Perspectives on Mortgage Servicing

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Disclaimers

- These are my views and not necessarily those of the Board of Governors of the Federal Reserve system or its staff.
- I will be making broad generalizations that may not reflect the circumstances, situation, or actions of any particular firm.
- I 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”)
- Servicers get 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?