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Mortgage Servicing Assets and Selected Market Developments

A mortgage servicer receives a fee to perform various administrative tasks that include collecting and remitting the principal and interest payments made by a borrower to the owner (e.g., lender, investor) of the mortgage asset; managing the borrower's escrow account; processing the loan title once paid in full; and administering loss mitigation (e.g., forbearance plans) or foreclosure resolution on behalf of the lender if full payment is not received. *Mortgage servicing assets* (MSAs), also referred to as mortgage servicing rights, generate fees reportedly averaging 25 basis points (0.25%, or $250 per $100,000 of an outstanding mortgage balance) per month. This InFocus describes the market for MSAs, recent developments, and issues pertaining to cash flow volatility.

Background

Just as a mortgage is an asset for the owner, the right to earn income for servicing a mortgage is an asset for a servicer. MSAs have properties similar to other assets. MSAs are traded (bought and sold) in a separate market from the original underlying mortgages. MSA values are based upon the discounted sum of expected future cash flows, calculated based upon the expected cash flows generated by the underlying mortgage itself. An MSA is conceptually similar to a financial derivative in that its value is linked to the performance of an underlying asset. An MSA's cash flows are linked to the cash flows of an underlying mortgage, which typically faces two key timing risks:

1. Mortgages have *prepayment risk*—the risk that a borrower repays the mortgage early or ahead of schedule, causing the asset to generate a lower yield (return) than initially expected. Declining interest rates increase a mortgage's prepayment risk, causing the value of the linked MSA to decline in anticipation of terminated future cash payments.
2. Mortgages have *credit (default) risk*—the risk that a borrower pays late or fails to repay the principal and interest obligations. Default risk reduces the cash flows for a mortgage and its linked MSA. Furthermore, the costs to service a defaulted mortgage rise substantially.

Servicers' potential profits, known as the *excess servicing fees (ESFs),* are the difference between the fees charged and servicing costs when borrowers repay mortgages as scheduled without any prepayment or default actions.

Servicers purchase the MSAs upfront for the right to receive future cash flows. Because the unpredictability of timing risks increases the difficulty to value MSAs linked to a mortgage portfolio, prospective servicing firms typically place bids on them at auctions. After settling on a price, a servicer may need to borrow funds to purchase the MSAs. One option may be to obtain a cash advance loan that uses anticipated ESFs as collateral. If a rising timing risk causes an MSA's cash flow (and value) to decline, then the servicer would likely receive a *margin call*, which would require either more collateral to be pledged or the cash advance to be repaid in full. Macroeconomic events (e.g., interest rate movements, rising unemployment) may trigger large amounts of unanticipated prepayments or defaults of mortgages, resulting in no ESF payments and possibly material financial losses for servicers.

Selected Regulatory Developments

Several regulatory developments following the 2007-2009 Great Recession had MSA market ramifications.

Bank Capital Requirements and Implications. According to the Federal Reserve, nonbank servicers purchased a significant share of MSAs beginning in 2011 following bulk sales by large banks in anticipation of the 2013 revisions to banks' capital requirements that increased the cost to hold MSAs. Specifically, if a bank's MSA holdings were valued at less than 10% of its common equity value, a risk weight of 100% would be applied to that amount. The risk-weighted amount would then be used to calculate how much additional capital must be held to absorb any potential credit losses. However, a bank's total capital reserves would be reduced by the value of MSA holdings exceeding the 10% threshold. On July 22, 2019, the federal banking agencies reduced the costs to hold MSAs for non-advanced approaches (non-AA) banks (i.e., defined as having less than $250 billion in total consolidated assets or less than $10 billion in foreign on-balance sheet exposure). Specifically, a non-AA bank's MRS holdings may exceed 25% of its common equity before having to reduce its capital reserves. However, the risk weight for MSAs below the threshold increases from 100% to 250%. After the revisions to banks' capital requirements, the Bank Policy Institute announced that non-AA banks increased their MSA holdings relative to the large AA banks by a statistically significant amount.

Consumer Protection Revisions and Implications. Servicers must comply with multiple sets of servicing rules that are designed to establish policies and procedures for borrower disclosures, notifications, and various other protections. The Consumer Financial Protection Bureau (CFPB) found that information about borrowers' circumstances was lost during transfers of delinquent and defaulted mortgages from current servicers to *specialty servicers*, which specialize in servicing such loans, thus resulting in delayed loss mitigation applications and

resolutions. Hence, the CFPB—as well as other federal and federally related entities that promulgate their own servicing rules—addressed borrower protection issues during these MSA transfers. In 2014, the CFBP specifically revised servicing rules for distressed mortgages and transfers that would not be guaranteed by a federal or federally related entity. Compliance with these rules requires greater interaction with borrowers to ensure that information is not lost during transfers of distressed loans. Greater reliance on manual labor, however, arguably runs counter to financial industry trends to automate mortgage servicing functions to streamline costs. Hence, servicers minimize the risk of incurring material costs to service non-performing loans by bidding predominantly on MSAs linked to mortgages originated for borrowers with pristine credit quality.

Credit Union Participation in MSA Markets. Partly in response to the Savings and Loan crisis of the 1980s, the National Credit Union Administration (NCUA), the primary regulator for credit unions, limited credit unions' exposure to various mortgage risks and MSA market participation. Specifically, a credit union could retain the MSAs for its own loan originations, but it could not directly purchase MSAs. Over time, credit unions have been allowed to increase their participation in the mortgage market and their use of financial derivatives to hedge exposures to mortgage-related risks. On December 23, 2021, the NCUA also permitted federal credit unions that meet the requirements to be well-capitalized to purchase MSAs from other federal credit unions. The ability to purchase MSAs will allow those credit unions choosing to specialize in this market to bypass membership restrictions and profit from scale (higher volume) advantages.

Recent MSA Market Resiliency Test

By April 2020, the Conference of State Bank Supervisors estimated that nonbank mortgage servicers held MSAs for approximately 50% of the federally insured mortgage market, which includes Fannie Mae and Freddie Mac—also referred to as the government-sponsored enterprises (GSEs)—as well as Ginnie Mae, the federal agency that facilitates the creation of mortgage-backed securities (MBS) linked to mortgages insured by various federal agencies. If a delinquency or default occurs on a securitized mortgage (typically held in a trust with other mortgages and funded with MBS issuances) by the GSEs and Ginnie Mae (the Agencies), a servicer must forward timely payments to MBS investors until the distressed mortgage has been repurchased out of the trust. Nonbank mortgage servicers, however, lack liquidity comparable to banks either in the form of available cash, liquid assets, or access to federal backstops such as the Federal Reserve.

In response to the COVID-19 pandemic, the Federal Reserve lowered interest rates, increasing prepayment risks for existing mortgages. Although rising unemployment filings might have signaled increased mortgage credit risks, rising home values may have had a dampening effect. Meanwhile, the CARES Act (P.L. 116-136) still required a foreclosure moratorium for all federally insured loans, allowing borrowers to request from their servicers 180 days forbearance relief for no additional fees and, if necessary, an additional 180 days. Servicers also faced greater liquidity pressures because (1) they had to continue forwarding payments to investors holding federally guaranteed MBSs, and (2) they faced margin calls following the decline in their MSA values.

Ginnie Mae and the Federal Housing Financing Agency (FHFA)—the primary regulator for the GSEs, including the Federal Home Loan Bank (FHLB) system—subsequently announced the expansion of various programs that would support liquidity for mortgage servicers. On April 7, 2020, Ginnie Mae announced a private market servicer liquidity facility for its servicers that borrow to finance their MSAs. On April 21, 2020, FHFA announced that servicers for GSE mortgages will have no further obligation to advance scheduled payments after having advanced four months of missed payments. In addition, FHFA allowed member institutions of the FHLB system to post residential mortgages in forbearance (i.e., the consumer defers payments) as collateral, which would allow them to continue receiving cash advances from their regional FHLBs. Some of the 11 FHLB institutions established additional collateral relief programs to allow member institutions to continue receiving wholesale funding.

Pay (Share Risk) Now or Pay Later?

In sum, MSAs are highly sensitive to sudden cash flow shifts, and nonbank servicers are unlikely to enjoy the same access to funds as depositories (i.e., banks and credit unions). In addition, servicers finance their MSAs by forgoing some ESFs as opposed to setting aside financial buffers for unanticipated macroeconomic events that would cause a decline in MSA values. Because Agencies' MSAs owned by nonbank servicers now comprise the largest share of the MSA market, the Agencies may prefer that ESFs be set aside to forward investor payments and administer loss mitigations to avoid foreclosures during adverse periods.

Proposals for the Agencies to require their servicers to accumulate higher cash buffers, likely to increase the costs to hold MSAs, could cause some nonbank servicers to react similarly to the large banks and limit their MSA holdings. As previously discussed, the banking regulators and NCUA recently implemented some regulatory changes that would encourage greater participation by depositories in the MSA market. In addition, building cash buffers against mortgage timing risks and margin calls might be accomplished if borrowers, the Agencies, or both share the costs. Although increasing servicing fees, with the possibility of charging higher basis points to higher-risk borrowers, is one option, various regulations discourage high-cost mortgage loan originations. Another option may be for the Agencies to hold excess capital on behalf of their servicers. Another option may be to charge servicers insurance premiums, paid to an Agency or other third-party insurers, for access to a specified amount of funds during an adverse event that would be used for forwarding payments to investors and mitigating foreclosures. Insurance may be less costly for many servicers compared to establishing their own capital buffers. Absent any action, stakeholders may be left to assume that the relevant federal agencies, Congress, or both will ease liquidity pressures for MSA holders in the event of market distress.

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