State Licensing Pitfalls Mortgage Servicers Must Beware

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In many states, a company that services a residential mortgage loan by collecting payments from borrowers must hold a mortgage servicer license. What can come as a surprise, however, is that those licenses can also apply to companies that never directly receive payments or interact with borrowers.

An enforcement action by the Washington State Department of Financial Institutions earlier this year emphasizes that point. In the Jan. 4 action, Sailfish Servicing LLC, a company applying for a mortgage servicing license, disclosed during the application process that it already owned the servicing rights on a number of loans. As a result of that ownership interest, the company found itself subject to a consent order by the department.

To provide some background, mortgage licensing has gone through significant shifts in the last few decades. The largest shift occurred after the 2008 financial crisis, when the SAFE Mortgage Licensing Act required states to begin licensing individual mortgage loan originators. Prior to that time, licensing in the mortgage space was largely limited to companies.

Another shift has been in the regulation of mortgage servicing. In recent times, states have increasingly regulated the business and conduct of mortgage servicers, and a large part of that regulation has focused on licensing.

This is a relatively new area of licensing. Although states have licensed collection agencies and debt collectors for many years, and those licenses can apply to mortgage servicing activities, mortgage-specific licenses tended to focus only on front-end origination activities, such as making or brokering loans. A company in the mortgage industry may have needed a mortgage lender license to make a loan, or a mortgage broker license to arrange a loan, but often no license was required beyond those.

However, at the time of the mortgage crisis and after, a number of states adopted mortgage servicer licensing requirements. Sometimes, these licenses are merely one category of activity that is part of states' mortgage lender or mortgage company license. In other instances, states have adopted specific mortgage servicer licenses.

While state variations are common, mortgage servicing licenses often apply to a person who receives a payment from a borrower on a mortgage loan and remits the payment to the owner of the loan. Payments include principal and interest due on the loan, as well as amounts for insurance and taxes.

As a result, a company that is in the business of receiving mortgage loan payments from borrowers probably falls within the scope of a state mortgage servicer license, although it sometimes matters whether the company receives the payment on its own behalf or for a third party. However, if a company is involved in the mortgage servicing process, but does not directly interact with borrowers, the licensing issue gets more interesting. That issue is particularly important for companies that hold mortgage servicing rights or act as master servicers.

As described in Title 12 of the Code of Federal Regulations, Section 1024.31, a master servicer is someone who owns the right to perform servicing.[1] A subservicer is a servicer that does not own the right to perform servicing, but that performs servicing on behalf of the master servicer. Accordingly, some companies do not directly engage in servicing activities or interact with borrowers, but instead own the right to perform servicing and
manage the servicing process. In those instances, all customer interactions are undertaken by another servicer.

That distinction can be very important from a licensing perspective. If a state license is required to receive and remit payments, a master servicer should not need the license if it engages a subservicer to handle the actual servicing. However, it's necessary to carefully parse the language of the law.

Some state servicing licenses apply to a person who receives mortgage payments from the borrower or has the right to receive such payments.[2] A master servicer that owns the right to perform servicing would likely fall within that definition, regardless of the involvement of a subservicer.

As another example, a state mortgage license might apply to a person who directly or indirectly services a mortgage loan.[3] A master servicer that mangages the servicing process and arranges for the use of subservicers might be deemed to be indirectly servicing the loan.

These subtle distinctions in licensing laws can come as an unwelcome surprise for a company. That fact was illustrated in a recent enforcement action out of Washington, involving loan servicing rights.

At the beginning of this year, the Washington State Department of Financial Institutions entered into a consent order with Sailfish Servicing LLC.[4] The facts leading to this consent order started several years ago when Sailfish applied for a consumer loan license in Washington. The Washington consumer loan license is needed to service residential mortgage loans, among other things.

The trouble arose when Sailfish disclosed, as part of the application process, that it already owned the servicing rights on several thousand Washington residential mortgage loans.

Washington is an example of a state where the license covers more than just receiving and remitting payments. Instead, Washington's license applies to a host of servicing-related activities, including persons who work with the lender or servicer to make decisions about various servicing activities.[5] Regulations issued by the department make clear that a master servicer that has a role in ongoing servicing administration is subject to the law.[6]

When Sailfish applied for a Washington license and disclosed in the application that it already owned servicing rights, the department was on notice that Sailfish may have engaged in unlicensed activity. The department ultimately fined Sailfish $43,000 and required assurances that Sailfish would not obtain any additional servicing rights until it obtained the Washington license. Sailfish did not admit any wrongdoing.

This action serves as a reminder that companies should determine whether aspects of their business may trigger a state license. That is particularly true if the company may be in the process of applying for a state license. During the application process, state regulators will often question an applicant about their business model, checking if the company may need additional licenses or may have engaged in unlicensed activities.

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