

## Mortgage Electronic Registration Systems, Inc. (MERS): Its Impact on The Credit Quality of First-Mortgage Jumbo MBS Transactions

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### OPINION

The ratings on first-mortgage jumbo MBS are not affected by the use of MERS as mortgagee of record on original mortgages or assignments of mortgage. The impact on the credit quality of jumbo first-mortgage MBS transactions through the use of MERS and MERSCORP, Inc. (MERSCORP) will be negligible because the legal mechanism set up to put creditors on notice of a mortgage is valid, the ability to foreclose and take REO will not be materially affected, the likelihood of a MERSCORP bankruptcy proceeding is slight, and the impact of a MERSCORP bankruptcy on first-mortgage jumbo MBS transactions should not be significant.

Likewise, credit enhancement levels for first-mortgage jumbo MBS will not be increased as a result of the use of MERS.

The concept of central electronic registration of ownership rights and avoiding the creation of new securities and their conveyance upon ownership transfer is not a new one. It has met with large success in the securities industry, where many stocks and bonds are centrally registered with the Depository Trust Company. The Federal Reserve Bank provides this function with respect to United States Treasury securities and Fannie Mae, Freddie Mac, and Ginnie Mae mortgage-backed securities.



Pooling and servicing agreements in first-mortgage MBS transactions should reflect that assignments of mortgage in the name of the MERS as nominee for the investors will be recorded. Furthermore, in transactions where the securitizer opts to use MERS, new assignments of mortgages to the trustee of MBS transactions will not be needed if MERS is already listed on the immediately prior recorded assignment of mortgage or, if there is no previous assignment of mortgage, the original recorded mortgage.

## **WHAT ARE MERSCORP AND MERS AND WHY WERE THEY FORMED?**

MERSCORP was formed about three years ago by major participants in the mortgage banking business, including Fannie Mae, Freddie Mac, and the Mortgage Banking Association (MBA) to provide a central electronic registry of the beneficial interests in mortgages, including owners of mortgages, creditors who lend against mortgages, (e.g., warehouse lenders), and servicers of mortgages. The central registry allows MERS to be named as the mortgagee on the public records. It is a voluntary system of registration.

MERS is a wholly owned subsidiary of MERSCORP. MERS was set up as a special-purpose corporation to help insulate MBS transactions from problems that could arise in the unlikely event of a MERSCORP bankruptcy proceeding.

Electronic Data Systems Corporation (EDS), has funded the systems development costs and is MERSCORP's official information technology partner. EDS is not an equity partner, but has a contract with MERSCORP. EDS is a financially strong company which has an **A1** long-term debt rating based on its leading market position in the computer services industry, its superior operating track record, and the positive outlook for continued revenue and cash flow growth.

The initial concept of MERSCORP was to have MERS named as the nominee on only a recorded assignment of mortgage. However, this has been expanded to include using MERS as nominee on the original recorded mortgage.

One initial purpose of MERSCORP was to cut down on the need for more than one assignment of mortgage during the life of the mortgage and more than one recordation of assignment of mortgage during the life of the mortgage. Loans originated in the name of correspondent lenders may have intervening assignments prepared.<sup>1</sup> Now, MERS can be used to avoid even one assignment of mortgage.

MERS brings the following benefits to the mortgage industry:

- **Cost Savings:** The assignment of mortgage recording fee can range from \$25 to \$50 per loan. Registering a loan with MERS will cost \$3.50. This cost savings will benefit the mortgage industry. Conduits may have significant savings. Residential Funding Corporation (RFC) anticipates it will save approximately \$15 – \$17 for each loan it buys and securitizes that uses MERS. Norwest Mortgage estimates it will save approximately \$300,000 to \$500,000 this year for its correspondent loans.<sup>2</sup>
- **Facilitate Recording.** A second initial purpose of MERSCORP was to help facilitate recordation, which will benefit warehouse lenders, many of whom do not currently have their assignments recorded.
- **Efficiency for Providing and Recording Releases:** MERSCORP will be able to provide servicers with the information necessary to release a mortgage after payment in full, saving the servicers the expense of going through their own records to complete the release of mortgage. Recording a release of mortgage may also be easier if the mortgagee of record is MERS because the release will also be in the name of MERS.

<sup>1</sup> Loans originated in the name of correspondents may have intervening assignments prepared, e.g., when a correspondent sells a loan to a conduit, there is typically an assignment of mortgage to the conduit; and when the conduit transfers that loan in a MBS securitization, there may be a subsequent assignment of mortgage to the trustee of the MBS transaction. It should be noted that some conduits may avoid doing two assignments by doing an assignment in blank.

<sup>2</sup> It should be noted that securitizers who do not currently record all their assignments of mortgage to the trustee of MBS and ABS transactions may not realize much in the way of hard cost savings. The securitizers who do not currently record all their assignments of mortgage to the trustee typically either provide legal opinions opining as to the impact that subsequent transferees and creditors of the loan seller will have on the investor or are very creditworthy.

Lenders using the MERSCORP registration system will have either the mortgage or assignment of mortgage listing MERS as the mortgagee as nominee for the real beneficial owner. For rated MBS, the beneficial owner will be the trustee of the MBS on behalf of the investors.

Except as discussed later on in this report, neither the mortgage note nor the assignment of the mortgage note will have the name of MERSCORP or MERS. Other than the mortgage or assignment of mortgage, neither MERSCORP nor should MERS named be on any loan documents.

**SUBSEQUENT CREDITORS AND TRANSFEREES OF LOAN SELLER ARE ON NOTICE: THEY SHOULD NOT BE ABLE TO CONTEST CONVEYANCE OF MORTGAGES TO MBS TRUSTEE BASED ON LACK OF NOTICE DUE TO USE OF MERS**

Using MERS as mortgagee of record on either the recorded assignment of mortgage or the original recorded mortgage will put the world on notice that MERS has a mortgage on the property as a nominee for a third party. Thus, subsequent creditors of the entity selling the mortgage to the MBS transactions should not be able to contest the conveyance of the mortgages based on lack of notice, due to the use of MERS. The same is true for subsequent transferees of the same mortgage from the entity selling the mortgage to the MBS transaction.

Although in many states the assignment of mortgage does not have to be recorded when the note is transferred, there are some states that require the assignment of mortgage to be recorded so that the buyer of the loan is protected against subsequent transferees and creditors of the seller of the mortgage. There are also some states where the law is uncertain as to the protection afforded loan buyers against subsequent transferees and creditors of the loan seller.

The name of the beneficial owner of the mortgage will not be a matter of public record. The language in the mortgage or assignment of mortgage will read as follows: "MERS, solely as nominee for Lender (as hereinafter defined), as beneficiary, and its successors and assigns." If MERS is named in a mortgage or assignment of mortgage, MERSCORP requires that those instruments will have to be recorded in the public recording offices.

The original note will be in the possession of the trustee in the MBS transactions. Generally, MERS will not be named on the note or the endorsement of the note.

Under common law principles, the mortgage is valid even though the name on the note is different than the name on the mortgage. The concept of undisclosed agency in business transactions has been around for a long time. The recording system has been set up to provide notice of security interests, but not necessarily the identity of the secured parties.

**NO MATERIAL IMPACT ON THE ABILITY TO FORECLOSE AND SELL FORECLOSED HOMES**

The ability of servicers to foreclose against defaulted mortgages and to have the trustee of the MBS sell foreclosed homes will not be materially impacted.

There will probably be an adjustment period during which the courts and the foreclosure attorneys will need to get familiar with MERS and learn how to deal with issues concerning foreclosure by a nominee that the foreclosure statutes did not contemplate.

Although there will probably be some situations where foreclosures and the sale of REO are delayed and where there are increased costs such as additional transfer taxes, the total impact should not be material and should be minimal for any particular mortgage-backed security transaction.

## **THE LIKELIHOOD OF MERSCORP GOING INTO A BANKRUPTCY PROCEEDING IS SLIGHT**

Because MERSCORP is the brainchild of Fannie Mae, Freddie Mac and the MBA, and because the Fannie Mae and Freddie Mac will allow mortgages to be registered in the name of MERS, it is unlikely that they will let MERSCORP fail to the detriment of investors in the mortgage business. At worst, they would probably stop MERSCORP from doing new business and close its operations in an orderly fashion.

MERSCORP is not heavily capitalized. MERSCORP believes it will make money once more of the major mortgage players use the system.

## **THE IMPACT OF A MERSCORP BANKRUPTCY PROCEEDING SHOULD NOT BE SIGNIFICANT FOR FIRST-MORTGAGE MBS TRANSACTIONS**

IF MERSCORP were to become subject to a bankruptcy court proceeding, the impact for first-mortgage MBS transactions should not be significant.

MERSCORP has set up a special purpose corporation, Mortgage Electronic Registration Systems, Inc. (MERS), which will act as the nominee of record on the recorded mortgages and recorded assignments of mortgage. In this respect, MERS is analogous to Cede and Co. which acts as the named party on behalf of the Depository Trust Company (DTC) on physical securities which become book-entry securities with DTC.

MERS has some mechanisms in place to try to make it more bankruptcy remote than its parent. MERS has an independent director, formalities to indicate separateness from MERSCORP, the requirement to have a unanimous vote of the board of directors to put itself into bankruptcy, and the requirement that the independent director has to agree to incur indebtedness.

If MERSCORP becomes subject to a bankruptcy proceeding and MERS does not, foreclosures brought by the servicers will be able to continue in the name of MERS. However, if MERSCORP is in bankruptcy, MERS may not have the funds to continue the mailroom function provided by EDS if the EDS contract expires or is terminated in a MERSCORP bankruptcy. If the mailroom is not functioning, MBS and ABS transactions with second mortgages could be adversely impacted. Without notice of a foreclosure of a first mortgage, the servicers of second mortgages may not be able to adequately protect their interests in a foreclosure proceeding of the first mortgage. This could increase the severity of loss on second mortgages.

If MERSCORP and MERS were both to become debtors in bankruptcy proceedings, neither organization should be able to successfully claim it has any beneficial ownership rights in the mortgages. MERS is just a nominee. Furthermore, the functions that both MERSCORP and MERS provide are not as detailed nor involved as the functions provided by servicers of first-mortgage MBS transactions. And there have been **Aaa**-rated first-mortgage MBS transactions where the servicers have not been financially strong.

## **FORECLOSURES**

### **Licensing and Qualified to do Business: How Does it Affect the Ability to Commence a Foreclosure Proceeding**

As a general matter in many states, if a company is doing business in a particular state, it has to be "qualified" to do business in that state and may also have to be licensed by the appropriate administrative agencies, such as state banking departments. One common penalty for failure to be qualified is the inability to commence a lawsuit, such as a foreclosure proceeding. According to MERSCORP's law firm, "the failure to be qualified does not generally impair the validity of any contract or prevent a company from defending any action..."

MERSCORP is qualified to do business in Six states<sup>3</sup> and does not believe it needs to be qualified in any other state.<sup>4</sup> MERSCORP is not licensed to do business in any state because it does not believe it is required to be licensed. If it is later determined that MERSCORP has to be qualified or licensed in any particular state, it will do so. Qualifying and licensing is an administrative headache that MERSCORP wants to avoid if unnecessary

### **Can MERS Be a Plaintiff in a Foreclosure Proceeding?**

In most states, the party named in the mortgage is allowed to commence the foreclosure proceeding. With respect to most states, the current practice in jumbo first-mortgage MBS transactions is that the servicer forecloses in the name of the trustee and can act on behalf of the trustee.

Servicers who are members of MERSCORP will have certain employees designated as officers of MERS, who will commence the foreclosures on behalf of MERS.<sup>5</sup> MERS, with the assistance of local law firms, has published recommended foreclosure procedures for every state, to be used when a foreclosure involves MERS.

There are some states where the foreclosure has to be commenced in the name of the investor or noteholder. In these states either the note will be assigned by the trustee of the security to MERS or MERS will assign the mortgage to the noteholder, i.e., the trustee. There are a number of other states where the notes will probably be endorsed over to MERS.

### **Notices**

If other entities have an interest in the property that is subject to a mortgage, such as another mortgage or a tax lien, state law may require that only the mortgagee of record be given notice of foreclosure proceedings.

MERS, as the named mortgagee of record, will, in many states, get notices of foreclosure of other liens and mortgages. EDS has set up a mailroom which receives the notices for MERS. EDS images the notices, e-mails them to the servicers, and then sends them the actual notice.

IF MERSCORP became bankrupt and the contract with EDS is either terminated or expires, there may be no funds to continue the mailroom, and thus, notices would not go to the servicers. As stated above, this is more significant in the case of MBS and ABS transactions with second mortgages.

## **TRANSFERRING FORECLOSED PROPERTIES: LEGALITIES AND LOGISTICS**

### **Credit Bid**

In most states, the foreclosing party can bid for the property and get credit for the amount of debt owed without having to put up cash. In most states the bid can be assigned to the real beneficial owner of the mortgage. However, there are just a few states where this cannot be done and MERS will probably take title in its name and then soon thereafter convey title to the beneficial owner, i.e., the MBS trustee.

### **Transfer Tax**

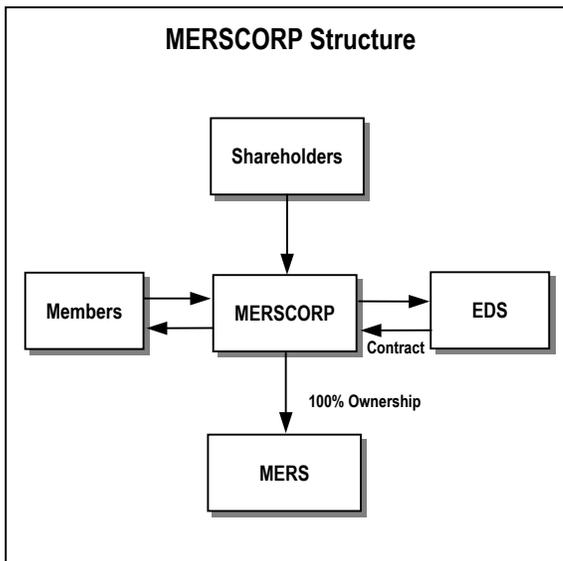
In most states, additional transfer taxes would not be payable because MERS is now involved in the foreclosure process.

In just a few states, there will be an additional transfer tax. When this does occur, it typically but not always, occurs in the state where MERS would have to make the bid and where title to the property cannot go directly to the beneficial owner of the mortgage (i.e., the trustee). The additional transfer tax will increase the severity of loss on the mortgage.

3 The six states are Delaware, Maine, Massachusetts, New Jersey, New York, Virginia.

4 Many of the states have exceptions for qualifying if the only activity conducted is creating or acquiring debt.

5 Although it is not expected to happen frequently, there may be some first-mortgage MBS transactions where the loans are registered with MERS and the master servicer is not a member of MERSCORP. In this situation, MERSCORP has indicated that MERS could give the master servicer the authority to commence a foreclosure proceeding in the name of MERS. If this authority is not given, MERS may have to assign the mortgage to the MBS trustee in order for the foreclosure to be commenced and the assignment may need to be recorded, potentially resulting in delay in starting the foreclosure.



## MEMBERSHIP, CAPITAL STRUCTURE, AND FEES

In June 1998, the original MERSCORP Delaware non-stock membership corporation was merged into a newly organized Delaware stock corporation.

Currently there are approximately 27 shareholders, including Fannie Mae, Freddie Mac, Mortgage Bankers Association of America (MBA), Norwest, GMAC Residential Funding Corp., and PNC Mortgage Corporation of America. The amount of investment by any of these entities is not very large, but it does show support for MERSCORP and the concept of central electronic registration.

There is a five-year \$8 million line of credit available to MERSCORP from NationsBank which is guaranteed by Fannie Mae, Freddie Mac, and the MBA on a several basis.

A company can be a member without being a shareholder. MERSCORP expects Chase and Countrywide to become members.

Membership fees will depend on size of servicing portfolio and degree of membership privileges and range from \$500 to \$7,500 a year

MERS will charge \$3.50 each time a loan is registered and \$8.50 each time servicing or ownership rights in the mortgage are transferred.

EDS is the provider of and designer of the registration system. It has a five-year contract with MERS that began in April 1997. MERS owns the system (EDS owns the hardware). EDS's compensation is payment of 60% of the transaction fees. EDS has ongoing performance and development responsibilities. However, if there is a new function developed, MERSCORP is responsible for the cost.

## DISPUTE RESOLUTION

One of the rules of MERSCORP is that if there are conflicting instructions from a servicer and a beneficial owner of an interest in the mortgage, the beneficial owner's instructions will prevail.

Disputes between MERSCORP and its members are supposed to be voluntarily worked out. However, if disputes cannot be worked out, there are procedures for mediation and then binding arbitration.

MERSCORP does not have substantive legal rules as to resolving priority conflicts. The applicable state law will govern that.

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