Perspectives on Mortgage Servicing

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I will welcome the opportunity to learn more from the audience about the issues and questions that I will be discussing.
Mortgage Servicing During the Financial Crisis

- Servicers did not always act in the best interest of borrowers or investors
  - Widespread sloppy practices led to harm to borrowers, investors, communities, and the government

- Mortgage servicing assets did not hold their value and were not a source of strength to banking institutions
Policy Response

- Consumer-facing servicing issues
  - New servicing regulations from CFPB
  - CFPB has the authority to supervise nonbank servicers
  - Consent orders and settlements with federal and state regulators

- Safety and soundness of the banking system
  - Revised regulatory capital rules
    - require more capital for mortgage servicing assets
    - provide a disincentive for concentrating activities in mortgage servicing
Effects on mortgage servicing

- Consumers are better protected
- The cost of servicing has increased
- Large banks have reduced market share; nonbanks and small banks have gained
  - Nonperforming loan policies seem to be a larger factor than capital rules in this shift
  - Bulk sales from banks to nonbanks were mostly nonperforming loans
    - These sales provide little capital relief because the MSA values for nonperforming loans are low
  - The capital rules have a minor effect on most banks
    - Although a big effect on some banks that specialize in mortgage servicing
Two concerns associated with the shift from banks to nonbanks

1. Are nonbanks able to fund servicer advances in the event of a rise in defaults?

2. If a large nonbank – or multiple nonbanks – fail, where does the servicing go?
Servicing Advances

- When borrowers stop paying their mortgages, servicers still have to pay investors (“advances”) eventually reimbursed for some or all of these costs – but possibly as long as 5 years later.
- The advances are difficult to fund because they earn zero return.
- Banks have low-cost funding sources (such as deposits).
- Nonbanks don’t—a problem when defaults are high.
Nonbank portfolios are more concentrated in nonperforming loans

- Nonbanks appear to be more concentrated in nonperforming loans
  - Nonbanks have purchased nonperforming loans from banks
  - Nonbanks have a disproportionate share of FHA servicing
  - FHA loans are most vulnerable to default if house prices decline
    - Of recent loan originations with FICO scores < 680 and LTVs > 80 percent, an estimated 75 to 85 percent are FHA-insured

- Seems like a bad combination:
  - Servicers that are most fragile in the face of default are holding loans most likely to default
What happens if a large nonbank servicer fails?

- In the 2007-09 crisis, large banking institutions took over the servicing portfolios of failing institutions.
- This would be harder today:
  - The capital requirements would make it difficult for many banking institutions to expand their portfolios dramatically.
  - Several nonbank servicers have quite large portfolios (6 of top 10 servicers are nonbanks).
  - Perhaps banking institutions would sub-service (does not require booking an MSA).
- Might also be hard for a nonbank to take over the portfolio:
  - Several nonbank servicers are not profitable.
  - Shocks might be correlated.
Policy solution 1: Revise servicing contract

- Revise the servicing contract to reduce the risks of servicer failure?
  - Compensate servicers separately for performing and nonperforming loans?
  - Reduce servicer liability for funding advances?

- Inherent tradeoff:
  - Reducing a servicer’s risk reduces its incentive to act prudently
  - Requiring a servicer to take on too much risk, though, also increases its incentive to go out of business
Policy solution 2: Require a more stable funding system

- Require servicers to fund their operations with longer-term debt?
- Impose universal prudential standards on servicers?
  - Might require an increase in the servicing fee
- Which agency should impose such standards?
  - FHFA and Ginnie Mae? State banking supervisors?
What would we like to know to gauge the risks better?

- What is the financial condition of privately held nonbank servicers?
- What are the terms of the nonbanks’ warehouse lines of credit? Under what conditions can banks pull the lines?
- How vulnerable are the nonbanks to swings in interest rates and default?
- How are the nonbank servicers connected to the broader financial system?