POLICY PERSPECTIVES

GINNIE MAE SERVICING STRESS BACKSTOP

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APRIL 2023

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TABLE OF CONTENTS

INTRODUCTION

Ginnie Mae guarantees over $2 trillion of government mortgage-backed securities of FHA and VA mortgages. As mission-focused federal agencies, FHA and VA convey the lowest possible mortgage rates to borrowers. However, about 90% of these mortgages are originated and serviced by independent mortgage banks under a risky servicing contract and with no federal backstop like deposit insurance. At best, the Ginnie Mae mortgage servicing system is capital inefficient. At worst, it risks chaotic systematic and systemic failure. Capital markets execution shows that there is no amount of capital Ginnie Mae servicers could hold that would ensure the system against failure because, unlike most assets, servicing asset value can become negative. This structure poses risk to taxpayers and raises costs for borrowers.

The risk of systemic failure exists because compliantly servicing FHA and VA non-performing loans (NPLs) can cost five times more than the fixed fee that servicers receive. Spikes in national NPL rates from external economic shocks like the pandemic cause immediate and severe declines in expectations of future servicing income, which dramatically reduces the value of the mortgage servicing rights (MSRs) used as collateral for servicer financing. Resulting margin calls and sudden evaporation of liquidity pose the risk of simultaneous correlated servicer collapses, with nowhere to place all the servicing. This potential disaster is widely recognized by stakeholders and regulators as a major systemic risk in the US mortgage ecosystem.

In this paper we discuss two types of solutions to mitigate the systemic risk embedded in Ginnie Mae securities servicing. We have previously pointed out that restructuring servicing fees to be more like subservicing fees—combining lower fees for performing loans with higher activity-based fees for NPLs that keep the present value of the servicing asset unchanged so that they align with expenses—is perhaps the first-best solution. A second-best solution is to create a federal backstop or insurance facility to stabilize this market during external stress.

Ginnie Mae has existing authority to use its balance sheet and guarantee fee revenue to absorb losses when servicers fail. We propose that Ginnie Mae use this authority to prevent systemic servicer failures by paying extra fees to servicers when national delinquency rates rise above a threshold level. Alternatively, Ginnie Mae could convene a private insurance market that pays this additional revenue during broad economic stress.

HISTORICAL PERSPECTIVE ON GINNIE MAE NPLS

Figure 1 illustrates the financial stress NPLs have on Ginnie Mae servicer income. Based on typical assumptions, servicing net cash flow turns negative at portfolio NPL rates above 13%. NPL rates rising from a 4% baseline to 8% could cut profit in half. Thus, long before the zero profit NPL rate, MSR values could decline dramatically and impair ongoing access to the financing of Ginnie Mae servicers. This is what happened during the pandemic.

Figures 2 and 3 show actual serious delinquency rates by vintage and portfolio. Because high delinquency vintages have fortunately been small—although several FHA vintages have had serious delinquency rates above 20% that lasted for years—Ginnie Mae portfolio serious delinquency rates have never reached 10%. However, the pandemic, combined with federal forbearance and NPL compliance expenses, severely strained the Ginnie Mae servicing market, with serious portfolio-level delinquencies for FHA and VA reaching 11% and 6%, respectively.

Figure 1 – Simple Servicing P&L by Delinquency

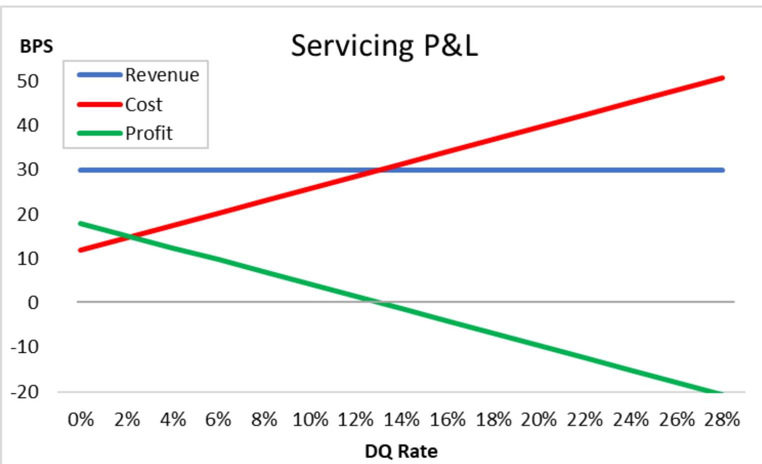


Figure 2 – Seriously Delinquent FHA Loans by Vintage

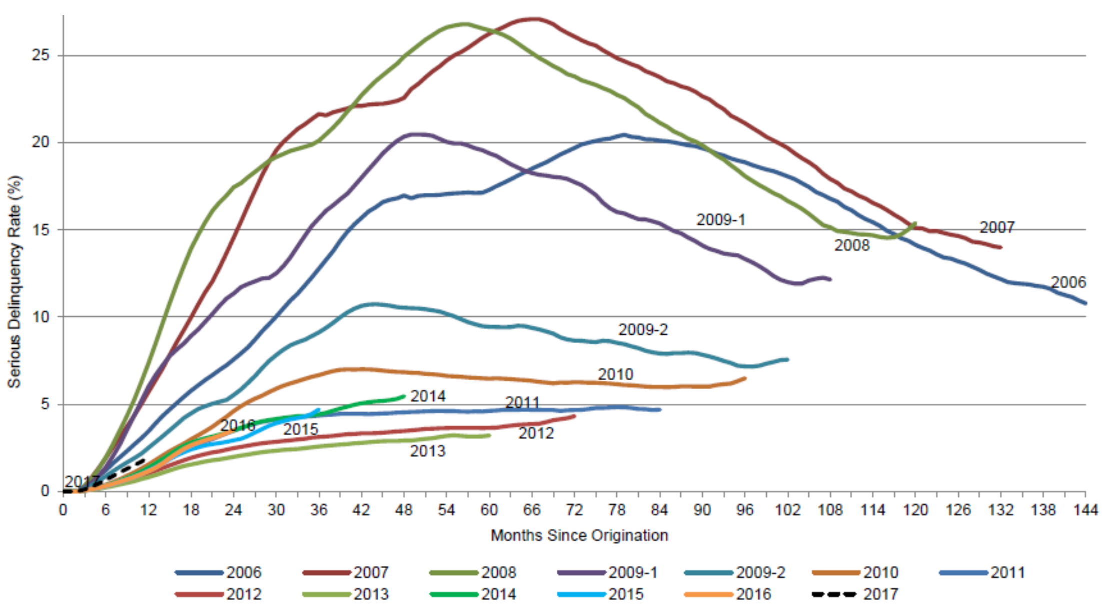
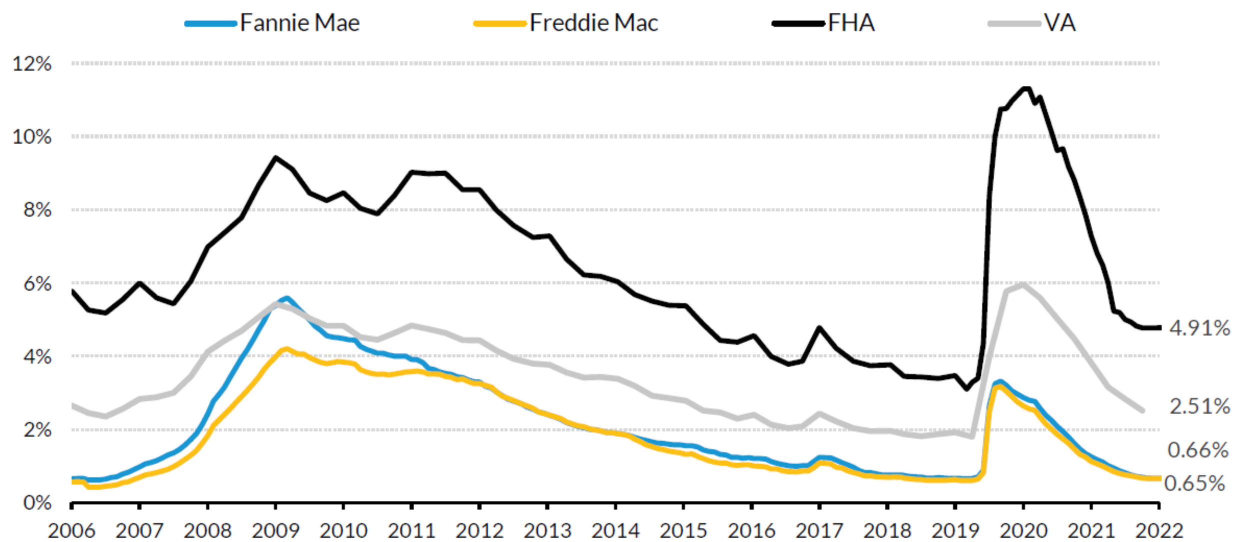


Figure 3 – Seriously Delinquent FHA Loans by Vintage



Sources: Fannie Mae, Freddie Mac, Federal Housing Administration, MBA Delinquency Survey and Urban Institute.
Note: Serious delinquency is defined as 90 days or more past due or in the foreclosure process. Not seasonally adjusted. VA delinquencies are reported on a quarterly basis, last updated for Q3 2022. GSE and FHA delinquencies are reported monthly, last updated for December 2022.

The market value of Ginnie Mae MSRs fell dramatically, by 30%–50%, early in the pandemic. There could have been contagious failures if not for two things outside the control of servicers: (1) the large profits and cash flows generated by the origination segments of servicers from historically low mortgage rates and the record refi wave, and (2) the financing and other changes that the federal government scrambled to implement. Such failures could potentially leave no firms willing or able to take over large, distressed servicing operations. The flawed servicing contract and federal regulation have driven banks away from this market and the remaining non-bank servicers would be under extreme stress. This raises the question of who would suddenly process 20 to 30% of the GNMA bond market.

The pandemic stress on the Ginnie Mae servicing market is a stark reminder that events difficult to foresee can threaten this segment of the national payments system. As long as servicing revenues and expenses are misaligned, this threat remains, and— in contrast to most of the rest of the mortgage ecosystem—this segment lacks a federal backstop.

PROPOSED SOLUTIONS

We propose two variations of a solution that provides increased servicing revenue for NPLs when a national benchmark rate is exceeded.

1) **Variable Servicing Fees** - The private MBS market has already begun to use variable servicing fees. The table in the Appendix shows the activity-based fees applied in a recently rated Wells Fargo RMBS prime deal. Servicing costs are much lower, but the key is that fees for NPLs are five times higher than for performing loans, and mods and FCL resolution payments are orders of magnitude higher. Applying such a solution would likely require cooperation between FHA, VA, and Ginnie Mae, and FDIC, Treasury, and Congress, along with servicers. We view this as the most streamlined economic solution, but the road to achieving it is long and uncertain, and it leaves the mortgage ecosystem exposed in the near term.

2) **Ginnie Mae Backstop or Private Insurance** - The entire Ginnie Mae servicing market is worth about 1%, or $22 billion, of the $2.2 trillion GNMA MBS market. Ginnie Mae's balance sheet has about $30 billion of equity at the US Treasury, and it earns about $1.3 billion in revenue annually; equivalent to 6 bps guarantee fee and 150 bps of capital. We propose that Ginnie Mae, or a private insurer, make payments to servicers on NPLs above a national threshold rate, such as twice the long-term average (we use 10% as a round number example). We'll show that Ginnie Mae has the ongoing financial strength to self-insure nearly any imaginable loss in the servicing market, and that the required insurance expense is manageable.

Two qualities of insurance make it an effective and practical solution: (a) it can replace some required capital, and (b) deductibles lower insurance costs. Effective insurance requires that incentives are aligned, poor performers are not rewarded, and deductibles are used. Ginnie Mae servicers hold up to 40% equity and finance the remainder of MSAs with debt at wide spreads that are below investment grade, plus recourse. Therefore, reducing stress losses should materially lower the cost of financing, and can be determined empirically. Further, a threshold NPL rate both lowers the cost of this insurance and focuses the revenues on when national NPLs spike. The trigger delinquency level could be vintage and/or segment weighted, but it is crucial to base it on national delinquency rates, not those of individual servicers. Servicers with better/worse than national average DQ rates and expense management will make more/less money than average servicers.

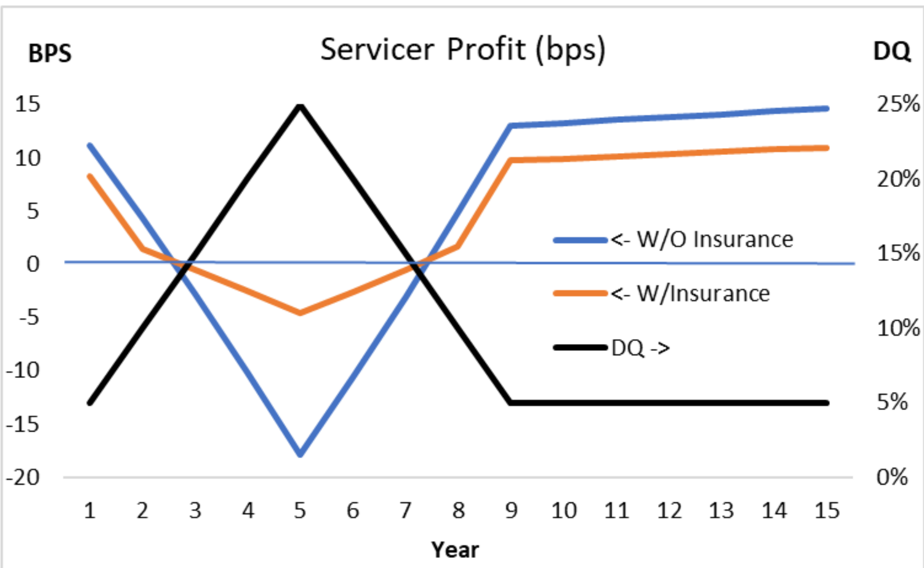
FHA and VA long-term average serious delinquency rates are about 5% and 3%, respectively. Average servicing fees are 30 to 40 bps, but it can cost 150 to 200 bps annually to compliantly service FHA/VA NPLs. We therefore propose a payment increase of 100 bps annualized for 60+ UPB above 10%. A more detailed analysis can be performed, but let us roughly consider the following:

- A national delinquency threshold of 10%, which might occur once every 10–20 years
- Payments of 1% annualized on delinquent balances above 10%
- An official policy that servicer financiers can rely on to lower borrowing costs, combined with regulatory capital reduction for participants

Figure 4 shows a heuristic example of annual profits, with and without insurance.

- Base assumptions include stable portfolio size, 30 bps servicing fee, 12 bps performing cost, and 150 bps NPL cost. This generates profits with NPL rates below 13%.
- NPL rates exceed 10% for five years, peaking at 25%.
- A 3 bps insurance fee balances out nominal profits, but the standard deviation of the insured profit stream is half that of the uninsured stream.

Figure 4. Annual Servicer Profits During Stress, With and Without Insurance



In addition to being flat to net income, insurance should lower the servicer's equity requirement and equity costs, as well as its cost of debt. This program could even be voluntary because insured servicers will have meaningfully lower capital costs even after paying fair insurance prices.

The objective of all of these options is to reduce the risk of liquidity and financing during stress, not to increase profits in other environments. Collateral and risk spread requirements to finance servicing assets depend on the present value and variability of future servicing net cash flows with respect to *expectations* of prepayment and delinquency duration. Pandemic dynamics illustrated that a surge in delinquency rate expectations can slash servicing asset values even before actual delinquencies rise. Stress period insurance payments can reduce or eliminate the negative net cash flow of future DQ surges, thus reducing the risks confronting servicer financiers and stabilizing servicing market financing in the face of systemic surges in DQs.

CONCLUSION

A basic principle of commerce—that prices relate to costs—is violated in the federal mortgage-backed securities servicing market, and thus poses persistent systemic risk to non-bank Ginnie Mae servicers, who represent about 90% of that market. Our proposed 100 bps supplemental fee to service NPLs above a benchmark level should flatten out the servicer return profile and lower the risk of lending against the servicing asset, which in turn should make access to liquidity more resilient and less expensive. It could also reduce required equity and its cost. Finally, using a threshold delinquency rate before insurance payments are made focuses the benefits solely on stress periods and significantly lowers the cost of the insurance.

Table 1 - Incentive Servicing Fee Framework

Incentive Servicing Fee Framework

Type of servicing fee	Incentive framework ($ per loan)
Base servicing fee(i)	40
Delinquent servicing fee(i)(ii)	
60-119 days delinquent and not in foreclosure or REO	210
120+ days delinquent or in foreclosure but not REO	260
REO	180
Bankruptcy but not REO	45
Additional servicing fee(ii)(iii)	
Re-performing--completed modification	2,500
Re-performing--cures from 60+ days delinquent(iv)	1,000
Default resolution—completed short sale	1,500
Default resolution--deed-in-lieu foreclosure	1,500
Default resolution--completed REO sale or third-party sale	1,000

(i)Paid monthly. (ii)Fees are paid in addition to the base servicing fee. (iii)To be paid upon completion. (iv)Only applies to a mortgage loan that cures for reasons other than by modification and only if this fee has not been paid with respect to the mortgage loan in the previous 11 months. REO--Real estate-owned.

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