POLICY PERSPECTIVES

GNMA ELIGIBILITY REQUIREMENTS: A REVIEW

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INTRODUCTION

Ginnie Mae recently released its eligibility framework for servicers—and it is reassuring in that it recognizes the riskiness of the servicing asset and aligns well with FHFA's framework.

In the realm of financial services, servicing mortgages is not an exotic business; its main functions are operations, compliance, and customer service. Indeed, banks service a few trillion dollars of their own mortgages. However, the federal mortgage securities servicing contract—because it pays a fixed fee for non-performing loan (NPL) servicing at a fraction of the cost to comply with federal requirements yet overpays to service performing loans—is a deeply flawed derivative. Thus, in establishing capital requirements for its servicers, Ginnie Mae confronts the challenge of balancing safety and soundness with the economic viability of this market. It must align capital with risk and take a comprehensive financial view of its servicers—especially as this market has come to be dominated by firms that are not backed by deposit insurance. Finally, Ginnie Mae must consider the existing capital rules and policies of several other government organizations.

Why do Ginnie Mae servicers need so much capital? It is because they are paid only a fraction of the cost to compliantly service NPLs and are overpaid to do the same for performing loans[1]. As a result, Ginnie Mae servicing has four major risks, only one of which can be effectively hedged. Banks previously dominated this market (when the cost to service NPLs was much lower), but now about 90% of Ginnie Mae loans are serviced by non-banks which lack access to the safety net of deposit insurance. The departure of banks from Ginnie Mae servicing is, in part, because federal mortgage securities servicing is a FASB Level 3 Asset with high capital requirements. Servicing risks are summarized as follows:

1. **IO Risk:** Servicing revenue is an interest-only (IO) strip of about 30 bps. Excess IO—that is, revenue exceeding cost—is a mortgage derivative, highly exposed to interest rate and prepayment risk. It can be hedged in the Treasury, MBS, and options markets.
2. **NPL Cost:** Servicing FHA and VA NPLs in compliance with Federal policy can cost 20 times more (upwards of 2% annualized) than performing loans. Figure 1 below shows average costs for a sample of the mortgage market, but FHA and VA NPL servicing costs are widely acknowledged to be at least twice the cost for GSE loans. Delinquencies are generally caused by external economic events that are typically unhedgeable. For example, as the seriousness of the pandemic became clear in early 2020, the **expectation** of surging mortgage delinquencies drove MSA (Mortgage Servicing Asset) values down by 30% to 50%.

Figure 1 – Servicing Costs Over Time

[1] Cooperstein, Richard, and Storms, Mickey. May 2020. "A Resilient Federal Mortgage Securities Servicing System: The Future Is Now." Policy Perspectives. https://www.ad-co.com/system/files?file=policy-perspectives/policyperspectives_federalmortgagesecuritiesservicingsystem.pdf.

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3. **Policy Cost:** Federal policies around consumer protection and creative foreclosure alternatives are often beneficial, but frequently impose additional costs upon servicers for which they are generally not compensated. The costs of future changes to federal policy are not hedgeable. Widespread pandemic-related mortgage forbearance is a good example.
4. **Financing Risk:** As with most financial services firms, non-bank Ginnie Mae servicers depend on liquidity in the debt markets to finance their operations and servicing asset. As history has repeatedly shown, the misalignment of revenue and expenses makes access to liquidity fragile and expensive in stress periods. This risk is generally not hedgeable.

THE GINNIE MAE PROPOSAL

Ginnie Mae's proposal might be described as risk-weighted rather than risk-based. Nevertheless, it aligns closely with both the current GSE standard and the components of FHFA's withdrawn proposal regarding net worth, minimum capital, and liquidity. Further, it takes an appropriately broader view of servicer balance sheets by requiring risk-weighted capital for other assets, just as the GSEs do. Federal alignment is a positive, and the metrics are a step in the right direction.

Risk-based capital and risk-weighting deserve a closer look. The core of Ginnie Mae's proposal is not the 250% risk-weighting for the Ginnie Mae servicing asset—which equates to 20% capital using the Basel 8% standard. Rather, the key is the net worth requirement of 35 bps of MSA, which, based on typical asset values of 75-85 bps, equates to 40%-50% capital. One problem in the proposal is that Ginnie Mae ascribes no value to excess MSRs, even though IO can be valued, hedged or sold. Indeed, servicers often securitize and sell excess servicing rights to offset this risk. So, this shortcoming won't distort the market too much, except to drive servicers even more extensively to hypothecate excess IO. Furthermore, in stress scenarios excess IO quickly becomes base revenue to offset surging operational costs of servicing NPLs. Thus, it's problematic to even define excess IO because enterprise servicing costs can range from 20 bps to 50 bps, depending on delinquency levels. If Ginnie Mae's requirements should evolve from risk-weighted to risk-based using a stress test like CCAR, there would be no excess IO. Therefore, rather than excluding excess IO, it would be better to ascribe zero asset value to delinquent loan servicing rights, even though the market value of Ginnie Mae delinquent MSAs is probably negative.

An essential indicator of potential market disruption is how much capital Ginnie Mae servicers already hold compared to requirements. Ginnie Mae naturally checked this and found that most servicers already hold more capital than the new standard. At best, servicers can borrow 30%–50% of MSA in the capital markets at wide spreads (below investment grade) combined with corporate recourse. This shows that even with 30% equity, MSRs are not an investment grade asset, and the capital markets are clear on this. Thus, the commentary about widespread capital disruption from this regulation is probably overstated. From another vantage point, Federal support of home ownership is reflected by the low borrowing costs of the federal mortgage ecosystem (GSEs, FHFA, FHA, VA, GNMA) which is super-AAA. However, the weak spot is the non-bank Ginnie Mae servicing market, which is below investment grade based on the flawed servicing contract. If the servicing contract isn't going to be changed, the proximate solution is capital.

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COMPARATIVE REGULATION

There are two Federal MBS markets, GSE and GNMA; two classes of servicers, banks and non-banks; and five oversight groups, CFPB, FDIC/OCC, FHFA/GSEs, GNMA/FHA/VA, and CSBS (Conference of State Bank Supervisors). This collection of entities has potentially varying economic views and standards that can lead to serious market distortions and risk, though one could imagine the specialized regulators reporting up through a combined council at Treasury. Nevertheless, since the 2007 financial crisis, certain views on the risks of federal mortgage securities servicing have coalesced, and these views have further unified through the pandemic economic dislocation. Given that it cannot unilaterally fix the underlying compensation problem, nor the variation across regulators, Ginnie Mae's proposal is also a clear step in this direction.

The table below summarizes various sets of financial resilience requirements for federal mortgage securities servicers, and a few themes are evident in how regulators view servicing risk.

- Ginnie Mae servicing is riskier than GSE servicing.
- NPL servicing is costlier than performing loan servicing.
- The net worth requirement is generally binding, not the capital requirement.
- The liquidity surcharge for delinquent loans is actually too high, but, in our view, doesn't become problematic until delinquencies exceed 15% or so.

As mentioned earlier, the need for these various resiliency requirements would disappear if servicing compensation was related to cost.

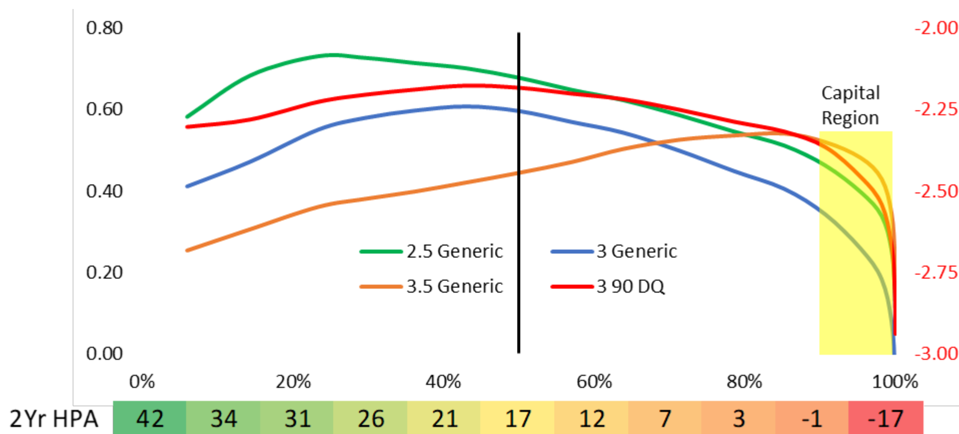
Figure 2 – Mortgage Servicing Asset Financial Requirements

	Net Worth	Capital	Liquidity
Banks		20% Capital when MSA ≤ 10% CET1 100% Capital when MSA > 10% CET1	
Non-Banks			
GSE	$2.5M + 25 bps of GSE UPB + 35 bps of GNMA UPB	Tangible Net Worth ≥ 6% Total Assets 20% MSA Risk-Weight	4 bps GSE UPB + 10 bps GNMA UPB + 3% NPL UPB ≥ 6%
GNMA	$2.5M + 25 bps of GSE UPB + 35 bps of GNMA UPB	Adjusted Net Worth ≥ 10% Total Assets 20% MSA Risk-Weight	10 bps GNMA UPB + 5 bps GSE UPB
CSBS	$2.5M + 25 bps of servicing UPB	Tangible Net Worth ≥ 6% Total Assets	3.5 bps UPB + 2% NPL UPB ≥ 6%
AD&Co		30%–50% of MSA	

Figure 3 shows results from a series of scenario tests run by Andrew Davidson & Co., Inc. (AD&Co). The tail results are analogous to those of stress tests like CCAR and can illuminate capital needs. AD&Co ran scenarios for a few different FHA loans with various coupons, seasoning, and payment status to assess the extent of interest rate and credit risk. The binding capital constraint for current loans is generally the high credit risk scenario, not the high prepayment scenario, even without hedging. MSRs for seriously delinquent loans actually turn from an asset into a liability because the **monthly** cost to service NPLs is nearly equal to **annual** revenue, and this can continue for a few years.

The difference in prices (PV of cash flows) can be thought of as a capital need, and the scenarios ranging from 90%–100% are the stress test confidence levels. For example, if the average price is $0.50 and the stress value is $0.30, then capital = 40% = 1 - $0.30/$0.50 of MSR asset value, or 0.2% of notional mortgage amount ($100).

Figure 3 – MSR Prices by Cumulative Probability



Next, we compare the financial resiliency metrics using a few basic assumptions: a large Ginnie Mae servicer ($100B UPB serviced) with MSA=75 bps and excess IO of 10% of MSA. Since two of three regulators have delinquency-based liquidity requirements, we use the GSE binding constraint of 3% and show results across a range of portfolio delinquency rates.

Because it's nearly half the MSA value for typical Ginnie Mae servicing, net worth is the binding financial requirement until delinquencies get quite high. Only the liquidity requirement and stress test are sensitive to portfolio quality as reflected by delinquencies.[2] The 20% capital requirement is not the binding constraint unless the Ginnie Mae MSA > 1.75%, the likelihood of which is vanishingly small.

Capital and liquidity needs could be invariant to delinquency rates if guarantors paid servicers for the cost of servicing. In such a world, these thresholds could be much lower, thus lowering costs for borrowers.

[2] Stress test results are roughly 40% capital for performing loans and 100% capital for delinquent loans.

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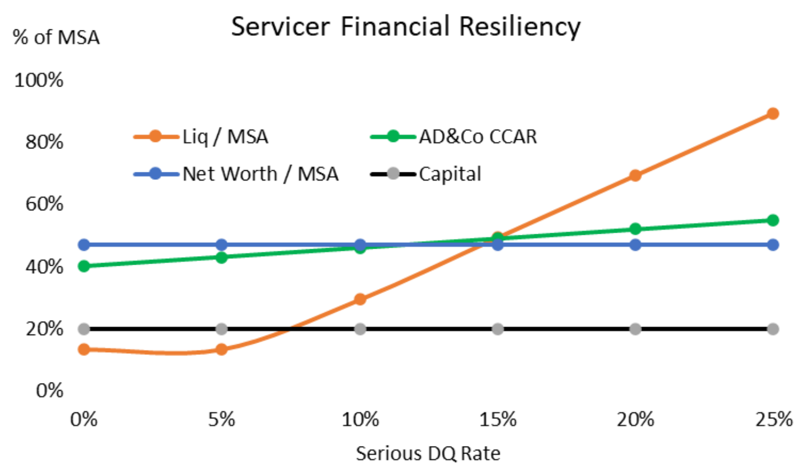
Figure 4 – Servicer Financial Resiliency



INSIGHTS/SUMMARY

Insights - Government mortgages are traditionally underwritten loans, and their servicing should be a stable business of operations and compliance, not a complex mixture of IO, credit, and policy risk. The most straightforward solution to Ginnie Mae's servicer counter-party risk problem is for the guarantors to pay servicers for the cost of servicing: somewhat less for performing loans and much more for NPLs. The aim isn't to change long-term average servicing fees, but rather to transfer the future uncertainty of credit-related servicing expenses back to FHA and VA, who already bear future credit risk with much lower costs of capital. The result could be (a) lower costs for homeowners by the difference in the cost of capital between FHA/VA and non-bank servicers, (b) dramatically reduced counter-party risk, and (c) better aligned incentives by following the most basic rule of economics; align price and cost.

Summary - Eligibility requirements for Ginnie Mae servicers must be assessed in the context of the structurally distorted servicing market and the limits of Ginnie Mae's charter. Since guarantors do not pay servicers for the cost of servicing and the contract itself is beyond Ginnie Mae's purview, very large reserves are necessary. Ginnie Mae's risk-weighted capital proposal is a positive step because it takes a broader view of servicer balance sheets and better aligns with GSE servicer capital standards. The 20% capital requirement itself is probably too low, but fortunately, the net worth requirement is effective up to fairly high portfolio delinquency rates. Crucially, non-bank Ginnie Mae servicers already hold substantial capital because the capital markets view this risk similarly. Therefore, this proposal should not disrupt the market. Excluding excess MSRs from asset value is unnecessary and can be corrected, though excluding NPL servicing rights would be useful since they are worthless at best. In the future, Ginnie Mae could consider a risk-based standard based on something like CCAR.

About Andrew Davidson & Co.

Andrew Davidson & Co., Inc. (AD&Co) is pleased to have the opportunity to provide our comments on the Request for Input on Eligibility Requirements for Single Family MBS Issuers by Ginnie Mae. For more than 25 years, AD&Co has provided analytical tools to the mortgage finance industry. These tools include models of mortgage loan dynamics including prepayments, delinquencies, and losses, as well as valuation models that assess the cash flows, value, and risk of mortgages, mortgage-backed securities, and mortgage securities servicing. The company's clients represent a broad cross section of the mortgage finance community, including originators, servicers, guarantors, investors, and regulators.

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