owner in avoiding loss or suspension of an Approval for an improper transfer of servicing. This becomes particularly important as interest rates begin to rise and the industry's profits come less from the origination of loans and more from loan servicing. As this shift occurs, companies will try to increase their servicing portfolios, leading to increased transfers of servicing and an increased need to focus on the proper transfer procedures.

Transfer of Ownership

Fannie Mae, Freddie Mac, Ginnie Mae, the FHA and the VA (collectively, the "Agencies") each requires written notice prior to any proposed major change in the ownership of a mortgage banking company. A change in ownership generally includes any merger, consolidation or reorganization and also a change in the ownership of the servicer's parent, any owner of the parent, or any other beneficial owner of the company.

The purpose of the notice is to provide the Agencies with an opportunity to evaluate how the new ownership will impact the performance and financial ability of the company. Generally, if there is a change in ownership only, with management remaining the same, the Agencies will focus on the capital structure to insure the company maintains the requisite net worth. However, if the new owners replace existing management, the Agencies will turn their focus on the new management's ability to operate the company.

Problems typically arise when an entrepreneur, in purchasing an existing mortgage banking corporation, buys only the corporate shell with the Approvals, intending to input new capital and replace management in its entirety. In this instance, Fannie Mae and Freddie Mac will generally terminate their respective Approvals and require the new ownership and management to apply for new Approvals. This is consistent with the tendency of Fannie Mae and Freddie Mac to be less concerned with the continuity of the corporate structure and more concerned with the continuity of management. Ginnie Mae, on the other hand, will generally focus on the continuity of the corporate structure and is not likely to terminate its Approval in such a transaction.

The termination of any of the Approvals will at a minimum result in a significant reduction in the value of the corporation and a delay in conducting business while the new applications are being reviewed for approval, a process which can take several months. If the investor and new management have no background in the mortgage banking business, it is highly probable that the investor will not be able to obtain new Approvals and, therefore, would ultimately have purchased an empty corporate shell.

One possible solution to this problem is to gradually phase out existing management and/or ownership over an extended perior of time, allowing the Agencies to become acquainted with the new management and ownership and hopefully more confident in their abilities. Freddie Mac and Fannie Mae have indicated that they are much less likely to terminate their respective Approvals if the old management and ownership is phased out slowly. In any event, the parties should at least provide that the close of the transaction is contingent upon the successful transfer of the existing Approvals or, in the alternative, that the purchase price will be reduced for each Approval that cannot be transferred.

When purchasing a corporate shell with only the Approvals, an investor must be able, at the close

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of the purchase, to provide sufficient capital to meet the minimum net worth requirements of the Agencies. This becomes a significant problem for some investors because of the high net worth requirements of the Agencies. The current minimum net worth requirement for Fannie Mae is $500,000, for Freddie Mac it is $1,000,000, and for Ginnie Mae it can be as high as $500,000 plus 0.2 percent of the amount by which the company's mortgages exceed $35,000,000, depending on the type of mortgage the company is selling and servicing. If there is a delay in providing the requisite net worth, Approvals may be suspended or even terminated.

In reviewing the purchase documents between the mortgage company and the Agencies, investors should be aware that in the event of a transfer of ownership and change in management, an Agency may exercise its right to reduce the annual amount of loans it will purchase from the mortgage company to limit the amount of exposure of the Agency in the event that problems arise with the new ownership and management. This factor should be taken into consideration when the investor is projecting future profits of the company to determine a fair purchase price.

While not directly related to the Approvals, one very important factor for a new owner is to insure that the company will have adequate warehouse credit to fund new mortgages. Although there has been a strong increase in the demand for credit from independent mortgage companies, at the same time, the major banks have tightened their credit standards. Therefore, the prudent investor should insure that a sufficient warehouse line can be arranged for the company prior to making his purchase.

These problems aside, the process of providing each of the Agencies with notification of change in ownership is otherwise a simple process. With respect to Fannie Mae, written notice must be provided 30 days prior to the scheduled date of the proposed change. As part of the notification, Fannie Mae must be provided with copies of any filings with, or approvals from, applicable state or other regulatory authority and may upon review of the notice, require audited financial statements before approval is granted.

Freddie Mac requires notification of a change in ownership one business day prior to its occurance. However, if practical, notice should be provided four to six weeks before the scheduled transfer to allow Freddie Mac sufficient time to review the transaction. Where there is substantial change in ownership, Freddie Mac will require audited statements for the acquired company within 90 days of a transfer of ownership.

Ginnie Mae requires notification ten calendar days prior to any proposed change in the ownership of the business. After the transaction is complete, Ginnie Mae should be provided with a letter summarizing the actual transaction. Ginnie Mae may require additional information, including audited financial statements, if as a result of the transfer, the business changes capital structure or its fiscal year.

The FHA must be notified within 10 business days of a change in ownership or management. The notification is to provided on form HUD-92001K. The FHA does not require additional information but has the authority to request the additional information, including financial statements, necessary to evaluate the impact of the change.

The VA requires notice of any proposed change in management or ownership a reasonable time prior to the scheduled date of the proposed change. As a general policy, if therre is a complete replacement of owners or management, the VA will withdraw existing approval and require the company to apply for new approval.

The risk of loss or suspension of the Approvals upon the transfer of ownership can be greatly reduced by following these prescribed notification procedures and taking certain precautions, including those described above. In addition, many problems can be avoided if, when negotiating the transfer of a mortgage company, the parties contact the appropriate Agencies early in the negotiation process, especially if there are any unusual circumstances or conditions in the transfer, to provide the Agencies with sufficient time to review the transfer and to recommend any appropriate actions.

Transfer of Servicing

As interest rates on fixed rate mortgages begin to rise, the mortgage companies will turn to servicing for revenues and thus significantly increase the demand for servicing portfolios. The entrepreneur in his new business must be aware of the need to adhere to certain procedures when purchasing or selling Fannie Mae, Freddie Mac or Ginnie Mae servicing portfolios as a company entering into an unauthorized transfer of servicing may find itself liable to an Agency for any losses incurred by the Agency as the result of the unauthorized transfer, and both the transferor and transferee servicers risk the suspension or termination of their Approvals. Special effort should be made to comply with these relatively simple procedures as the downside risk of noncompliance is so high. Following is a brief summary of the general transfer requirements of Fannie Mae, Freddie Mac and Ginnie Mae. These requirements may vary depending on the particular terms of the transaction.

Thirty days prior to the proposed transfer date, the transferee and transferor servicers must provide Fannie Mae with a $500 transfer fee, a Request for Approval of Servicing Transfer and Consents for Transfer of Servicing Portfolio Agreement, and if the transferred portfolio includes MBS pools, a Custody Document Information Record. The transferor and transferee must assure that certain third parties, including the mortgage insurer and borrower, receive prompt and accurate notice of the transfer. In some instances, the transferor must obtain the consent of the mortgage insurer before transferring a particular mortgage. By the effective date of the transfer of the servicing, the transferor must have delivered to the transferee information and records relating to the entire portfolio of mortgages being transferred. In addition, no later than 30 days after the effective date of the transfer, the transferor servicer must deliver to the transferee the individual mortgage file for each mortgage included in the transfer.

As part of the transfer, the

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transferee servicer must agree to assume responsibilities, duties, and selling warranties that were agreed upon between Fannie Mae and the transferor when the mortgage was originally sold to Fannie Mae. After conclusion of the transfer, the transferor and transferee servicers remain jointly and severally liable to Fannie Mae for all warranties in the purchase documents, and any repurchase or recourse agreements previously entered into between Fannie Mae and the transferor. However, Fannie Mae, at its sole discretion, may agree to release the transferor from such obligation.

Freddie Mac requires the transferor to submit a $500 transfer fee, an Agreement for Subsequent Transfer of Servicing and Summary of Freddie Mac Accounting Group(s) to be Transferred at least 45 days prior to the requested transfer date. The transferor must provide timely notice to certain third parties including among others the borrower and the mortgage insurer. By the effective date of the transfer of servicing, the transferor must have delivered to the transferee detailed information regarding the mortgages being transferred. Upon the transfer, the transferee becomes liable to Freddie Mac for all sale and servicing representations, covenants, and warranties in the purchase documents with respect to the transferred mortgages.

The written request for approval to transfer Ginnie Mae servicing must be received by Ginnie Mae no later than the third business day of the month prior to the month in which the new servicer will begin servicing the mortgages. Ginnie Mae must be provided with a new Servicing Agreement, and a new Letter for Servicer's Principal and Interest Custodial Account, ACH Debit Authorization, Letter Agreement for Servicer's Escrow Custodial Account and a Custodial Agreement, as appropriate, if there are to be changes in the Principal and Interest or Tax and Insurance Custodial Accounts, or in the document custodian. Like Freddie Mac and Fannie Mae, Ginnie Mae requires that the transfer be made to a servicer who has the requisite Approval, is in good standing, and has facilities adequate to perform the servicing being transferred.

As with the transfer of ownership, when parties are negotiating a transfer of servicing, they should contact the appropriate Agency early in the negotiation process to provide the Agency with sufficient time to respond.