# Should Nonbank Mortgage Companies Be Permitted to Become Federal Home Loan Bank Members?

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On February 24, 2020, the Federal Housing Finance Agency (FHFA) issued a request for input (RFI) on eligibility requirements for membership into the Federal Home Loan Bank (FHLB) System.[1] The RFI raised important questions about whether current membership rules promote a safe and sound FHLB system while furthering the system's mission to provide reliable liquidity to member institutions to support housing finance and community development.

The FHFA had last assessed the FHLB membership rule in 2015, when it was determining whether captive insurance companies should be barred from FHLB membership. The Urban Institute submitted a detailed comment letter focused on mortgage real estate investment trusts (REITs), arguing that the business activities of REITs were substantially aligned with the mission of the FHLBs and that any safety and soundness risks posed by REITs could be managed using the FHLBs' risk management tools (Goodman, Parrott, and Kaul 2015). The final rule, issued in January 2016, excluded the captive arrangement. To the extent the FHFA is revisiting membership requirements for REITs, we suggest it revisit our prior comment.

In this comment letter, we assess whether FHLB membership should be expanded to include other types of institutions not currently eligible for membership. We focus on independent mortgage bankers, commonly known as nonbank mortgage lenders and servicers. Nonbanks have drastically expanded their mortgage market activities over the past decade, accounting for 90 percent of lending backed by the Federal Housing Administration (FHA) and the US Department of Veterans Affairs (VA) and about half of all lending backed by Fannie Mae and Freddie Mac. Yet they do not enjoy the same access to federally backed lending that depositories do. This strains nonbank liquidity, especially during downturns, such as the present COVID crisis. This comment letter thus addresses the question of whether nonbanks should be eligible for membership.

In this brief, we evaluate the pros and cons of expanding FHLB membership to nonbanks, hurdles that stand in the way, and potential ways to overcome them. Consistent with the RFI, we break down our analysis into two buckets: (1) alignment of nonbank business activities with the housing mission of the FHLBs and (2) safety and soundness implications for the FHLBs.

The brief is organized as follows. First, we elaborate on the role nonbanks play in the mortgage market and explain why their inclusion would further the FHLBs' mission. We then explain key safety and soundness implications of expanding membership to nonbanks. In the last section, we outline additional hurdles that would need to be addressed as part of the FHFA's evaluation.

# How Well Do Nonbanks Align with the FHLBs' Housing Mission?

Leading up to the financial crisis, banking institutions dominated almost all segments of the mortgage market, including origination, servicing, and the secondary market. Since the financial crisis, however, depositories have ceded significant market share throughout the mortgage market to nonbanks.

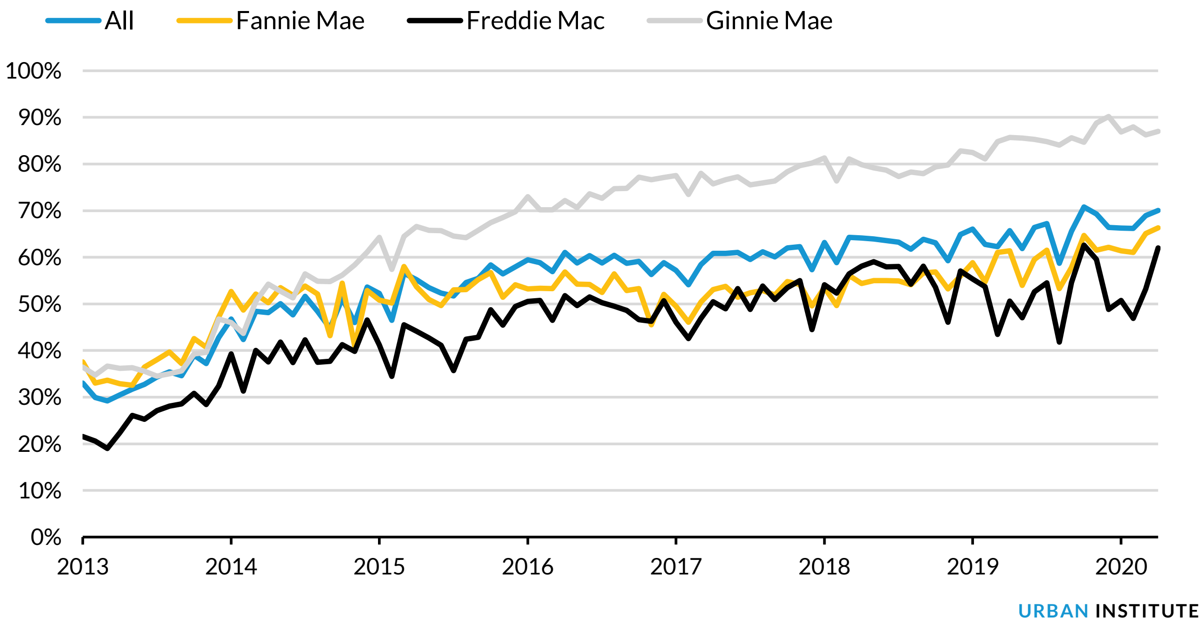
There are a few reasons for this shift (Kaul and Goodman 2016). Large depositories were heavily exposed to loans made during the last housing bubble. As defaults mounted, many loans were subjected to buybacks under Fannie Mae and Freddie Mac's representations and warranties and the FHA's indemnification policies. This forced banks to not only repurchase billions of dollars in troubled loans but pay tens of billions of dollars in hefty fines and legal settlements. Worried about future litigation and reputational damage, banks curtailed their mortgage activities. Other factors that contributed to this pullback were higher capital requirements in the wake of the Great Recession, the unfavorable treatment of mortgage servicing assets under the Basel III capital regime, and skyrocketing mortgage servicing and origination costs. Nonbanks—often smaller, nimbler, and less complex, with lower regulatory, capital, and compliance costs—were well suited to step in.

## Nonbanks Play the Dominant Role in Originating and Servicing Single-Family Mortgages

The nonbank share of originations for Fannie Mae, Freddie Mac, and Ginnie Mae has risen dramatically in recent years (figure 1). The increase has been broad based, spanning both conventional and government channels and origination and servicing. Today, close to 90 percent of Ginnie Mae–backed new mortgages and about half of Fannie Mae– and Freddie Mac–backed new mortgages are originated by nonbanks.

FIGURE 1

**Nonbank Share of Agency Mortgage Originations**




**Source:** Urban Institute calculations based on eMBS data.

Additionally, because of a willingness to take on slightly more credit risk than banks (Kaul 2017), nonbanks compose a much larger share of lending to first-time homebuyers and low- and moderate-income households and minorities, who rely disproportionately on FHA- and VA-insured mortgages.

As nonbanks are retaining servicing for their mortgages, they also maintain a relationship with their borrowers through the life of the loan. As of year-end 2019, nonbanks serviced 50 percent of the $11 trillion in unpaid principal balance of single-family mortgages outstanding, according to Inside Mortgage Finance. In the government lending space, close to 70 percent of unpaid principal balance outstanding is serviced by nonbanks. Nonbanks thus play an outsized role in servicing mortgages made to low- and moderate-income and first-time homebuyers. This is a key point to remember in the context of mission alignment with the FHLBs.

## The FHLBs' Role in the Residential Mortgage Market Has Declined over Time

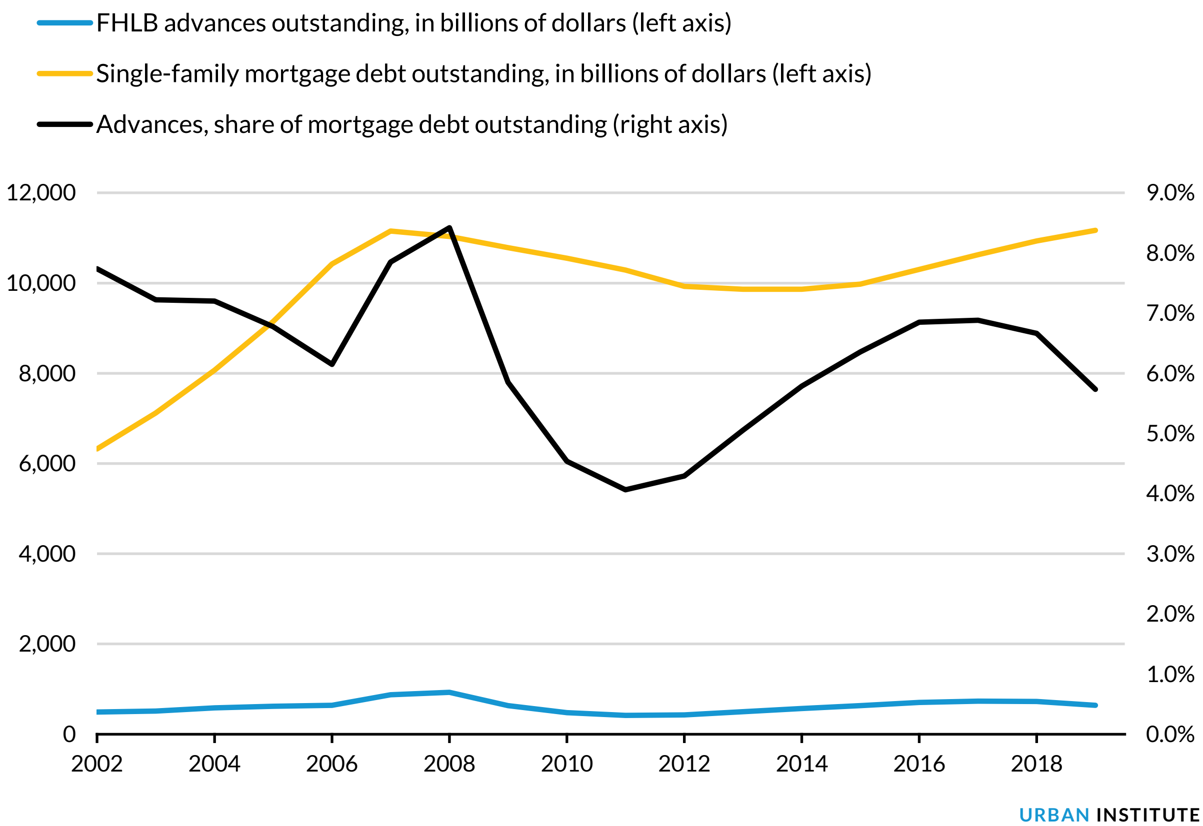
Depositories dominate the FHLB system. As of year-end 2019, depositories (i.e., commercial banks, savings institutions, and credit unions) have accounted for 80 percent ($511 billion) of the $640 billion of FHLB advances outstanding. Insurers have accounted for 18 percent ($112 billion) while the remaining 2 percent ($116 billion) was borrowed by community development financial institutions (CDFIs) and others. CDFIs represented only 0.04 percent of the total.

But depositories have been pulling back from the mortgage market, reducing their share of single-family mortgage debt outstanding. According to the Federal Reserve's Flow of Funds, at year-end 2019, loans held in depository portfolios accounted for $3.35 trillion of the $11 trillion in single-family unpaid principal balance outstanding, or 30 percent. This is down from 37 percent in 2004.

The result is a shrinkage of the role FHLBs play in the mortgage market; the ratio of FHLB advances to mortgage debt outstanding has declined (figure 2). It stood at 5.7 percent in 2019 compared with well over 8 percent in the early 2000s. In addition, at $640 billion, FHLB advances are still below their crisis-era peak of $929 billion, even as mortgage debt outstanding of $11.1 trillion now slightly exceeds its bubble-era peak. This reflects the growth of nonbanks and their exclusion from FHLB membership. More importantly, it raises the question of whether FHLBs can make a significant contribution to their mission—to provide reliable liquidity to support housing finance and community development—without nonbanks.

FIGURE 2

**How Well Are FHLBs Meeting Their Housing Mission?**




**Sources:** FHLB (Federal Home Loan Banks) *Combined Financial Report for the Quarterly Period Ended September 30, 2019* (Reston, VA: FHLB, n.d.); and the Federal Reserve's Flow of Funds section.

Not only is there is a strong alignment between nonbanks' housing market activities and the FHLBs' mission, then, but their absence from the system is impairing the role the FHLBs used to play in the mortgage market. Expanding membership eligibility to include nonbanks could advance the housing finance and community development mission of the FHLB system. Doing so would give FHLBs a larger and more diversified member base, which is primarily dependent on depository institutions and, to a lesser extent, insurance companies and CDFIs.

But mission alignment by itself is not sufficient for membership. Below, we discuss the impediments that would need to be overcome before membership can be responsibly expanded.

# What Safety and Soundness Risks Would Nonbanks Pose to the FHLB System?

As the RFI implies, a key consideration in expanding FHLB membership is safety and soundness risks posed by potential new members. In this section, we explore the two biggest drivers of nonbank safety and soundness in the context of FHLB membership.

## Nonbanks Face Substantial Liquidity Risks

Today, when a nonbank commits to originate a mortgage, it draws on a preapproved line of credit provided by a warehouse lender, typically a large commercial bank. In return, the nonbank turns over ownership of the new mortgage to the warehouse lender as collateral, subject to appropriate haircuts. This arrangement is unwound when the loan is sold in the secondary market, either to a government agency (e.g., Fannie Mae, Freddie Mac, or Ginnie Mae) or to a private investor. The nonbank uses sale proceeds to repay the warehouse lender and turns over legal ownership of the loan to these secondary market entities. Although this arrangement works well during good times, it is highly prone to disruption during downturns, when warehouse liquidity dries up or becomes expensive (FSOC, n.d.). In such times, nonbanks, like all lenders, find it difficult to fund new originations, thus curtailing a much-needed revenue stream at the worst possible time.

More importantly, nonbanks need ongoing funding for advancing principal and interest payments to mortgage-backed securities (MBS) investors and taxes and insurance payments to relevant entities when a borrower stops paying. This funding is available at reasonable terms during good times—either unsecured borrowing from the credit markets or borrowing against the value of mortgage servicing rights (MSRs). But this lending is also highly procyclical and unlikely to be available at reasonable terms during downturns. This has been made painfully clear during the current pandemic, as millions of borrowers have exercised their right to COVID-19 forbearance under the Coronavirus Aid, Relief, and Economic Security Act, putting enormous liquidity stress in the servicing market. Servicers could ultimately end up advancing more than $100 billion in principal, interest, taxes, and homeowners insurance payments on behalf of delinquent borrowers, depending on how many obtain forbearance and for how many months.[2]

In light of this, Fannie Mae, Freddie Mac, and Ginnie Mae have announced emergency steps to aid servicer liquidity. Ginnie Mae announced a new Pass-Through Assistance Program that would allow servicers of government mortgages to borrow funds to cover payment shortfalls as a last resort, at a high interest rate.[3] Similarly, Fannie Mae and Freddie Mac will cap servicer advances at four months.

Although these measures have reduced uncertainty among servicers, they do not fully address the liquidity risk. In particular, servicers of Ginnie Mae securities must continue to advance real estate taxes and insurance payments, as well as FHA mortgage insurance premiums. For Fannie Mae and Freddie Mac securities, the servicer must continue to advance real estate taxes and insurance payments, guarantee fees, and private mortgage insurance premiums (if applicable). If forbearance take-up rates were to rise further in the coming weeks or months, the liquidity strain that was front and center in March and April will return.

This is primarily a liquidity issue to start with, as opposed to a credit risk issue. The agency backing the loan eventually reimburses these funds. The risk for nonbanks is an increase in borrower defaults to levels that force them to advance payments well in excess of what they had anticipated or saved for, as is the case in the present crisis. Unlike depository institutions, nonbanks do not have access to any Federal Reserve emergency lending facilities, consumer deposits, or FHLB advances. As a result, what starts as a liquidity issue can eventually turn into a solvency issue if firms cannot meet their financial obligations to investors or creditors.

## Nonbanks Lack Prudential Financial Regulation

Nonbank safety and soundness concerns are amplified by a lack of prudential financial regulation. FHLBs rely extensively on the prudential regulators of their members to manage counterparty risk. As the RFI notes, this helps the FHLBs extend credit safely. As part of their due diligence, FHLBs rely on information, data, and reports from federal banking regulators; public company filings; or other periodic regulatory assessments. Primary regulators have close visibility into the operational and financial condition of the regulated entities through ongoing examinations and inspections. They are better situated to act promptly in times of distress.

FHLBs have statutory rights to regulatory assessments pertinent to the safety and soundness of their members. This allows FHLBs to identify any pockets of concern earlier and take corrective steps, such as by curtailing lending or increasing the level of overcollateralization on a targeted basis. Depositories, credit unions, and insurance companies are prudentially regulated at either the federal level or the state level. CDFIs are not regulated this way, though at 0.04 percent, they account for a tiny share of FHLB advances outstanding.

Banks are subject to highly comprehensive and prescriptive capital requirements by the Federal Reserve. These requirements vary by bank size and degree of financial interconnectedness and are more stringent for riskier assets. Large banks are also subject to comprehensive periodic stress tests, the results of which the Federal Reserve publicly releases. As insured depositories, banks are also subject to stringent regulation, supervision, and examination by the Office of the Comptroller of Currency for national banks, the Federal Reserve for state-chartered banks that are Federal Reserve members, and the Federal Deposit Insurance Corporation (FDIC) for most banks with deposits. Federally chartered credit unions are regulated by the National Credit Union Administration (NCUA). (State-chartered credit unions have no federal regulator.)

Nonbanks, on the other hand, are not subject to comprehensive prudential regulation. Nonbanks are typically subject to requirements put forth by Fannie Mae, Freddie Mac, and Ginnie Mae as a set of minimum criteria for doing business. These requirements are meant to mitigate specific counterparty risks to these agencies and thus are not a replacement for comprehensive prudential regulation. These requirements serve to set minimum capital and liquidity ratios for servicers that seek to do business with the agencies. More importantly, the requirements are not risk based. Fannie Mae, Freddie Mac, and Ginnie Mae require their servicers to report detailed information on delinquencies and financial and operating conditions but none of this is publicly released. The RFI is thus rightly concerned about potential safety and soundness risks posed to FHLBs.

This question, then, is how to address it. There are a couple of important observations.

Fannie Mae, Freddie Mac, and Ginnie Mae already have a well-developed "pseudo-regulatory" infrastructure to approve and monitor their counterparties. Most nonbank servicers, and all the large ones, are Fannie Mae, Freddie Mac, and Ginnie Mae counterparties. Servicers are required to report comprehensive loan-level activity every month to track delinquencies, prepayments, and other loan activity. In addition, servicers must submit detailed quarterly reports showing minute details about assets, liabilities, capital and cash position, and financial condition (Freddie Mac 2008). It seems logical that any future prudential regulation of nonbanks should leverage the existing infrastructure as much as possible to minimize additional regulatory and reporting burden.

The second key consideration is the entity that would be best situated to become the nonbank prudential regulator. One option would be for Congress to grant the FHFA the regulatory authority to supervise nonbanks. The FHFA already has significant experience overseeing the mortgage market through its regulation of Fannie Mae, Freddie Mac, and the FHLBs. The FHFA may also benefit from leveraging Ginnie Mae's monitoring infrastructure. Bringing nonbank servicers under this umbrella will allow for a more holistic yet streamlined regulatory regime for the mortgage market and would minimize the burden on everyone, as the FHFA could most easily leverage the existing monitoring framework to carry out its regulatory activities.

A second option would be to expand the Federal Reserve's regulatory authority to supervise nonbanks. This could give nonbanks access to the Fed's emergency liquidity and lending facilities, similar to what banks enjoy. The downside is that the Federal Reserve, a bank regulator, would have to tailor its supervisory approach to account for the fact that nonbanks do not take consumer deposits. This makes the Federal Reserve a much less natural fit than the FHFA. Regardless of whether the FHFA, the Federal Reserve, or some other entity ought to regulate nonbanks, legislation will likely be required to grant appropriate statutory authority.

A third option, that likely will not require legislation, is for nonbanks to restructure as industrial loan companies (ILCs). ILCs are depository financial institutions insured and supervised by the FDIC with one major difference: they are owned by a parent financial or nonfinancial firm that is exempt from the Bank Holding Company Act and is thus not required to be regulated by a federal banking agency such as the Office of the Comptroller of the Currency or the Federal Reserve. This allows the ILC's parent to have an FDIC-insured subsidiary without subjecting itself to the broader banking and supervision regime. As prudentially regulated entities, ILCs are subject to FDIC examination and supervision and are generally held to same regulatory requirements as other FDIC-insured depositories. This should substantially mitigate the FHFA's concerns about nonbanks' lack of prudential regulation. Recently, some financial technology firms have explored the ILC route to becoming FDIC insured (Congressional Research Service 2019), and a couple have even been approved.[4]

We note that the ILC option is essentially a conduit arrangement similar to captive insurers but with strong prudential regulation. Nonbanks would establish an ILC subsidiary, which would seek to become an FDIC-insured depository and be subject to the FDIC's prudential regulation. Because the current FHLB membership rule does not bar ILCs, they could presumably access FHLB advances as depository institutions. In practical terms, we are concerned that this is a "back door" way into the FHLB system that may be closed in the future. The most preferred approach here would be one that gives market participants long-term clarity. We urge the FHFA to undertake a thorough assessment of the ILC conduit route as part of this RFI evaluation.

# What Other Issues Need to Be Resolved?

Although prudential safety and soundness regulation is arguably the biggest hurdle to expanding membership to nonbanks, it is not the only one.

## The Law Governing FHLB Membership Does Not Permit Nonbank Mortgage Companies

As the RFI notes, by law, FHLB membership is generally open to three types of financial institutions: federally insured banks and credit unions, insurance companies, and CDFIs. In the past, some nonbanks and REITs established captive insurance subsidiaries as conduits solely for the purpose of seeking FHLB membership. But the 2015 final rule for FHLB membership banned the insurer conduit arrangement altogether. To allow nonbanks to become eligible for membership, Congress would have to expand FHLB eligibility to nonbanks or the FHFA would need to permit a conduit arrangement via captive insurance companies or ILCs. With congressional action unlikely in the foreseeable future, any near-term expansion of membership to nonbanks would need to happen through an FHFA action.

## Mortgage Servicing Rights Are Not Eligible Collateral for FHLB Advances

By law, FHLBs are required to secure their advances by obtaining eligible collateral from members. The market value of the collateral is the basis on which FHLBs decide how much to lend, subject to appropriate haircut. Assets that are hard to value or suffer from too much price volatility are unlikely to be eligible. Nonbanks have two main classes of assets that could serve as collateral: (1) newly originated single-family residential mortgages before they are sold in the secondary market or delinquent mortgages bought out of MBS pools and (2) mortgage servicing rights. Single-family mortgages are already eligible collateral. If nonbanks were permitted to become members, FHLB advances will bring stability to the mortgage origination market during downturns when private warehouse lines of credit become scarce. It would also give nonbanks access to FHLB financing for the purpose of buying delinquent loans out of the pool.

But FHLB advances for new originations do not mitigate nonbank liquidity concerns, which are more rooted in the obligation to advance delinquent payments to security investors and delinquent property taxes and homeowner insurance premiums to relevant entities. MSRs are the predominant asset class servicers own, but this collateral is not FHLB eligible. MSRs also exhibit substantial price volatility, as witnessed during the early stages the COVID-19 crisis, when interest rates fell dramatically and MSR values collapsed. In March and April 2020, MSR values fell from a multiple of roughly four to five times the base servicing fee to as low as two times, reflecting a 50 to 60 percent drop in value. If FHLBs were to lend against MSR, haircuts would need to reflect this volatility. Additionally, under agency rules, owners of MSRs need to have a servicing license and either service the loans themselves or hire a subservicer. If FHLBs were to accept MSRs as collateral, they would either need a servicing license or need to have a contract in place where another licensed servicer automatically steps in.

There is no easy solution to these issues. FHLBs could approve MSRs as an eligible asset and lend against it but would need to apply a large haircut. Further analysis needs to be done to examine the economics of this. Servicers have greater flexibility for Fannie Mae and Freddie Mac loans because they, unlike Ginnie Mae loans, allow MSRs to be bifurcated into components. This creates the possibility to split off the servicing advance receivables component of MSRs into a separate asset that could be pledged as FHLB collateral. There is ample precedent for this financing in the private market.[5] As mentioned earlier, any delinquent principal and insurance payments or taxes and homeowner insurance payments that servicers advance to MBS investors are fully reimbursed by Fannie Mae and Freddie Mac and present minimal or no credit risk. As a separate legal asset, these receivables would suffer from minimal price volatility and be easier to value. These two features would mitigate risk for FHLBs relative to lending against MSRs for Fannie Mae and Freddie Mac loans.

Another option, which could be done in conjunction with splitting off the servicer advance receivables, would be to allow members to borrow against excess IO (i.e., a portion of the servicing fee in excess of the amount needed to service mortgages). The collateral could be either a structured product or simply unstructured cash flows from the underlying mortgages. This structure would, however, suffer from more price volatility than servicing advance receivables. This option will also require MSR bifurcation and therefore is unlikely to work in the Ginnie Mae space.

## The FHLBs Must Be Able to Swiftly Perfect Interest in the Collateral Should a Member Fail to Repay Advances

FHLBs obtain an interest in the collateral via security agreements with their members. This allows them to obtain ownership interest in a portion or all of a member's assets. Typically, this would be subject to lien priority under bankruptcy resolution. But under federal law, FHLBs enjoy a "super lien"[6] status that gives them priority over the claims of most other parties, including the FDIC or the NCUA. Thus, when a depository bank or credit union with FHLB advances outstanding becomes insolvent, the receiver—either the FDIC or the NCUA—pays off FHLB advances in exchange for getting the super lien released. To the extent recoveries from asset sales are insufficient, those losses are absorbed by the FDIC or NCUA's insurance funds, not the FHLBs. The super lien status is a key element of FHLBs' AAA credit rating, allowing them to borrow at low rates and in turn pass those on to their members. Without the super lien, the FHLBs' ability to obtain collateral would be subject to bankruptcy proceedings. And they would need to risk less than 100 percent recovery. Super lien status eliminates this risk.

The federal statute, however, does not cover insurance companies, as they are state regulated. Insurers are subject to the receivership provisions of individual state insurance commissioners, who possess varying degrees of authorities under state law. This can limit the FHLBs' ability to perfect their interest. FHLBs manage this risk by subjecting insurance companies of similar credit quality as depository institutions to more stringent collateral quality, haircuts, and other terms. Lastly, CDFIs present a different challenge, as they do not have a dedicated receiver. This means FHLBs would need to sell the collateral to recover their advances if a CDFI member fails. We note that insurers and CDFIs account for only 18 percent of FHLB advances outstanding, which serves as a mitigating factor (FHLB, n.d.). Advances to CDFIs account for only 0.04 percent of the advances outstanding.

Nonbanks would present a similar issue to that of CDFIs, as there is no dedicated receiver for nonbanks. Additionally, FHLBs' ability to perfect interest in nonbank collateral via super lien has not been tested in federal courts, as it has been for depositories. FHLBs could address these risks by subjecting nonbanks' collateral to more stringent terms, as they do for their nondepository members.

# Conclusion

The discussion and evidence in this brief show a strong alignment between the nonbank business model and the mission of the FHLBs. The bigger hurdles to FHLB membership for nonbanks, in our view, are lack of prudential regulation and issues concerning collateral eligibility and perfection of interest, which affects the safety and soundness of the FHLB system. The prudential regulation issue could be addressed by bringing nonbanks under the supervision of an existing regulator such as the FHFA, the Federal Reserve, or the FDIC, by leveraging existing infrastructure, and providing a level of prudential regulation commensurate with risks. The issues concerning eligible collateral and perfection of interest present additional challenges. But if the prudential regulation issue could be addressed, there may be ways to work through other issues. Perhaps there is room for compromise (e.g., prudential regulation of nonbanks in exchange for FHLB membership eligibility), provided outstanding issues can adequately be resolved.

# Notes

1 Federal Housing Finance Agency, "FHFA Issues RFI on FHLBank Membership," press release, February 24, 2020, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-RFI-on-FHLBank-Membership.aspx.

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