MORTGAGE M&A MINUTE

HUNTON ANDREWS KURTH

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Market Snapshot

In Q2 2024, **$275.05 billion** of agency MSRs were transferred. This represents a more than two-fold increase over the volume traded in Q1 of 2024. (Inside Mortgage Finance)

Declining interest rates have taken monthly payments in new purchase applications down to **$2,057** in August of 2024. This is the fourth straight month of decline and represents a more than **$100** decrease from August of 2023. (Mortgage Bankers Association)

Housing inventory reached its **highest point** since May 2020 in the first week of October. (Altos)

As of the end of 2023, **7 of the top 10** MBS servicers were non-bank entities. Chase Home Finance, Wells Fargo and U.S. Bank NA were the only banks included in the top 10.

Quick Numbers

70.4% The percentage of consumer debt in the United States comprised of mortgage debt. (LendingTree)

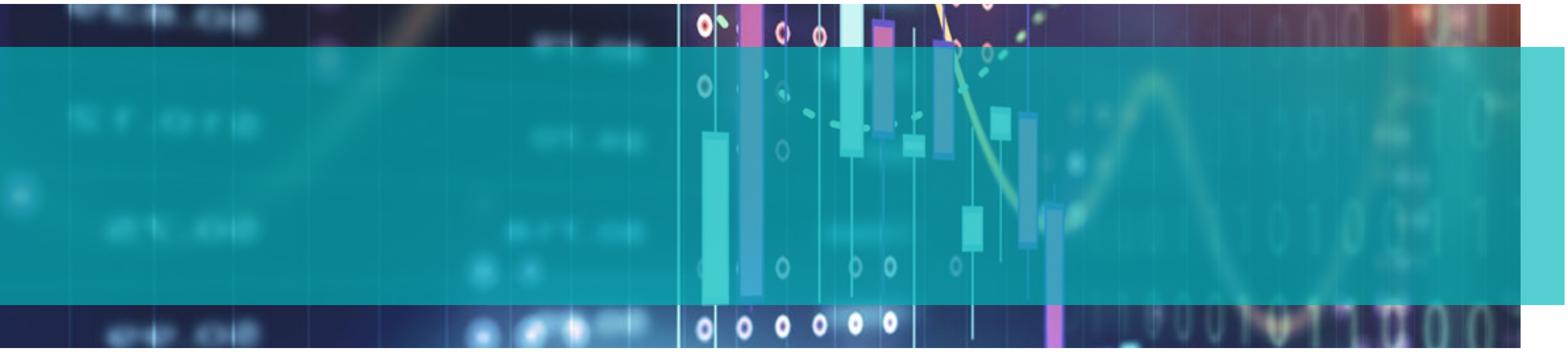
6.56% The lowest weekly mortgage rate between 1972 and 2001, occurring in November 2001. (Federal Reserve Bank)

$171,000 Median home price in the United States in November 2021. (Federal Reserve Bank)

$412,300 Median home price in the United States in June 2024. (Federal Reserve Bank)

Quick Links

Lauren Richmond Chief Legal Officer, General Counsel & Secretary Finance of America Companies Inc.



The Role of MSRs in Mortgage Industry M&A Transactions

The Fed's recent rate cut put months of speculation to rest and has given rise to new prognostications on what the central bank will do next. Uncertainty over interest rates has chilled certain portions of the financial services and mortgage M&A market for the better part of the last 18 months, but certain segments have remained active. In this month's newsletter, we focus on mortgage servicing rights (MSRs) and the prominent role they have played in M&A in the mortgage space recently.

MSRs

As has been the case for at least 24 months, increased interest rates have led to increased M&A activity relating to MSRs. As most who are reading this know, at a basic level, rising interest rates increase the value of MSRs since borrowers are less likely to refinance or pay off mortgages in a high-interest rate environment. Not all interested buyers are able to acquire MSRs at the snap of a finger. Buyers must have proper licensing and servicing functions (personnel, software platforms, etc.) in place to acquire MSRs and fulfill the servicing obligations after the transfer of servicing is completed. If these things are not already in place, it can take significant amounts of time and effort to arrange them for a buyer. One way to accelerate the process is for a buyer to acquire a shell licensed servicer entity and complete the applicable change-of-control filings and approvals. Another way is for potential investors to partner with licensed servicers to acquire (at least in part) the benefits of owning MSRs. Likewise, regulatory requirements of a different kind have driven some servicers, particularly banks, away from the space as we will discuss below.

MSR assets are classified as one of the most volatile financial assets that a company can hold given the valuation fluctuations with market rates. This is even more significant for chartered banks given the capital requirements in relation to the value of the MSRs. Basel III increased the risk weight of MSRs from 100 percent to 250 percent, leading to significantly increased capital requirements for banks holding significant volumes of MSRs. While some banks have been able to meet these capital requirements and still find MSRs to be a worthwhile investment, we have seen a number of bank and non-bank players look to divest their MSRs for a variety of reasons, but increased capital requirements are often a key driver of these sales for chartered banks. Studies have shown that banks have been increasingly likely to transfer MSRs (as compared to non-bank servicers) since the implementation of increased capital requirements.

While non-bank servicers do not operate in the "wild-west" with no regulatory or capital requirements, the lower risk weighting applied to non-bank servicers mitigates one of the primary hurdles to servicing for chartered banks. This has led to an increasing number of non-bank participants entering the MSR market. Some participants have long histories in the servicing space and are able to purchase MSRs and related assets with little trouble as they already are fully licensed on both a state and federal level. For new participants, M&A (or joint ventures) is often the most efficient route to entering the MSR market. Below we discuss a couple of the key issues that our team frequently comes across in MSR-driven M&A deals.

KEY ISSUES IN MSR TRANSACTIONS

Hedging and Valuation Shifts

Given that MSR-focused M&A transactions are likely to involve regulatory approvals, and oftentimes consent rights of third parties, we typically see some period of time pass between signing and closing. Sometimes (or with some states) this interim period can be lengthy. In addition to the usual interim period issues (interim operating covenants, closing documentation negotiation, etc.), M&A deals involving MSRs present an additional wrinkle given the volatility in value of the MSR asset. Regardless of how frequently a seller "marks" their MSRs to a given market price, sellers and buyers seek to protect themselves from fluctuations that could materially change the economics of an M&A deal through a few common mechanisms.

Sometimes, the simplest way for a seller and buyer to address this MSR valuation issue is to separate the MSR trade from the underlying M&A transaction—particularly if the M&A transaction is an asset deal. In these structures, the parties can enter into MSR Purchase and Sale Agreements (MSRPSA) that follow a customary market format, and the parties can address the MSR-specific issues in the MSRPSA, such as purchase price holdbacks, recapture risk, interim servicing, document deliveries and other transfer mechanics.

As for the economics, the biggest issue is how the parties set the purchase price calculation and account for (or protect against) market volatility. One way this can be addressed is by fixing the price at some agreed upon date that allows the parties the ability to enter into separate hedging arrangements from and after that date to protect against market volatility. The benefits of this arrangement are that each party can choose to calibrate the hedging arrangement in the manner best suited for their specific risk tolerance and desired economic outcomes in the deal. On the flip side, these arrangements can be costly and potentially unnecessary depending on market moves. Additionally, if a particular deal has timing uncertainty, parties may struggle to determine the appropriate hedging arrangement to enter into at signing when visibility into a specific closing date may be difficult to ascertain.

Another approach that parties can employ to address fluctuations in value of the underlying MSR asset is to agree on a form of purchase price calculation for the subject MSRs that incorporates market movement by fluctuating based on particular market index movements between signing and closing. This type of formula works if both parties are in relative lockstep on how they view the economics of a transaction but can also be paired with hedging arrangements if a party is looking for further downside protection or has to make economic concessions to their counter-party that may present further downside for one party.

Regulatory Challenges

We've discussed economic issues created by lengthy periods between signing and closing in MSR-driven M&A deals but what is behind these often lengthy "interim" periods? Regulatory and licensing approvals in various states. The number of approvals required and the expected time to obtain such approvals is often driven by the nature of the acquirer. For purposes of thinking about the length of time that will be required to obtain all necessary approvals, we think about the identity of the buyer in three high-level "groups" (of course, not every buyer fits neatly in these groups): (i) buyers who are fully licensed as servicers at the federal level and in all applicable states (Existing Servicers), (ii) buyers who are not licensed but are purchasing the equity of an entity that holds all necessary licenses to service the underlying MSRs (Shells), and (iii) buyers who are forming a new, stand-alone entity that will need to obtain all necessary licenses to service the acquired MSRs (New Entities).

Existing Servicers acquiring MSRs in an M&A transaction are likely to provide the quickest path to closing from a regulatory perspective. Existing Servicers are not completely free from regulatory requirements but typically have a smaller list of notifications and consents that they need to pursue and these are usually at the federal level and can depend on the nature of the mortgage loans underlying the subject MSRs (i.e., agency or non-agency).

Shell entities have proven to be an attractive acquisition target for buyers who are looking to enter the MSR market. Acquiring Shells does not eliminate regulatory approval requirements but buyers have found that acquiring an existing entity is much faster than "standing up" a new entity that needs to acquire new licenses in various states and at the federal level. Shell entity transactions are popular for this reason but can create complexity due to valuing any other assets that may be in the Shell, as well as requiring parties to allocate risk for any pre-acquisition liabilities that remain in the Shell.

The formation of a New Entity to hold and service mortgage loans is the least common of the three approaches outlined here due to the regulatory headache of acquiring new licenses in numerous states along with the operational and logistical challenge of building out a team to run the new business line. For this reason, M&A has become an increasingly attractive way for new participants to enter the MSR space.

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Applicability of HSR to MSR Transactions

The acquisition of mortgage servicing rights (MSRs) may require submitting a Hart-Scott-Rodino Act (HSR) filing to the Federal Trade Commission (FTC) and the Department of Justice (DOJ) under certain circumstances. Many M&A practitioners are comfortable offering quick advice on the applicability of HSR to transactions based on their size or where a common exemption applies, but transactions involving MSRs are fact-sensitive and can be more complex than a "typical" HSR analysis.

HSR applies to transactions that meet certain thresholds based on the value of what is to be acquired, and the respective size (sales/assets) of the buyer and seller—unless the transaction meets certain requirements to be exempt from HSR. Currently, the "size-of-transaction" threshold is $119.5 million for parties that meet the "size-of-person" test (one party has $23.9 million in current assets/sales in the preceding calendar year, and the other has $239 million assets/sales). Transactions valued above $478 million do not need to meet the size-of-person test.

MSRs are exempt from HSR when they are sold together with the mortgage loans underlying such MSRs. The analysis is more complicated when MSRs are sold separately from their underlying mortgage loans. In such a scenario, the circumstances of the sale will determine whether an exemption applies.

The HSR Act provides an exemption for certain transactions that occur in the "ordinary course of business" for the parties involved. This exemption can often apply to the sale of MSRs if the seller is not selling all of its assets. However, there are additional circumstances that can give rise to an HSR filing in the sale of MSRs. If a seller is exiting a business line that involves, or consists of, MSRs, such a sale is likely to trigger an HSR filing. In many cases, if the buyer is not acquiring all of the seller's MSRs, the transaction can be deemed to occur in the ordinary course and be exempt. On the other hand, if the buyer is acquiring all of the seller's MSRs, the transaction would occur in the ordinary course only if the seller retained other assets and was not exiting the loan servicing business or another business line which housed the seller's MSRs. The analysis surrounding application of HSR to MSR sales can be extremely fact-sensitive and should always include consultation with antitrust counsel.

Hunton Andrews Kurth's antitrust, M&A and structured finance teams regularly consult on MSR sale transactions, including some of the largest transactions in the space in recent years.

Bennett Sooy
Associate, Washington, DC

Q&A with Lauren Richmond

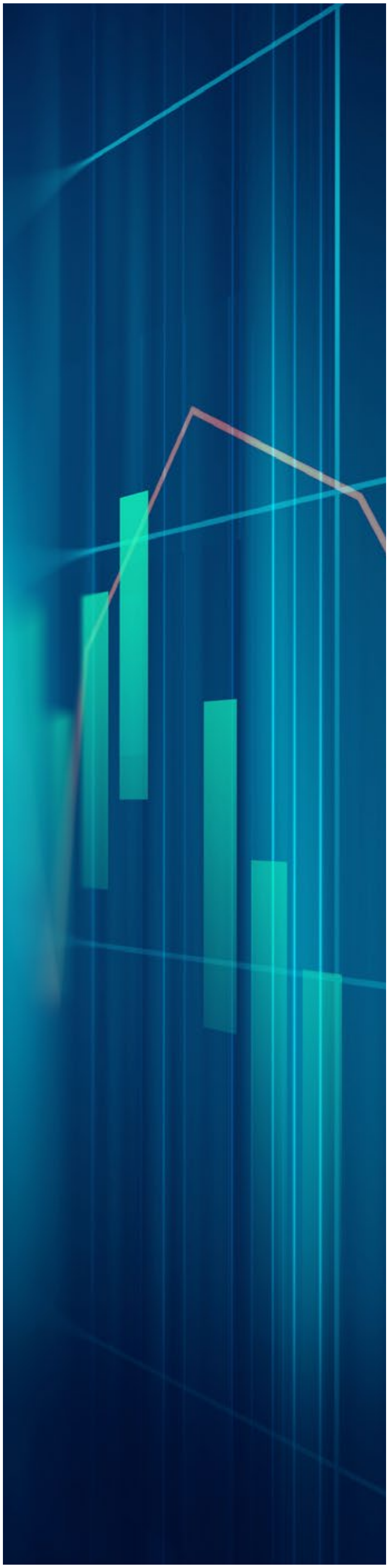
Chief Legal Officer, General Counsel & Secretary
Finance of America Companies Inc. (FOA)

Q: Can you explain to us what your role is at FOA and how it has evolved since you joined FOA in 2016?

A: I started working with FOA as outside counsel at Hunton in 2014, representing the company initially in the equity investment by Blackstone and subsequently, the company's acquisition of several mortgage originators, title companies and lender services businesses. In 2016, I moved in house as an associate general counsel at FOA and focused primarily on M&A and operational contract negotiations. Over the next several years, my role grew to include corporate governance, structured finance and other complex transactional work, as well as operational compliance and regulatory support. In 2019, our general counsel announced her retirement and I was promoted to general counsel of our family of companies. In 2021, we went public via a SPAC transaction, and shortly thereafter in 2022, I was promoted to my current position of chief legal officer, general counsel & secretary of our public parent company, as well as each of our subsidiary companies. In this role, I oversee the legal, compliance, enterprise risk and, administratively, internal audit functions of the company. I also interface regularly with our board of directors and participate as a member of the executive management committee. My job spans a number of responsibilities, and I learn something new every day.

Q: From 2015 through 2022 FOA grew aggressively through acquisitions and strategic transactions—what were some challenges you experienced through those transactions? Any lessons learned? What went well and what were some pitfalls?

A: Because we operate non-bank lenders in the financial services industry, consistently our biggest challenge pre-closing is the regulatory approval process. We certainly got smarter with each incremental deal, learning how to structure appropriately, get ahead of follow-up and informational requests from various regulators and set more accurate and attainable closing timelines. Post-closing, our biggest challenge is typically integration—and more specifically, operational and systems integration. There are always unforeseen hiccups as you merge processes and systems, and it's impossible to plan for everything. That said, at the height of our acquisition spree, we were generally a well-oiled machine—we got better at anticipating those hiccups and better at managing around them as well. We became quite nimble in our structures and were able to build on each deal to improve the next.



Q: For a while, FOA was on an acquisition spree, acquiring a variety of players in the mortgage and consumer finance space. Recently, it seems as though the focus has shifted to emphasizing the reverse mortgage business and divesting some non-core assets. How does your role change with the emphasis being less on growth through M&A and an increased focus on internal processes and divesting non-core businesses?

A: I had the unique experience of sitting on both sides—the acquisition and the subsequent disposition—of multiple companies and business lines over the past 10 years. Sitting on the sell side certainly helps build empathy for sellers! We have found that, for many regulated companies, getting out is just as a hard as getting in. There is a long tail on the exit, particularly in an asset sale, and we continue to learn a lot about the nuances of discontinued operations. While we've been light on M&A, most recently we have been knee-deep most recently in negotiating an exchange offer with respect to our corporate high yield debt, which has taken the bulk of my time. Outside of those types of strategic transactions, I am spending time reviewing existing processes to determine where we can optimize our time. Many of our processes were built for a much larger, more diverse enterprise—with a fresh look, there are often opportunities to tailor the approach to better fit where we are today, while maintaining certain features so that we're poised to scale again when the time comes.

Q: What advantages does FOA have in a fragmented market as a national player as compared to regional and local lenders?

A: After acquiring the operations of another large reverse lender, AAG, our reverse company, Finance of America Reverse, scaled our retail call center process quite significantly. Our national footprint allows us to run a very efficient and sweeping retail operation, and allows us to reach a wide audience through mediums like national television campaigns. Of course, each state has unique regulations and quirks which requires us to keep up with a vast and wide regulatory regime. Through our national wholesale platform, we are able to partner with regional and local lenders to reach those smaller markets as well.

Q: You lived through a SPAC—how was that and how did that shape the last few years?

A: Going public via a SPAC was certainly a novel and interesting experience, however the biggest impacts were felt by our accounting teams. There are a number of accounting nuances that come with SPACs that kept our teams busy for quite some time. Our transaction was also an Up-C structure, which adds a layer of complexity not only for the legal and accounting teams, who have to operationalize new processes like tax receivables and exchangeable units, but also for the legacy equity holders, who have to learn a new regime of equity. Initially, coordinating all of the various teams to implement things like the exchange process was challenging and clunky, but a few years out, we are largely running smoothly day-to-day.

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