URBAN INSTITUTE

# The Need for a Federal Liquidity Facility for Government Loan Servicing

*Karan Kaul and Ted Tozer*

*July 2020*

The COVID-19 economic shock that began in early March prompted Congress to pass the Coronavirus Aid, Relief, and Economic Security (CARES) Act, giving borrowers of federally backed mortgages the right to receive up to 12 months of payment forbearance, provided they are affected by COVID-19. The program's scale is monumental, covering 70 percent of all outstanding single-family mortgages (33.4 million loans), with an unpaid principal balance of $7 trillion. According to the Mortgage Bankers Association, 4.2 million homeowners were in forbearance plans at the end of June.

At the same time, the CARES Act did not address how to pay for nationwide forbearances. It thus fell to mortgage servicers, who are contractually responsible for advancing delinquent payments to securities investors, regardless of whether the borrower pays. The nationwide scale of the CARES Act forbearance caused fears of a liquidity crunch for servicers, a collapse in mortgage servicing asset values, and a tightening of credit as lenders reduced risk. Moreover, distress in the industry at a time when borrowers most need assistance often leads to poor servicing outcomes for consumers (Kaul 2020).

Although the servicing market is no longer in panic mode and servicers have weathered the first four months of the crisis better than many feared at the outset, we remain concerned about the fallout from the second wave of COVID-19 infections over the coming weeks. If more households exercise their right to forbearance, the servicing market could witness a repeat of the March liquidity panic. This time, though, the financial stress will disproportionately affect the market for government loans and the consumers that depend on it. The Federal Housing Finance Agency (FHFA), Fannie Mae, and Freddie Mac have taken steps to reduce stress for their servicers, but not enough has been done to address the risks for loans backed by the Federal Housing Administration (FHA), the US Department of Veterans Affairs (VA), and the US Department of Agriculture Rural Housing Service (USDA-RHS).

## About the Mortgage Markets COVID-19 Collaborative

Initially convened in March 2020 by the Urban Institute, the Mortgage Markets COVID-19 Collaborative (MMCC) brings together a wide range of experts and stakeholders who share data and discuss how the mortgage market's response to the current pandemic can ensure equity, inclusion, and sustainability for homeowners

The COVID-19 public health crisis has created wide-ranging disruptions and a fast-moving economic downturn, with job losses and consumer hardships that are rippling through housing markets and crippling the housing finance system. Congress has quickly passed stimulus packages, and the major federal housing agencies have enacted federal and state forbearance and foreclosure and eviction moratoriums to help homeowners struggling to make their mortgage payments during this pandemic. In addition, the Federal Reserve and the US Department of the Treasury are taking actions to bolster the housing market by buying mortgage-backed securities at unprecedented levels and creating vehicles to bring liquidity to the mortgage servicing system that supports more than 48 million homeowners with mortgages.

This crisis has the potential to be more disruptive and far reaching than the 2008 crisis, with different implications and ramifications, given its potential length, national scale, unemployment projections, and loss and default projections.

The housing crisis in 2008, natural disasters, and similar incidents have taught us that aligned, coordinated, and intentional engagement by mortgage industry, nonprofit, and consumer groups is critical to developing and implementing thoughtful, evidence-based, and effective policies and practices that will mutually benefit consumers and the mortgage industry.

The MMCC seeks to

- produce a shared repository of data, research, and policy proposals; and
- increase understanding among all participants of the existing data and research and of the concerns and perspectives of other industry and community stakeholders.

For more information about the MMCC or to see the list of collaborators and research assembled, visit the program page at http://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-markets-covid-19-collaborative.

In this brief, we focus on government loans and explain why this segment remains a weak spot going forward. We begin by discussing the usefulness of the actions Ginnie Mae, the FHA, Fannie Mae, and Freddie Mac have taken so far. We then discuss fundamental differences between the Ginnie Mae and government-sponsored enterprise (GSE) business models and explain why Ginnie Mae cannot be as expansive as the FHFA and GSEs in mitigating liquidity risk for its issuers. Ultimately, we conclude that a federal liquidity facility is the only practical solution for mitigating forbearance-related liquidity risks for government loans.

# What Actions Have Fannie Mae, Freddie Mac, and Ginnie Mae Taken So Far?

Ginnie Mae, Fannie Mae, and Freddie Mac took some early steps to ease servicer stress. Ginnie Mae announced a last-resort lending facility (Pass-Through Assistance Program, or PTAP) for servicers of government mortgages.[1] The facility charges a high interest rate, though (generally 5 to 6 percent), and imposes several restrictions. Moreover, the facility covers only principal and interest advances, not real estate taxes, FHA insurance premiums, Ginnie Mae's 6 basis-point guarantee fee, or homeowners' insurance payments. The latter four compose about 30 percent of the average monthly payment. PTAP use has remained low so far, suggesting that servicers, for now, can meet their advancing obligations by either using corporate resources or securing financing from private markets.[2]

Fannie Mae and Freddie Mac did not announce a new lending program but made several policy changes to mitigate servicer liquidity risk, most notably by capping servicers' obligation to advance principal, interest, taxes, and insurance payments at four months. This gave servicers clarity with respect to their maximum financial obligations. More importantly, this certainty makes it less likely that warehouse lenders will curtail lending to servicers of GSE loans.

Servicers' ability to withstand the crisis so far was assisted by other factors too. Record-low interest rates spurred refinances and lifted origination incomes, helping servicers accumulate liquidity. Another contributor was the float of principal from heavy refinance activity, caused by the timing delay between principal payoff and advance remittance. Additionally, the forbearance take-up rate appears to have peaked at around 9 percent, according to the Mortgage Bankers Association. Many borrowers in forbearance continued to make their payment anyway, likely reflecting the impact of the temporary boost in unemployment insurance payments under the CARES Act. This supplemental income, which is slated to expire at the end of July, no doubt helped keep the number of borrowers seeking forbearance down. Lastly, early confusion about the terms of repaying the forborne amounts likely inhibited some from seeking forbearance. These factors likely explain why the worst-case scenarios for the servicing market have not yet materialized.

At the same time, the market is hardly out of the woods. A cloud of uncertainty exists as we head into late summer and fall. It is highly uncertain whether Congress will extend the temporary unemployment insurance payments beyond July 31. If not, we could see an uptick in forbearance requests and rates in August. And given the escalating count of COVID-19 infections in June and July, more closures and public restrictions remain likely, causing more economic pain, job losses, and delinquencies. As we explain below, the servicing market for government loans will be not only disproportionately affected by this but highly constrained in its ability to respond effectively.

# The Ginnie Mae Market Is at Much Greater Risk Than the GSE Market

Ginnie Mae issuers service higher-risk loans than GSE servicers do. The average FICO score for Ginnie Mae's book of business is around 680, compared with above 750 for the GSEs. The average loan-to-value ratio for Ginnie Mae loans is 96.5 percent, compared with 78 percent for the GSEs, while the average debt-to-income ratios are 41 percent and 35 percent, respectively. This is by design because the government lending market was created to serve the affordable credit needs of low-wealth households and first-time homebuyers. As a result, these loans default at higher rates. The GSEs do risk-based pricing (based on combinations of loan-to-value ratios and credit scores) that raises the cost of a GSE loan well above the cost for a comparable government loan with similar characteristics. High-loan-to-value GSE loans require private mortgage insurance, which also relies on risk-based pricing. As a consequence, the government market leans more heavily toward borrowers with less wealth and less robust credit, concentrating mortgage default risk to a higher degree than in the GSE market. In contrast to GSE and private mortgage insurers, there is no risk-based pricing in the government lending market. According to the Mortgage Bankers Association, at the end of June, 11.8 percent of Ginnie Mae borrowers were in forbearance, compared with 6.2 percent of GSE borrowers.

In addition, Ginnie Mae issuers have to advance delinquent principal, interest, taxes, insurance, FHA annual mortgage insurance premiums, and the 6 basis-point guarantee fee charged by Ginnie Mae until the loan reperforms, is liquidated via foreclosure or short sale, or is bought out from the pool by the issuer using out-of-pocket funds. If advance obligations exceed what issuers have the financial capacity to pay, it could trigger issuer default. Thus, while greater borrower credit risk in the Ginnie Mae space creates higher risk of borrower default, servicer-unfriendly advancing obligations compound the problem. In comparison, the advancing obligation for GSE loans ends after four months, limiting downside risk.

This issue also has a major systemic implication. About 90 percent of Ginnie Mae mortgage-backed securities (MBS) in recent years have been issued by nonbanks, compared with around 50 percent for the GSEs. Nonbanks service more than 70 percent of unpaid principal balance outstanding for Ginnie Mae loans. At the same time, nonbanks do not enjoy the same access to liquidity facilities as banks do. For instance, they do not have access to consumer deposits, to the Federal Reserve's discount window and other lending programs, or to Federal Home Loan Bank advances (Kaul and Goodman 2020). All these factors increase the risk of a liquidity crisis in the Ginnie Mae space.

# Why Ginnie Mae Cannot Assist Its Issuers as the GSEs Have Done for Their Servicers

To fully appreciate the heightened liquidity risk that servicers of government mortgages (i.e., Ginnie Mae issuers) face, one must understand the different roles Ginnie Mae issuers and GSE servicers play in

the housing finance system. The terms used to describe the two groups reflects the basic differences in their roles.

## Ginnie Mae Issuers Are Responsible for Much More Than Servicing

Ginnie Mae issuers are called "issuers" because they issue MBS, as the GSEs do, in addition to servicing the loans. Ginnie Mae neither buys loans from lenders nor issues MBS. An easy way to think of the issuer's relationship with Ginnie Mae is as a cosigner. The issuer pays Ginnie Mae a guarantee fee of 6 basis points to be the counterparty and assumes responsibility for securitization, issuance, and advancing timely principal and interest to investors. In other words, the issuer is on the hook for these functions. Ginnie Mae's role is to provide an explicit backstop for the benefit of MBS investors if the issuer becomes insolvent. This allows investors to be indifferent to the issuer.

GSE servicers play a more limited role. They are called "servicers" because they service loans only. The GSEs own and securitize the loans, issue MBS, and guarantee the timely payment of principal and interest to investors. They receive a base guarantee fee of 55 basis points for this. Because their charters do not allow GSEs to service loans, they hire servicers as contractors. Although this contract requires servicers to advance principal and interest, the GSEs are responsible for it. Following are a few examples of how the GSEs can relieve their servicers from financial stress.

1. The GSEs can pay servicers supplemental fees above the base 25 basis-point servicing fee. For example, the GSEs have announced[3] incentive fees for various types of loan workouts after borrowers complete their COVID-19 forbearance. Ginnie Mae has no such flexibility.
2. Although GSE servicers advance monthly principal and interest payments to the Common Securitization Platform for payment to MBS investors, the GSEs can advance directly to the platform using their corporate resources or by issuing debt. In fact, this is how MBS investors will get paid once servicers stop advancing after four months of COVID-19 delinquency.
3. The GSEs, being the owners of the loan and issuers of their MBS, need to ensure that the value of the mortgages is not impaired through a tax lien being filed or the mortgaged property being damaged. This is why they reimburse servicers for property taxes and homeowners' insurance premiums on behalf of delinquent borrowers. In the Ginnie Mae space, issuers are responsible for this. They must deliver a clean title to the FHA or other government insurer to be reimbursed.

In sum, Ginnie Mae issuers are much more than servicers. They are responsible for performing many of the same functions in the government lending space that the GSEs perform in the conventional space.

## Ginnie Mae's Role Is More Limited Than the GSEs' Role

If issuers securitize loans and issue Ginnie Mae MBS, what role does Ginnie Mae play? Ginnie Mae's sole role is to administer the MBS guarantee for the benefit of securities investors. It does so by establishing

program guidelines and by setting financial and operational requirements for issuers. This parallels the way the FHFA sets requirements to ensure the GSEs operate their MBS guarantee in a safe manner. We also note that unlike the GSEs, Ginnie Mae does not manage mortgage credit risk, does not set origination or servicing policies, and does not engage in loss mitigation. These functions are performed by the FHA, VA, and RHS.

Because of Ginnie Mae's narrow role, PTAP is the most it can do. Note that when an issuer borrows money under PTAP, Ginnie Mae uses its statutory authority to draw funds from the US Treasury (i.e., taxpayers) on behalf of the issuer. PTAP's purpose is not to help issuers weather the COVID-19 crisis. Ginnie Mae does not have the authority to do that. *Ginnie Mae's authority is solely to fulfill its obligation to MBS investors by ensuring timely payment of principal and interest.* PTAP's purpose is to protect the integrity of Ginnie Mae's MBS guarantee by avoiding systemic failure of multiple issuers. This construct necessitates that PTAP be available only to issuers that do not have financial capacity to make required payments to investors.

### Can the FHA, VA, and RHS Cover Servicer Advances?

Given that the FHA, VA, and RHS are the credit risk takers for government loans and are ultimately on the hook for credit losses, it is worth asking whether they can support their servicers, as the GSEs are doing. To a limited extent, the FHA can, and it has taken a major step in this direction, as described below. But the FHA, VA, and RHS provide loan-level insurance or guaranty to protect lenders from credit losses. They are set up to reimburse issuers' actual losses incurred, which are known only after liquidation.

Because the FHA insures 100 percent of the loan amount, it has agreed to accelerate the payment of claims[4] through the new COVID-19 National Emergency Standalone Partial Claim program. The new policy requires FHA servicers to evaluate borrowers for partial claim at the end of their COVID-19 forbearance plan, allowing servicers to get their advances reimbursed. This will provide some liquidity to Ginnie Mae issuers. At the same time, its impact is limited. The FHA insures only about half the $2 trillion in outstanding Ginnie Mae loan balance. Most of the rest is guaranteed by the VA up to a maximum of 25 percent. If the VA were to accelerate claims like the FHA, it would need a partial claim offering, something it does not offer currently (Goodman et al. 2018). It would also need to make sure any funds paid out before liquidation do not exceed 25 percent of the original loan amount. Either way, the VA is not set up for this. It would need to develop the necessary infrastructure, which cannot happen in time to mitigate the impact of the COVID-19 crisis.

## Borrowing against Ginnie Mae Servicing Rights Is Constrained

Mortgage servicers routinely meet their liquidity and working capital needs by borrowing against the value of mortgage servicing rights (MSRs). But only a few creditors are willing to lend against Ginnie

Mae MSRs even during normal times. Ginnie Mae's acknowledgment agreement, the instrument that governs how MSRs can be pledged, states that if an issuer fails to make full and timely payment to MBS investors, the issuers' creditor(s) must protect their collateral by taking ownership of the loans collateralizing the MBS and assume responsibilities of the issuer, including the obligation to service the underlying loans and advance principal and interest. If creditors choose not to take ownership of the loans or assume responsibilities of the issuer, Ginnie Mae will take ownership of the loans and issuer obligation without compensation to the creditors.

Creditors are typically willing to fund principal and interest advances on behalf of failed issuers, as they are eventually reimbursed by the FHA, VA, and RHS, but they are mostly unwilling to assume servicing responsibility. The latter requires obtaining a servicing license and having in-house servicing infrastructure or a subservicing arrangement. If creditors will not accept these obligations, Ginnie Mae will exercise its right to place the loans and issuer responsibilities with another entity. For example, if Issuer A cannot meet its financial obligation to pay MBS investors timely principal and interest, its creditors will have to decide if they want to take over issuer responsibilities. If they decide not to, Ginnie Mae will move the mortgage portfolio underlying Ginnie Mae guaranteed MBS and Issuer A's responsibilities to Issuer B without compensating Issuer A's creditors for any economic value of the servicing portfolio. This is a big risk for any creditor. The result is that only a few lenders are willing and able to lend against Ginnie Mae MSRs. Most are not. This limits the amount of financing available against Ginnie Mae MSRs and results in less attractive lending terms.

The obvious solution to this problem is to amend Ginnie Mae's acknowledgement agreement to allow MSRs to be bifurcated into a base MSR and an advance receivables asset. The former would come with the obligation to service loans and right to receive servicing income. The latter could be pledged on a stand-alone basis to obtain liquidity for principal, interest, taxes, and insurance advances. But this solution runs into a major problem. Creating two separate liens, one on base MSR and one on advances, would be workable only if lien holders agree that, at the time of issuer failure, either Ginnie Mae takes all economic value of the mortgage portfolio and issuer obligation, or one of the lien holders agrees to immediately take ownership of the mortgages and assume issuer responsibilities.

Absent this understanding by lien holders, Ginnie Mae would have to pay off the creditor that put a lien on advances to have the lien released. Only then could it place the servicing portfolio in a new home. Ginnie Mae does not do this for two reasons. First, resolving liens erects a barrier to speedy transfer of servicing, which is crucial. Upon issuer failure, Ginnie Mae typically has only a couple of days to find a new issuer to advance timely principal and interest to investors and service the loans. Lien resolution would slow this process. Second, lien payoff would put Ginnie Mae into a position of guaranteeing the issuer's creditors. Ginnie Mae was created to guarantee only the timely payment of monthly principal and interest to investors. Guaranteeing that an issuer's creditor is paid upon the issuer's failure would be a major expansion of Ginnie Mae's charter and would fundamentally change the Ginnie Mae program.

A related question that is often asked is if the GSEs allow their MSRs to be bifurcated, why does Ginnie Mae not allow it? The GSEs allow their MSRs to be bifurcated because, as loan owners,

guarantors, and credit risk takers, they are in full control of the timing and extent of reimbursements of principal, interest, taxes, and insurance. In the Ginnie Mae space, issuers are the owners of the loans, and they have transferred credit risk to the FHA, VA, and RHS. The latter have full control over reimbursements, not Ginnie Mae.

# Given These Constraints, How Can We Ensure Liquidity for Government Loans?

Given these limits to what Ginnie Mae can do, we recommend the creation of a federal liquidity facility for servicing advances. We envision a structure under which the Federal Reserve would fund Ginnie Mae issuers either through direct lines of credit, or indirectly, where the lines of credit would be administered via banking organizations that are existing warehouse lenders to issuers. That is, banks would originate COVID-19 lines of credit to Ginnie Mae issuers. The Federal Reserve would commit to purchase these lines of credit. The Treasury would agree to take an equity position large enough to absorb potential credit losses if an issuer fails to pay back its line of credit. This structure would be conceptually along the lines of the Federal Reserve's Commercial Paper Funding Facility but tailored to address liquidity risks for government loans.[5] The lines of credit would remain open for draws for a set duration until COVID-19 liquidity risks have significantly moderated. Issuers would pay off the line of credit when the forborne payments are reimbursed. For FHA loans, this would happen when a COVID-19 partial claim is paid by the FHA at the end of the forbearance period. For VA loans, it would take longer, as forborne amounts will likely be paid back when the loan is paid off through a refinancing, home sale, or foreclosure.

# Conclusion

The fundamental differences between the Ginnie Mae and GSE models are central to understanding the need for a federal liquidity facility for government loans. The flexibility the GSEs have has enabled them to take effective action to limit downside risk for servicers of their loans, primarily by capping principal, interest, taxes, and insurance advances at four months. In comparison, Ginnie Mae's limited role and various constraints leave it unable to go beyond PTAP. Furthermore, Ginnie Mae has no authority to advance taxes and insurance.

Given the escalating count of new confirmed COVID-19 cases, we are concerned that the COVID-19 liquidity crisis could reemerge just as quickly as it started in March and that the servicing market for government loans will bear a disproportionate share of the impact. This will cause financial trouble for Ginnie Mae issuers but will eventually harm consumers because financially stretched servicers will not be able to provide effective and sustainable assistance to struggling borrowers, the vast majority of whom are low- and moderate-income households and first-time homebuyers. We recommend the Federal Reserve and the Treasury begin developing a liquidity facility that could be activated quickly to minimize any potential market disruption.

# Notes

[1] "Ginnie Mae PTAP Assistance," Ginnie Mae, accessed July 13, 2020, https://www.ginniemae.gov/issuers/program_guidelines/pages/ptap.aspx.

[2] "Ginnie Mae PTAP Assistance," Ginnie Mae.

[3] Fannie Mae, "Lender Letter (LL-2020-09)," letter to all Fannie Mae single-family servicers, June 10, 2020, https://singlefamily.fanniemae.com/media/23091/display.

[4] Brian D. Montgomery, assistant secretary for housing, "FHA's Loss Mitigation Options for Single Family Borrowers Affected by the Presidentially-Declared COVID-19 National Emergency in Accordance with the CARES Act," US Department of Housing and Urban Development mortgage letter 2020-06 to all FHA-approved mortgagees and others, April 1, 2020, https://www.hud.gov/sites/dfiles/OCHCO/documents/20-06hsngml.pdf.

[5] Board of Governors of the Federal Reserve System, "Federal Reserve Board Announces Establishment of a Commercial Paper Funding Facility (CPFF) to Support the Flow of Credit to Households and Businesses," press release, March 17, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200317a.htm.

# References

Goodman, Laurie, Karan Kaul, Alanna McCargo, and Todd Hill. 2018. "Government Loan Modifications: What Happens When Interest Rates Rise?" Washington, DC: Urban Institute.

Kaul, Karan. 2020. "A Liquidity Vehicle for Mortgage Servicing Advances Is in Consumers' Best Interest." Washington, DC: Urban Institute.

Kaul, Karan, and Laurie Goodman. 2020. "Should Nonbank Mortgage Companies Be Permitted to Become Federal Home Loan Bank Members?" Washington, DC: Urban Institute.

# About the Authors

**Karan Kaul** is a senior research associate in the Housing Finance Policy Center at the Urban Institute. He publishes innovative, data-driven research on complex, high-impact policy issues to improve the US mortgage finance system. A strategic thinker and thought leader with over 10 years of experience in mortgage capital markets, Kaul has published over 100 research articles on such topics as mortgage servicing reforms, efficient access to credit, benefits of alternative credit data and scoring models, and single-family rentals. He has advocated for efficient industry practices, regulation, and legislation to make the mortgage market work better for all Americans. Kaul was the lead researcher on the Mortgage Servicing Collaborative and senior researcher on the Urban Institute's Mortgage Markets COVID-19 Collaborative. He regularly speaks at housing market events and conferences and advises policymakers on the full range of housing finance issues. Before joining Urban, he spent five years at Freddie Mac as a senior strategist analyzing the business impact of postcrisis regulatory reforms. He holds a bachelor's degree in electrical engineering and a master's degree in business administration from the University of Maryland, College Park.

**Ted Tozer** is a senior fellow at the Milken Institute's Center for Financial Markets, where he helps lead the institute's housing finance reform work. Before joining the Milken Institute, Tozer was president of Ginnie Mae for seven years, bringing with him to the institution more than 30 years of experience in the mortgage, banking, and securities industries. As president of Ginnie Mae, Tozer managed Ginnie Mae's

nearly $1.7 trillion portfolio of mortgage-backed securities (MBS) and more than $460 billion in annual issuance. Before joining Ginnie Mae, Tozer was senior vice president for capital markets at the National City Mortgage Company for more than 25 years, overseeing pipeline hedging, pricing, loan sales, loan delivery, and credit guideline exceptions. He was also a member of Freddie Mac's National Lender Advisory Board. In addition, he was chairman of the Capital Markets Committee of the Mortgage Bankers Association of America (MBA) from 2002 to 2004, a member of the MBA Board of Governors from 2002 to 2004, a trustee of the Ohio Mortgage Bankers Association from 1999 to 2001, and as part of the Fannie Mae Midwest Secondary Advisory Group from 1994 to 1999. He received his bachelor's degree in accounting and finance from Indiana University. He became a Certified Public Accountant in 1980 and a Certified Management Accountant in 1984.

# Acknowledgments

This brief was funded by some of the members of the Urban Institute's Mortgage Markets COVID-19 Collaborative. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute's funding principles is available at urban.org/fundingprinciples.

URBAN INSTITUTE

500 L'Enfant Plaza SW
Washington, DC 20024

www.urban.org

## ABOUT THE URBAN INSTITUTE

The nonprofit Urban Institute is a leading research organization dedicated to developing evidence-based insights that improve people's lives and strengthen communities. For 50 years, Urban has been the trusted source for rigorous analysis of complex social and economic issues; strategic advice to policymakers, philanthropists, and practitioners; and new, promising ideas that expand opportunities for all. Our work inspires effective decisions that advance fairness and enhance the well-being of people and places.