Ginnie Mae's Proposed Eligibility Requirements for Single-Family Issuers

The Proposal Is Too Punitive and Detrimental for Nonbank Liquidity

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On July 12, Ginnie Mae issued a request for input (RFI) on eligibility requirements for its single-family mortgage-backed securities (MBS) issuers (Ginnie Mae 2021). This proposal is the latest in a series of proposals various federal agencies have issued in recent years to bolster financial requirements for nonbank mortgage servicers. In October 2020, the Conference of State Bank Supervisors (CSBS), a consortium of state banking regulators, proposed prudential regulatory standards for nonbank servicers, covering all aspects of business, such as capital, liquidity, stress testing, risk management, data standards, cybersecurity, and corporate governance. The CSBS finalized these requirements in July 2021 (CSBS 2021). In January 2020, the Federal Housing Finance Agency (FHFA) proposed eligibility requirements for servicers doing business with Fannie Mae and Freddie Mac. The agency withdrew the proposal as the pandemic began but noted that it would be reproposed in the future.

Efforts to enhance financial requirements for nonbank servicers are needed to ensure servicers remain financially stable during times of distress. These efforts also facilitate stability of the broader mortgage finance system and ensure a minimum level of service for borrowers in all environments. We applaud Ginnie Mae for giving interested market participants the opportunity to comment on this important proposal before it goes into effect. Moreover, we support the proposal's intent and Ginnie Mae's efforts to align eligibility standards with the actual risk posed. That said, there is much room for improvement.

The proposed standard has two parts. The first part bolsters net worth and liquidity standards for all Ginnie Mae issuers, both banks and nonbanks. The second part, which applies only to nonbanks, introduces a minimum risk-based capital ratio. In general, we support the changes to the net worth and liquidity requirements, but we believe the risk-based capital requirements, as proposed, are very detrimental to the marketplace. Below, we analyze both parts of the proposal and propose amendments that will allow Ginnie Mae to better accomplish its objectives while minimizing adverse impacts on the market.

Changes to the Net Worth and Liquidity Standards Are Mostly Reasonable

The proposed net worth and liquidity standards are intended to account for the totality of the business done by the Ginnie Mae issuer, not just Ginnie Mae business. Conceptually, this makes sense, as most large issuers originate and service both GSE and government loans, and we generally support these standards.

But even though the net worth and liquidity rules apply to banks and nonbanks, the rules have virtually no impact on banks (for whom mortgage origination is a small part of their activities) and are more meaningful for nonbanks (for whom agency mortgages are the predominant activity).

The current net worth requirement is

$2.5 million + 35 basis points (bps) of Ginnie Mae outstanding obligations. (1)

The proposed net worth requirement is

$2.5 million + 35 bps of Ginnie Mae outstanding obligations + 25 bps of government-sponsored enterprise (GSE) outstanding obligations. (2)

This proposed requirement is similar to the FHFA's withdrawn proposal, except that the FHFA's proposal applied the 25 basis-point charge to all nongovernment residential loans serviced (including portfolio and private-label securities, or PLS, loans). Given the relatively small volume of PLS outstanding ($400 billion), the practical impact of Ginnie Mae's proposal to exempt PLS from the 25 basis-point requirement is small. But regulation should hold up to changing circumstances, and we do not understand the case for excluding PLS servicing. We also note that Ginnie Mae's proposed net worth requirement exceeds the CSBS's recently finalized prudential standards, which require a net worth of $2.5 million + 25 basis points of unpaid principal balance (UPB) serviced.[1] The higher net worth requirement for Ginnie Mae servicing can be justified because of the tail risk[2] and increased liquidity requirements of a Ginnie Mae issuer.

The current liquidity requirement is

$1 million or 10 bps * Ginnie Mae MBS outstanding, whichever is greater. (3)

The proposed liquidity requirement is

$1,000,000 or (10 bps * Ginnie Mae single-family MBS + 5 bps * all other GSE single-family obligations + 20 bps * total held-for-sale, or HFS, loans), whichever is greater. (4)

Again, this considers the totality of an institution's agency MBS obligations but does not consider private-label securities. Because the liquidity requirements are geared toward nonbanks (even though these rules apply to banks and nonbanks), and because the PLS market is small, this does not make a large difference, though the rules may need to be reevaluated if the PLS market grows.

To the extent there is room for improvement in the liquidity requirement, Ginnie Mae may want to reconsider the minimum liquidity requirement for held-for-sale (HFS) loans that have been committed for delivery into a to-be-announced pool or hedged. An argument can be made that they should receive the same treatment as loans sold in MBS transactions.

The Risk-Based Capital Framework, as Proposed, Has Serious Flaws

The proposed minimum risk-based capital ratio requirements are new and apply only to nonbanks. Today, Ginnie Mae has a minimum required capital ratio of 6 percent of total assets, which is not risk sensitive. The proposed risk-based capital ratio is an attempt to tailor the amount of capital held to the institution's riskiness. While well intentioned, the risk-based capital requirement, as proposed, is highly punitive for nonbanks. It will likely disrupt mortgage servicing values and raise mortgage rates for Federal Housing Administration (FHA) and US Department of Veterans Affairs (VA) borrowers, who will pay for any adverse impact on servicing values.

The RFI proposes a risk-based capital requirement of 10 percent, which is defined as

(adjusted net worth – excess MSRs) / risk weighted assets. (5)

Assets receive similar risk weights as they do in bank capital standards:

- 0 percent for cash and cash equivalents, reverse mortgages held for investment, and Ginnie Mae loans eligible for repurchase
- 20 percent for government loans HFS
- 50 percent for conforming and other loans HFS
- 250 percent for total mortgage servicing rights (MSRs), not to exceed adjusted net worth
- 100 percent for all other assets not included above

In the calculation of risk-based capital, MSRs in excess of adjusted net worth are subtracted from adjusted net worth. This is adapted from bank capital standards, which cap permissible MSRs at 10 percent of the common equity of Tier 1 capital.[3]

Imposing the bank framework on nonbanks is inappropriate, as the fundamental risk is very different. Banks face balance sheet insolvency, they have plenty of liquidity, and they can borrow from both the Federal Home Loan Banks (FHLBs) and the Federal Reserve. In contrast, nonbanks face liquidity risks; the risk that they may need to liquidate assets to meet their obligations. Ginnie Mae's goal is to be sure that issuers have enough capital to withstand losses during periods of economic stress and market illiquidity. The amount of capital needed in turn is proportional to the liquidity risk of assets on the balance sheet.

The RFI's biggest shortcoming is the direct subtraction of excess MSRs from the adjusted net worth. The current proposal—by assessing the risk-based capital up to the amount of MSR equal to the adjusted net worth, with nonbanks required to hold capital equal to the value of the excess MSRs—is extremely punitive, as it assumes excess MSRs are valued at zero (a complete write-down). This assumption does not address the concept of a liquidity-based insolvency. The market value of excess MSRs would be the same regardless of the relationship between MSRs and adjusted net worth. By fully excluding excess MSRs from the numerator, the proposal would give issuers incentives to sell MSRs to other entities whose finances are not as visible to Ginnie Mae. More importantly, less issuer appetite for owning MSRs would dampen bids and put downward pressure on values, eventually raising rates for FHA and VA borrowers, an outcome that is most undesirable. Thus, our most significant recommendation is that the numerator of the risk-based capital ratio not subtract excess MSRs. Rather, we urge Ginnie Mae to assess the same risk weight to all MSRs.

A simple example illustrates how punitive this is. Assume a nonbank issuer has $100 million in net worth and $110 million in MSRs. The amount of capital necessary to support the MSRs is (($100 million * 250 percent * 10 percent) + $10 million), or $35 million. If excess MSRs were not subtracted, the amount of capital necessary to support the MSRs is ($110 million * 250 percent * 10 percent), or $27.5 million. That is, each excess MSR requires four times as much capital per dollar of MSR investment as one that is not excess.

The risk weight assigned to MSRs in this formula is the same 250 percent as in the Basel risk-based capital rules for banks. This number was the result of negotiation among a group of international regulators, with only the US banks having MSRs on the balance sheet. US regulators realized this was punitive but concluded it would not have a major impact on banking organizations, given that MSRs are a relatively small share of their balance sheet. Applying this risk weight to nonbanks, where these MSRs are a substantial portion of total assets, is a conservative assumption in itself.

The flat 250 percent risk weight for MSRs assumes all MSRs are unhedged. MSRs that are hedged should carry a lower risk weight of 150 percent or less. This is because the volatility in the valuation in MSRs is reduced dramatically by hedging. By not recognizing the benefit of MSR hedging, the proposal discourages it. This would make the system more vulnerable to liquidity shocks.

The proposal, as written, would discourage hedging a second way. As rates rise and MSRs gain value, the proposal would require all issuers who mark their MSR assets to market—regardless of whether they hedge—to hold proportionally more capital. Issuers with fully hedged MSRs would end up holding more capital, even though their net worth did not change.[4] A better approach would be to subject unhedged MSRs to the 250 percent risk weight, with lower risk weights for hedged MSRs.

Eliminating the subtraction of the excess MSRs from capital and subjecting all MSRs to the 250 percent risk weight, with a more favorable risk weight for hedged assets, would facilitate a risk-based capital framework without disruption to the market. This recommendation is consistent with typical lending terms observed in the MSR financing market. Nonbanks can generally borrow approximately 70 percent of the MSR's value. If an institution is required to hold a 10 percent risk-based capital requirement, it will likely try to hold a buffer so that an increase in MSR valuation will not cause the risk-based requirements to be violated. If we assume an institution chooses to hold 12 percent, MSRs would effectively carry a capital charge of 30 percent (250 percent * 12 percent), effectively allowing for funding up to 70 percent of the value.

We also recommend applying different risk weights to HFS loans based on how long ago they were closed. Although, again, this was an attempt to mimic bank capital requirements, a loan HFS that was closed less than 60 days ago and will be sold into Fannie Mae, Freddie Mac, and Ginnie Mae pools has less risk than a loan created to be held in portfolio over the life of the instrument. We would argue that there is no reason to risk-weight loans HFS that were closed less than 60 days ago. Such loans will create liquidity by being sold into MBS pools. Loans HFS that were closed more than 60 days ago should have the proposed risk weights assessed because these loans could have issues preventing immediate salability.

These three changes we have suggested—eliminating the subtraction of excess MSRs from the numerator, applying a lower risk weight for hedged MSRs, and applying different risk weights to HFS loans depending on how long ago they were closed—will tailor the capital requirements to underlying risks more accurately than the RFI. The most important of these suggestions is eliminating the subtraction of excess MSRs from net worth.

One other consideration: capital as described in this RFI is equity capital. The risk that Ginnie Mae is trying to protect against is liquidity risk. Borrowing in the capital markets provides liquidity. Ginnie Mae may want to give issuers some credit for term debt with a remaining maturity of two years or longer, as this debt is a source of near-term liquidity. This would encourage nonbanks to borrow sooner rather than borrowing after liquidity issues have emerged, when it will be both more expensive and more difficult to do so. The rationale for the two-year minimum is that it gives Ginnie Mae adequate time for pursuing remedial action, and gives the issuer another source of liquidity, without the added pressure of debt coming due. That said, the degree to which term debt counts as capital should be capped.

The RFI, as proposed, would negatively affect servicing values and increase rates for borrowers. It will also drive MSR holdings to entities that may have little expertise in servicing. But with our proposed adjustments, Ginnie Mae could have a well-balanced risk-based capital regime that would guard against nonbanks' liquidity risks turning into solvency risks.

Ultimately, Enhanced Regulation by Itself Will Not Mitigate Nonbank Liquidity Risks

Ginnie Mae's RFI, coming on the heels of the FHFA's withdrawn 2020 proposal and the CSBS's finalized prudential requirements, raises a broader issue about regulating nonbank servicers. Our prior research shows the main liquidity risk nonbanks face is the timing delay between the payment of delinquent principal, interest, taxes, and insurance to relevant parties and the reimbursement of those advances by the agencies (Kaul and Goodman 2020a; Kaul and Tozer 2020). Nonbanks also face high MSR volatility, although it is either actively hedged or naturally hedged by strong origination income when rates fall.

These risks are well understood by all stakeholders, as is the fact that the risks are more pronounced for Ginnie Mae issuers than for GSE servicers. More importantly, these requirements did not vary substantially until the introduction of Ginnie Mae's risk-based capital framework in the current RFI, which appears to be an attempt to reflect the increased risk of being a Ginnie Mae issuer (table 1). Beyond these financial requirements, nonbank servicers are subject to operational and reporting requirements, ongoing monitoring, and examinations by each agency. It is not clear how much incrementally safer the system becomes by having multiple regulatory, reporting, and supervisory regimes whose approaches are fundamentally similar.

TABLE 1

Nonbank Servicer Minimum Net Worth, Capital, and Liquidity Requirements

	The GSEs' current standard	The FHFA's withdrawn proposal	The CSBS's final prudential standards	Ginnie Mae's standard in effect	Ginnie Mae's proposed RFI
Minimum net worth	\$2.5 million plus 25 bps of SF servicing UPB	\$2.5 million plus 35 bps of Ginnie Mae UPB plus 25 bps of all other UPB	\$2.5 million plus 25 bps of owned SF servicing	\$2.5 million plus 35 bps of Ginnie Mae servicing UPB	\$2.5 million plus 35 bps of Ginnie Mae servicing UPB plus 25 bps of GSE servicing
Minimum capital ratio	Tangible net worth/total assets of ≥6%	Tangible net worth/total assets of ≥6%	Tangible net worth/total assets of ≥6%	Tangible net worth/total assets of ≥6%	Adjusted net worth/total assets of ≥10%
Minimum liquidity	3.5 bps of agency servicing UPB plus incremental 200 bps charge for agency NPLs over 6%	4.0 bps of GSE servicing UPB plus 10 bps of Ginnie Mae servicing plus incremental 300 bps charge for agency NPLs over 4%	3.5 bps of agency servicing UPB plus incremental 200 bps charge for agency NPLs over 6%	10 bps of Ginnie Mae servicing UPB	Greater of \$1 million or (10 bps of Ginnie Mae servicing plus 5 bps of GSE servicing plus 20 bps of HFS loans)

Sources: Federal Housing Finance Agency, Ginnie Mae, and Conference of State Bank Supervisors.

Notes: bps = basis points; CSBS = Conference of State Bank Supervisors; FHFA = Federal Housing Finance Agency; GSE = government-sponsored enterprise; HFS = held-for-sale; MSR = mortgage servicing rights; NPL = nonperforming loans; RFI = request for input; SF = single-family; UPB = unpaid principal balance. The FHFA's withdrawn proposal refers to the January 2020 proposed eligibility requirements that were withdrawn but will be reproposed soon. The CSBS's final prudential standard refers to requirements finalized in July 2021. Ginnie Mae's proposed RFI refers to proposed standards released in July 2021.

There is a strong case for consolidating nonbank regulation into a single federal regulator to reduce redundancy, confusion, and complexity (Kaul and Goodman 2020b). The most optimal option is for Congress to grant the FHFA the authority to supervise nonbanks because of its experience overseeing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Fannie Mae and Freddie Mac already have a well-developed "pseudo-regulatory" infrastructure to approve and monitor counterparties. Ginnie Mae has a well-developed issuer-monitoring framework. 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 and annual reports showing minute details about assets, liabilities, capital and cash position, and financial condition. The FHFA should be able to leverage this infrastructure and implement a risk-based framework that accounts for key differences between GSE servicers and Ginnie Mae issuers (Kaul and Tozer 2020). Bringing nonbank servicers under the FHFA's supervision will also allow for more holistic regulation of the mortgage market.

Although enhanced regulation of nonbanks is desirable, the most effective way to contain liquidity risk is to explicitly recognize the need for emergency federal lending. Note that bank depositories, despite pulling back from the agency mortgage market post-2009, have access to the Federal Reserve's lending facilities and to FHLB advances. Banks account for roughly 80 percent of FHLB advances outstanding. The bank share of FHLB advances increased even more in the first quarter of 2020 as they sought liquidity at the start of the pandemic. On the other hand, nonbanks, despite their dominant role in the mortgage market and strong mission alignment with the FHLBs, are not eligible for FHLB membership. There is a strong case for expanding FHLB membership to nonbanks (Kaul and Goodman 2020b). Although some issues will need to be resolved, we believe FHLB membership, paired with prudential nonbank regulation at the federal level, is the most effective way to mitigate the perpetual liquidity risks this sector faces.

Notes

1 The CSBS rules apply only to nonbanks.

2 The tail risk is driven primarily by limited guarantee on US Department of Veterans Affairs loans and the limited reimbursement of expenses by the Federal Housing Administration (FHA). For example, the FHA does not reimburse for the first two months of delinquent interest; it has tight timelines on delinquent loan servicing, which leads to interest curtailment; and it does not always reimburse all expenses the servicer incurs.

3 In addition, MSRs in conjunction with deferred tax assets and equity interests in unconsolidated financial entities cannot exceed 15 percent of the common equity component of Tier 1 capital.

4 Institutions may elect to hold their MSR assets either (1) on a fair-value (mark-to-market) basis or (2) on a lower of cost or market basis. In the latter case, the MSR asset is carried at the lower of its original cost or its current market value.

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