Understanding Liquidity Needs in Mortgage Servicing

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April 17, 2020

The Housing Policy Council (HPC) is a national trade association whose members are among the nation's leading mortgage originators, servicers (bank and nonbank), insurers & data/settlement service providers. The members of the HPC believe there is an urgent need for the Federal Government to assure markets that temporary liquidity support will be available for nonbank servicers, when and if, needed. Such support would enable nonbank servicers to fulfill the CARES Act mandate for mortgage payment forbearance. This mandate is also disrupting new mortgage lending. The key points are:

- Mortgage servicers face unprecedented impacts to their liquidity due to COVID-19. In providing mortgage payment forbearance to borrowers, certain nonbank servicers may require temporary liquidity support to meet significant and prolonged forbearance.
- Uncertainty surrounding the depth and duration of job losses resulting from the pandemic is reducing credit access for both nonbank servicer advances and new lending. Recent liquidity support for Ginnie Mae advance obligations has helped, but a similar vehicle using Federal Reserve authority would deliver similar support for GSE-backed mortgages.
- New loan originations are being jeopardized by government rules precluding the delivery of new loans where the borrower has requested a CARES Act forbearance on a loan originated to government or GSE program rules.
- Quick action will help address liquidity needs to support borrower forbearance and credit availability while also reducing systemic risk, thereby avoiding further harm to consumers, nonbank servicers, and the mortgage market.

HPC members believe that a near-term announcement that temporary liquidity support will be available for nonbank servicers, when and if, needed would stabilize the market, give lenders greater confidence to continue lending, and could start the path to needed, longer-term reforms.

I. Background

The economic impact of the pandemic and mortgage forbearance mandated by the CARES Act have created growing liquidity pressure for mortgage servicers.

The country's response to COVID-19 has constrained economic activity, dramatically reducing or eliminating the income of millions of workers. With enactment of the CARES Act, homeowners with Federally-backed mortgage loans (backed or owned by HUD, FHA, VA, USDA, Freddie Mac, or Fannie Mae) are entitled to up to six months of payment forbearance, which may be extended up to a year, upon a simple attestation of financial hardship. Forbearance requires a homeowner to make up the missed mortgage payments, but that could be months or years later.

Standard commercial practices and government agency rules require mortgage servicers to advance the missed principal and interest payment to bondholders and fulfill the property tax, mortgage insurance, and hazard insurance payments when the homeowner does not make the payments.

Virtually all Federally backed mortgages are packaged into mortgage-backed securities that are sold to investors. These investors are guaranteed the payment of principal and interest each month, whether the borrower pays their mortgage or not. When a borrower fails to pay, the responsibility to pay the investor, and ensure tax and insurance payments are made, falls to the mortgage servicer. This forwarding of principal, interest, taxes, and insurance (PITI) on behalf of the borrower is called a servicer advance. Should a servicer fail, Ginnie Mae, Freddie Mac, and Fannie Mae must satisfy the obligation to the bondholders.

In the case of Federally backed mortgages, the servicer is ultimately repaid for these advances, perhaps months or years later, by FHA, VA, USDA or by Freddie Mac or Fannie Mae. In other words, a temporary federal liquidity facility should be tailored to bridge the timeframe from the outset of forbearance, when the borrower stops making payments and the servicer begins advancing these funds to the bondholder, until the future date when the servicer is reimbursed by the government guarantor or insurer.

The capital and liquidity profiles of bank and nonbank mortgage servicers are dissimilar.

Banks with insured depository institution charters (commercial banks, savings and loans, credit unions – generically referred to here as “banks”) have access to low-cost insured deposits, the Federal Reserve’s discount window, and other liquidity vehicles. Banks are subject to comprehensive prudential regulation, community lending requirements, and stringent capital standards. Banks may be stressed by the mortgage payment forbearance program imposed by the CARES Act, but most bank servicers believe they will be able to manage the liquidity demand from their normal reserves and the other pre-existing support systems available.

Nonbank, or independent servicers (independent mortgage banks and others), rely upon credit lines from so-called warehouse lenders, most of them banks. They do not have access to the Federal Reserve or other emergency liquidity services, and their access to commercial credit lines may be restricted when credit quality or market uncertainty limits liquidity or credit from commercial sources. It is the prospect that a servicer’s obligation to advance borrower mortgage payments may exceed liquidity resources established for “stress scenarios,” combined with limits on commercial credit lines, that produces the need for temporary liquidity support for nonbank mortgage servicers.

II. Sizing the Need

In the face of uncertainty regarding the depth and duration of the economic slowdown, mortgage servicers must prepare for various possible outcomes.

HPC members report that roughly 5 to 6 percent of borrowers are on a COVID-19 payment forbearance plan just two weeks after enactment of the CARES Act. The take-up rate is higher in Ginnie Mae loan pools than in GSE loan pools. Requests for forbearance continue and the May 1 payment deadline is expected to produce another surge in requests.

In these early days, financially sound nonbank servicers should have the capacity to meet near-term forbearance demand. That will not remain the case if worsening economic conditions persist. Further, if return to normal business activity is protracted, the need for forbearance and the associated liquidity demands will be similarly affected.

III. A Federal Commitment to Act is Needed Now, Not Later

> *Markets are reacting to the crisis and delay in federal affirmation of support exacerbates the liquidity needs of mortgage nonbank servicers.*

The Federal Government could greatly aid market functioning by affirming today that a federal financing mechanism will be deployed, as necessary, to meet the servicing advance needs of nonbank mortgage servicers. Uncertainty regarding the magnitude of the health crisis and its impact on the economy generates a level of market anxiety and perception of market deterioration that serve as reasons to act now. In the absence of an explicit commitment to deliver liquidity support when needed, market volatility will prevail.

Every day, mortgage servicers and their creditors and investors must evaluate and price for the range of possible outcomes. The legal mandate of up to twelve months mortgage payment forbearance in these uncertain times could require mortgage servicers to advance payments at a level far greater than "stressful" economic scenarios used in pre-existing business *and* regulatory risk analysis.

Rating agencies have put some companies on credit watch and may downgrade them, raising their cost of capital. Mortgage servicing rights (MSR), a key asset for servicers (and the government or GSEs in the event of servicer failure), are losing value, further reducing capital and access to liquidity. In the event of a servicer failure, the servicing book must be transferred. Such transfers will not be easily achieved under current conditions and run the risk of further borrower disruption. Moreover, with the value of MSRs declining, liquidity needs soaring, and limited market appetite to take on the portfolio of any failed servicer (especially a servicer with significant Ginnie Mae exposure), the overall market deterioration will be amplified.

Thus, HPC supports a clear statement from the Federal Government that it will stand behind the liquidity needs of financially sound nonbank mortgage servicers as they fulfill their obligations under the Congressionally mandated mortgage forbearance program. Such clarity will immediately remove a critical uncertainty. It will also prevent the needless loss of private capital caused by continued uncertainty..

IV. Forbearance Requests are Disrupting New Lending

> *New loans underwritten with intention to deliver to the GSEs or Ginnie Mae may not be delivered if the customer requests forbearance, thereby exacerbating liquidity risk for nonbank lender/servicers.*

Apart from servicer advances, the CARES Act payment forbearance mandate is creating another liquidity issue that adds to the challenges facing lender/servicers. Included in the population of homeowners requesting forbearance are those who recently completed refinance or purchase transactions. Forbearance requests on such loans are causing significant market distress because the government insurance may be denied or the GSEs may not accept delivery of these mortgages. As a result, warehouse lines for new loan origination are tightening and credit restrictions are limiting borrower eligibility for new loans.

Deliverability of new loans to the GSEs or Ginnie Mae mortgage-backed securities are in question since any borrower that requests forbearance before the loan is delivered may be ineligible for government insurance or securitization. This issue further exacerbates liquidity risk for nonbank lender/servicers who then must fund the loans themselves and exposes all lenders to unanticipated credit risk. HPC believes that, along with the additional liquidity support for servicer advances, government programs should ensure these loans are eligible for delivery to GSE or Ginnie Mae mortgage-backed securities. That is, if a loan was funded to the appropriate guidelines, it should be insurable and deliverable into the Federally-backed securitization program even if the borrower requests a forbearance per the CARES Act.

V. How Should the Government Provide Liquidity Support?

> *The Federal Reserve should establish a facility to funnel funding through the undercapitalized GSEs to cover the servicer PITI advances, expenses that the GSEs would ultimately reimburse anyway.*

HPC commends Ginnie Mae for its leadership in adapting its existing authorities to help meet the liquidity need and provide some market certainty. On April 11th, Ginnie Mae announced changes to its Pass-Through Advance Program, which permits Ginnie Mae to temporarily fund the advances of principal and interest on loans in Ginnie Mae pools, should the servicer lack liquidity alternatives (although advances for taxes and insurance remain a concern). FHA is also taking steps to adjust its program rules to this situation. While extremely helpful, alone they may be insufficient given the potential magnitude of forbearance demands.

A similar vehicle could be set up for GSE-backed mortgages, using the Federal Reserve authority to provide funding that would flow through the GSEs to cover the advances that the servicers are otherwise making on behalf of the GSEs. The continued operation of the GSEs in conservatorship makes understandable the perspective of the Federal Housing Finance Agency that Fannie Mae and Freddie Mac cannot step in to meet this need. HPC agrees that, in a systemic, national emergency, achieving public policy objectives in financial markets should be the responsibility of the Federal Reserve and Treasury, not the GSEs.

The Federal Reserve is the logical liquidity provider, as servicer advances are made on behalf of borrowers to investors whose securities are government or GSE guaranteed. Combined with the CARES Act authorization for the Treasury Department to credit-enhance any Federal Reserve lending, the Federal Reserve could deliver the needed liquidity directly to Freddie Mac and Fannie Mae just as the Treasury is financing the aforementioned Ginnie Mae approach, to allow these agencies to temporarily advance funds to bondholders in lieu of servicer advances. Other approaches are also possible.

HPC expects that, under any option used, the Federal Reserve advance would be properly collateralized, including through the repayment obligation of the homeowner, backstopped in most cases by the guarantee support of the government insurance program or the GSE. And HPC expects that any facility would be conditioned on a liquidity need that cannot be met via normal commercial means. HPC also acknowledges and appreciates the Federal Reserve's considerable investment in Federally-backed mortgage-backed securities, which has helped stabilize MBS values.

VI. Conclusion

Prudent business practice and thoughtful regulatory oversight should lead both private sector and public sector leaders to recognize the risks and uncertainty the current environment poses. Since no one knows the course of the national health emergency, we also do not know the course of our economic recovery. Therefore, the sensible and appropriate course of action is to ensure market participants know that: a federal liquidity source for servicer advances will be available when and if market capacity is reached, and new loans will be insurable and deliverable for securitization even if the borrower requests a forbearance per the CARES Act. HPC stands ready to engage on implementing these immediate needs, and on addressing longer-term reforms.

Ed DeMarco is President of the Housing Policy Council. Prior to joining HPC, DeMarco was a senior fellow at the Milken Institute's Center for Financial Markets. From 2009 to 2014, DeMarco was acting director of the Federal Housing Finance Agency (FHFA), where he served as the conservator for Fannie Mae and Freddie Mac and regulator of those companies and the Federal Home Loan Banks.