POLICY PERSPECTIVES

GINNIE MAE

REQUEST FOR INPUT: ELIGIBILITY REQUIREMENTS FOR SINGLE FAMILY MBS ISSUERS

by Richard Cooperstein and Mickey Storms

SEPTEMBER 2021

TABLE OF CONTENTS

03 OVERVIEW

04 MSR ECONOMICS

06 THE GINNIE MAE PROPOSAL

07 COMPARATIVE REGULATION

10 INSIGHTS / SUMMARY

© 2021 policy perspectives

OVERVIEW

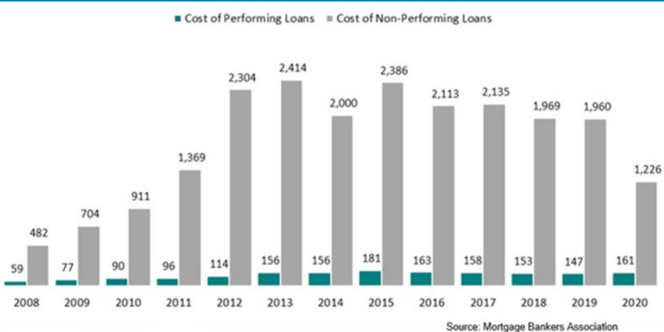
Government mortgage securities servicing is a highly volatile mortgage derivative caused by a deeply flawed compensation structure. Thus, in establishing capital requirements for its servicers, Ginnie Mae confronts the difficult task of balancing safety and soundness with the economic viability of this 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 not backed by deposit insurance. Finally, Ginnie Mae must account for the existing capital rules and policies of several other government organizations.

About Andrew Davidson & Co.

Andrew Davidson & Co., Inc. (AD&Co) is pleased to have the opportunity to provide our comments in response to Ginnie Mae's Request for Input: Eligibility Requirements for Single Family MBS Issuers. For more than twenty-five 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 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.

Servicing is a business of operations and compliance—so why do servicers need so much capital? The reason is that guarantors pay servicers only a fraction of the cost to compliantly service non-performing loans, yet overpay for performing loans.[1] As a result, Ginnie Mae servicing has four major risks—only one of which can be effectively hedged—and thus requires large amounts of capital. Banks previously dominated this market (when the cost to service NPLs was much lower), but now over ninety percent of Ginnie Mae loans are serviced by non-banks, who 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.

FIGURE 1: FULLY-LOADED SERVICING COSTS (DIRECTING SERVICING COSTS, UNREMIMBUSED FC AND REO COSTS, CORPORATE ALLOCATIONS



1. **IO Risk:** Servicing revenue is an interest-only strip of about 30 bps. Excess IO—that is, revenue exceeding cost—is a mortgage derivative highly exposed to interest rate and prepayment risk that can be hedged in the Treasury, MBS, and options markets.

2. **NPL Cost:** To work with borrowers in compliance with Federal policy, non-performing loan servicing for FHA and VA can cost 20 times more than performing loans, upwards of 2% annualized. Figure 1 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%–50%.

3. **Policy Cost:** Federal policies around consumer protection and creative foreclosure alternatives are often beneficial, but frequently impose additional costs—for which they are generally not compensated—upon servicers. The costs of future changes in 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. The misalignment of revenue and expenses makes access to liquidity fragile and expensive in stress, as history has repeatedly shown. This risk is generally not hedgeable.

[1] https://www.ad-co.com/system/files?file=adco-articles/A-Resilient-Federal-Mortgage-Securities-Servicing-System_0.pdf

 © 2021 policy perspectives

MSR ECONOMICS

Two other activities that are issues only because of the backward nature of servicing compensation bear mentioning: access and cost of advance financing, and the surge of Ginnie Mae buyout activity in refinance markets.

Advance Financing: Federal guarantors do guarantee timely payment of principal and interest to bondholders, eliminating counter-party risk. However, guarantors require servicers to advance mortgage payments, which non-bank servicers must then finance in the capital markets. If nothing else, this substitutes private non-IG cost of capital for federal cost, which raises mortgage rates. Non-bank servicer advancing costs are typically manageable as long as the financing market is functioning, but if the markets become dislocated it can cause instant bankruptcy. The federal policy of widespread forbearance during the pandemic quickly required 5%–10% of mortgage payments to be advanced indefinitely. FHFA recognized the avoidable risk of this servicer obligation and limited servicer advances to 120 days.

Ginnie Mae Buyouts: Delinquent loans are generally bought out of MBS pools at par after 90 days delinquency, and this practice is appropriately independent of mortgage coupon. The GSEs use their own capital to purchase and hold these loans—currently about $15B—on their balance sheets. These portfolios evolve as loans re-perform, resolve, or get sold and new loans are bought out. Reperformance is unlikely (20% or less), but does provide a profit or loss to the GSEs to the degree loans are premium or discounts. Net profits are likely to be quite small over time as interest rates vary.

By contrast, the guarantors of Ginnie Mae loans (FHA/VA) don't have buyout programs, so this obligation falls to non-bank servicers that operate on a capital-light business model. Consequently, a market has developed that extracts profits for servicer financiers—at FHA/VA's expense—for delinquent insured loan coupons that are premium to the market. Servicers bear the cost of the negative value of delinquent loan MSRs, which translates into higher consumer mortgage rates for FHA/VA borrowers. As with the GSEs, buyout capital for FHA/VA could be federal—and not create a financial burden and profit opportunity for the private market at the expense of government homeowners.

THE GINNIE MAE PROPOSAL

Ginnie Mae's proposal might be described as risk-weighted rather than risk-based. Nevertheless, it aligns more closely with both the current GSE standard and the components of FHFA's now 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 equates to nearly 50% capital, based on typical asset values of 75 bps. Servicers typically borrow 30%–50% of MSA in the capital markets at wide spreads (below investment grade) combined with corporate recourse. This suggests that even with 30% equity, MSRs are not an investment grade asset.

One problem in the proposal is that Ginnie Mae ascribes no value to excess MSRs, which is clearly wrong; IO can be valued and hedged. Indeed, servicers often securitize excess servicing rights to offset this risk. So, even this shortcoming won't distort the market 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. Thus, rather than excluding excess IO, it would be better to ascribe zero asset value to delinquent loan servicing rights of the GSEs and Ginnie Mae, although the market value of Ginnie Mae delinquent MSAs is probably negative.

© 2021 policy perspectives

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 the potential for varying economics and inconsistent 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. Since the 2007 financial crisis, views on the risks of federal mortgage securities servicing have coalesced, and these views have further unified through the pandemic's economic dislocation. Differences do remain, and the market's structural flaw continues to be papered over by necessarily large reserve standards. Ginnie Mae's proposal is a clear step in this direction given that it cannot unilaterally fix either the underlying compensation problem or the variation across regulators.

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

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

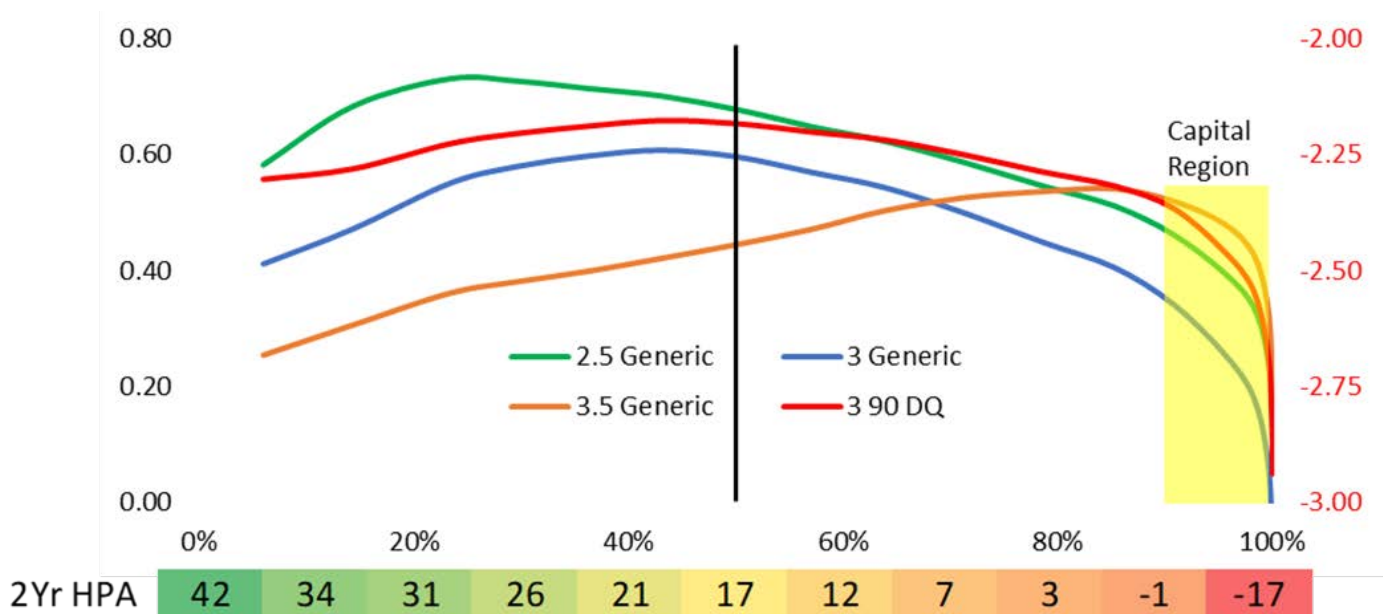
FIGURE 2: MORTGAGE SERVICING ASSET FINANCIAL REQUIREMENTS

	Net Worth	Capital	Liquidity
Banks		20% Capital when MSA ≤ 10% CET1 100% Capital when MSA > 10% CET1	
Non-Banks			
GSE	$2.5 M + 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	$2.5 M + 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	$2.5 M + 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 AD&Co. The tail results are analogous to 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% to 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 CUMMULATIVE PROBABILITY



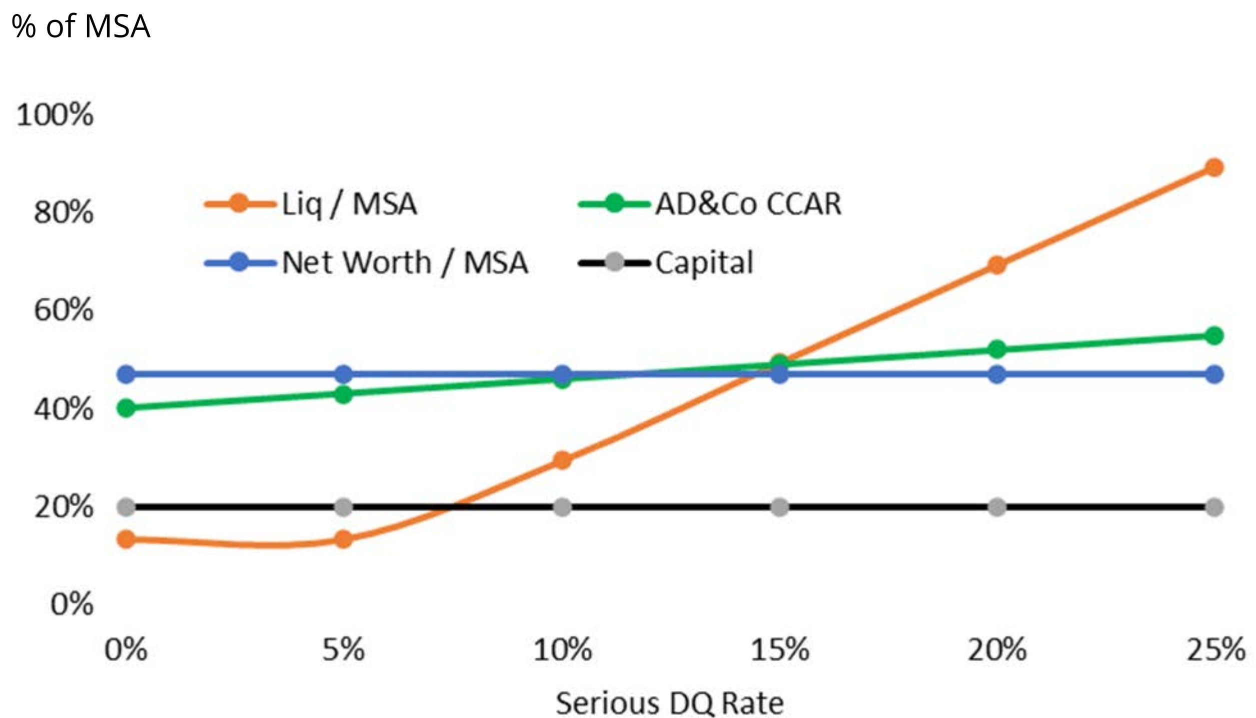
© 2021 policy perspectives

Next, we compare the financial resiliency metrics using a few basic assumptions: a large Ginnie Mae servicer ($100 B 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 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, lowering costs for borrowers.

FIGURE 4: SERVICER FINANCIAL RESILIENCY



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

Government mortgages are generally traditionally underwritten loans, and their servicing should be a stable business of operations and compliance, not a complex mixture of managing 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 changelong-term average servicing fees but rather to 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

Evaluating eligibility requirements for federal mortgage securities servicers must be assessed in the context of the structurally distorted servicing market. Since guarantors do not pay servicers for the cost of servicing, 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, as the net worth requirement is effective up to fairly high portfolio delinquency rates and non-bank government servicers already hold substantial capital, this proposal should not disrupt the market. Excluding excess MSRs from asset value is a mistake 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.

This publication is believed to be reliable, but its accuracy, completeness, timeliness, and suitability for any purpose are not guaranteed. All opinions are subject to change without notice. Nothing in this publication constitutes (1) investment, legal, accounting, tax, or other professional advice or (2) any recommendation or solicitation to purchase, hold, sell, or otherwise deal in any investment. This publication has been prepared for general informational purposes, without consideration of the circumstances or objectives of any particular investor. Any reliance on the contents of this publication is at the reader's sole risk. All investment is subject to numerous risks, known and unknown. Past performance is no guarantee of future results. For investment advice, seek a qualified investment professional. Note: An affiliate of Andrew Davidson & Co., Inc. engages in trading activities in securities that may be the same or similar to those discussed in this publication.

Andrew Davidson & Co., Inc. (AD&Co) was founded in 1992 by Andrew Davidson, an international leader in the development of financial research and analytics, mortgage-backed securities product development, valuation and hedging, housing policy and GSE reform, and credit-risk transfer transactions. Since its inception, the company has provided institutional fixed-income investors and risk managers with high quality models, applications, consulting services, research, and thought leadership, aimed at yielding advanced, quantitative solutions to asset management issues. AD&Co's clients include some of the world's largest and most successful financial institutions and investment managers. For more information, visit www.ad-co.com.

New York
65 Bleecker Street, Fifth Floor
New York, NY 10012-2420

Raleigh
150 Fayetteville Street, Suite 1030
Raleigh, NC 27601-2957

212.274.9075
support@ad-co.com
www.ad-co.com