For release on delivery
12:30 p.m. EST
November 19, 2020

The Changing Structure of Mortgage Markets and Financial Stability

Remarks by

Michelle W. Bowman

Member

Board of Governors of the Federal Reserve System

at

"Financial Stability: Stress, Contagion, and Transmission"
2020 Financial Stability Conference
hosted by the Federal Reserve Bank of Cleveland and the Office of Financial Research

Cleveland, Ohio
(via webcast)

November 19, 2020

Good afternoon, everyone. It is a pleasure to join you here today and to share a few of my thoughts on financial stability issues with you. I would like to thank the Cleveland Fed and the Office of Financial Research for hosting this conference and for that very kind introduction. It is encouraging to see so many great minds devoting their time and attention to studying financial stability. At the Board, we dedicate considerable attention to this topic as well, and I would like to thank my colleagues, Vice Chair for Supervision Randy Quarles, Chair of the Financial Stability Board (FSB), and Governor Lael Brainard, for their leadership on these issues both internationally and at the Board.

It seems especially relevant to look closely at financial stability at this time, as the COVID-19 pandemic has had a profound impact on the U.S. economy and has tested the resilience of our financial system over the past nine months. Efforts to contain the virus triggered an economic downturn that was unprecedented in both its speed and its severity. Early on, more than 22 million jobs were lost in March and April, and though a significant number of people have returned to work since that time, we still face a shortfall in employment relative to its level before the onset of the pandemic.

Fortunately, both our economy and our financial system were very strong when the pandemic hit. Most banks began 2020 with higher capital ratios and more liquid assets than they had in previous downturns, which helped them remain a source of strength in March and April. As the crisis intensified in March, serious cracks emerged in several areas of financial intermediation crucial to the health of the economy, including Treasury markets, corporate and municipal bond markets, money market mutual funds, mortgage real estate investment trusts, and residential mortgage markets. Today I am going to focus on the strains in mortgage markets.

To address strains in mortgage finance, the Federal Reserve took prompt action to purchase large quantities of agency-guaranteed mortgage-backed securities (MBS), because as we learned during the previous financial crisis, the proper functioning of mortgage markets is necessary for monetary policy to support the economy. Unfortunately, the problems in mortgage finance in this crisis were broader than just the MBS markets. This crisis period has also revealed a number of new—or, in some cases, renewed—vulnerabilities related to lending and loan servicing by nonbank mortgage companies, which I will refer to from here on as mortgage companies.

These vulnerabilities were not entirely a surprise to me. When I served as a banker and, subsequently, as the state bank commissioner in Kansas, I saw firsthand the increasing share of mortgage companies in mortgage origination and servicing as well as some of the weaknesses in the mortgage company business model. And in my role as a Board member with a focus on community banks, I frequently hear about the issues that have caused some regional and community bankers to pull back from originating and servicing mortgages. I view this as a significant problem, because I believe firmly that a healthy financial system must have a place for institutions of many different types and sizes that are able to serve the varying needs of different customers.

I will begin today by describing the evolving role of mortgage companies in mortgage markets and the risks to financial stability that activity entails. I will then focus on developments in mortgage markets during the COVID-19 pandemic and discuss how actions by the Federal Reserve and the other parts of the government helped stabilize financial markets and prevent more severe damage to the economy. Finally, I will explain how vulnerabilities associated with mortgage companies could pose risks in the future, and I will review ongoing work across the regulatory agencies to monitor and address these vulnerabilities. I will end by enlisting your help. Figuring out how to achieve a balanced mortgage system—one that delivers the best outcomes for consumers while being sufficiently resilient—is a highly complex task that could benefit from the insights of those of you here today.

The Role of Nonbank Financial Institutions in Mortgage Markets

In the 1980s and 1990s, the share of mortgages originated by mortgage companies increased considerably, as expanded securitization of mortgages allowed mortgage companies, which lack the balance sheet capacity of banks, to compete with banks in the mortgage market. The role of mortgage companies increased further in the 2000s with the growth of the private-label mortgage market, where MBS sponsors are private firms without government support. But the last financial crisis and the prolonged housing slump that followed led to a sharp contraction in mortgage company activity. In 2006, mortgage companies accounted for around 30 percent of originations; by 2008, at the bottom of the housing crisis, this share had fallen to around 20 percent.

In the past few years, the market share of mortgage companies has risen sharply, well surpassing their share before the housing crisis. Today these firms originate about half of all mortgages, including more than 70 percent of those securitized through Ginnie Mae and the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.[1]

---

[1] See You Suk Kim, Steven M. Laufer, Karen Pence, Richard Stanton, and Nancy Wallace (2018), "Liquidity Crises in the Mortgage Market," *Brookings Papers on Economic Activity,* Spring, pp. 347–413, https://www.brookings.edu/wp-content/uploads/2018/03/KimEtAl_Text.pdf; and Laurie Goodman, Alanna McCargo, Jim Parrott, Jun Zhu, Sheryl Pardo, Karan Kaul, Michael Neal, Jung Hyun Choi, Linna Zhu, Sarah Strochak, John Walsh, Caitlin Young, Daniel Pang, Alison Rincon, and Gideon Berger (2020), *Housing Finance at a Glance: A Monthly Chartbook, October 2020* (Washington: Urban Institute, October 27), https://www.urban.org/sites/default/files/publication/103123/october-chartbook-2020_2.pdf. The expansion of mortgage companies in this market partly reflects a decision by many banks to exit that

Nonbanks also service roughly three-fourths of mortgages securitized through Ginnie Mae and about one-half of those securitized through the GSEs.[2] Although some mortgage companies specialize in origination or servicing, most large firms engage in both activities.

The expanding presence of mortgage companies has brought benefits to consumers and the economy. Among the benefits are increased competition and technological innovation. Mortgage companies are generally able to react more nimbly to changes in market conditions and have been faster to deploy new technologies such as online mortgage origination platforms. But the rising market share of mortgage companies has also brought with it increased risks. I will focus here on the risks most relevant to financial stability.

One major vulnerability of mortgage companies is liquidity—that is, their ability to finance their portfolios of assets.[3] Unlike banks, mortgage companies typically do not have access to liquidity from the Federal Home Loan Banks or the Federal Reserve System. Mortgage companies also do not have access to deposits as a stable funding source. So while banks will hold some originations on their balance sheets, mortgage companies first fund their originations on warehouse lines of credit that are usually supplied by banks. Typically, after a couple of weeks, the mortgage company repays the warehouse line and securitizes the mortgages. During the last financial crisis, when the private-label mortgage securitization market started to freeze, mortgage lenders could not

market to avoid regulatory complexity and the financial, compliance, and reputational costs associated with default servicing and foreclosure.

[2] The data are Federal Reserve Board staff calculations based on Recursion Co. (2020), Agency Mortgage Market Monthly Update, November.

[3] See Financial Stability Oversight Council (2019*), 2019 Annual Report* (Washington: FSOC, December), p. 42, https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf.

transition their originations from the warehouse lines to securitization. Warehouse lenders became concerned about their exposures to the nonbank companies and cut off their access to credit. As a result of this funding crunch and other factors, many lenders failed, including household names like New Century Financial Corporation.

The risk of events like this one repeating is probably more limited today because mortgage companies primarily originate mortgages that are securitized through the far more stable GSE or Ginnie Mae markets. Instead, the main liquidity concern today comes from mortgage servicing. If borrowers do not make their mortgage payments, mortgage servicers are required to advance payments on the borrowers' behalf to investors, tax authorities, and insurers. Although servicers are ultimately repaid most of these advances, they need to finance them in the interim. The servicers' exposure is greatest for loans securitized through Ginnie Mae, as they require servicers to advance payments for a longer period than the GSEs. In some cases, servicers may also have to bear large credit losses or pay significant costs out of pocket. Because mortgage companies are now the major servicers for Ginnie Mae, this liquidity risk—and possibly solvency risk—is a significant vulnerability for these firms if borrowers stop making their payments.

If these firms collapse, what are the repercussions? Clearly, there is considerable potential for harm to consumers, and that harm would likely be concentrated in communities that are traditionally underserved. In recent years, mortgage companies originated the majority of the mortgages obtained by Black and Hispanic borrowers as well as the majority of mortgages to borrowers living in low- or moderate-income areas.

What does this have to do with financial stability? One aspect of financial stability is the amplification of shocks—in other words, how a problem initially confined to one part of the financial system can spread to involve broader swaths of borrowers and investors. During the housing crisis, the fragility of mortgage companies was an important source of this kind of amplification. In particular, rising mortgage defaults led to the collapse of many mortgage companies, which in turn was one of the key drivers of a significant pullback in the supply of mortgage credit. That tightening in credit then weighed on house prices, as potential homebuyers, who once would have been able to get a loan, found mortgages expensive or impossible to obtain. As a result, even families who had not been involved in the mortgage frenzy of the mid-2000s found the prices of their homes falling sharply. Today's housing market is much more robust, and the risk of a financial crisis originating from this sector is currently low. Nonetheless, if some large mortgage companies fail and other firms do not step in to take their place, we could see adverse effects on credit availability.

Policy Responses to the COVID-19 Crisis

Against this backdrop, the massive economic shock triggered by the COVID-19 pandemic broadly tested the resilience of our financial system. As the pandemic unfolded, strains occurred across financial markets as investors dashed for cash amid widespread lockdowns and fears about the economic and financial outlook. Mortgage markets, in particular, began to show significant signs of stress. The MBS market, like those for other fixed-income securities, became extremely volatile, and with the unemployment rate spiking, market participants worried that borrowers would be unable to make their mortgage payments.

The Federal Reserve's response to the crisis, which was prompt and forceful, included moving the policy interest rate to the effective lower bound, conducting large-scale purchases of Treasury securities and agency MBS, and implementing a number of emergency lending facilities to support the continued flow of credit to families, businesses, nonprofits, and state and local governments.

On the fiscal policy front, the CARES Act (Coronavirus Aid, Relief, and Economic Security Act) provided economic stimulus checks and enhanced unemployment benefits to individuals as well as eviction moratoriums for renters and a requirement that mortgage servicers grant borrowers up to 12 months of forbearance. All of these policy responses were crucial in easing the stresses in financial markets and helping us weather the period when much of the economy was shuttered.

An unfortunate consequence of the mortgage forbearance measure was the pressure it put on the funding needs of servicers, particularly mortgage companies, which are required to continue advancing payments on loans in forbearance. In April, Ginnie Mae alleviated these strains somewhat by announcing a program that provides servicers with financing for principal and interest advances, and which would not be considered a default by the servicer.[4] Similarly, in April, the Federal Housing Finance Agency (FHFA) announced that servicers would be required to advance only four months of missed payments for GSE loans.[5]

---

[4] See Ginnie Mae (2020), "Ginnie Mae Approves Private Market Servicer Liquidity Facility," press release, April 7, https://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=194.
[5] See Federal Housing Finance Agency (2020), "FHFA Addresses Servicer Liquidity Concerns, Announces Four Month Advance Obligation Limit for Loans in Forbearance," news release, April 21, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Addresses-Servicer-Liquidity-Concerns-Announces-Four-Month-Advance-Obligation-Limit-for-Loans-in-Forbearance.aspx.

Looking Back and Taking Stock

Although we continue to closely monitor the path of the virus and the public response to it, economic and financial conditions have improved much more than many had expected in the spring. It is a great relief that the most dire scenarios that seemed possible in the spring have not come to pass, which is largely due to supportive fiscal and monetary policy. In addition, the near-term stresses in financial markets have abated, providing support for the very strong recovery to date. The Federal Reserve's interest rate actions and MBS purchases have contributed to exceptionally low mortgage rates, which have boosted housing demand and the associated mortgage originations for new home purchases. We are also seeing a surge in mortgage refinancing. As a result, mortgage companies have experienced an influx of cash and an increase in profitability, and they have not had difficulties financing the advance payments.

To date, mortgage delinquencies and the take-up on forbearance appear to be limited and well below early fears of significant problems. The increase in employment since April, income support from stimulus payments, programs such as the Paycheck Protection Program that helped small businesses retain workers, and enhanced unemployment insurance all helped borrowers continue making their mortgage payments. And forbearance provisions in the CARES Act to homeowners with mortgages securitized by the GSEs or Ginnie Mae (around 65 percent of outstanding mortgages in the United States) have, so far, helped prevent foreclosures, which also supports home prices.

The share of mortgages in forbearance rose above 8 percent last spring, but it has since fallen to below 6 percent. And of those loans in forbearance, about one in six are current in their payments, reflecting the broader economic recovery.[6] This improvement has not been uniform, though, and the decline in the forbearance rate for loans in Ginnie Mae pools has been slower than those in GSE pools. And, of course, significant uncertainties remain, including the fact that forbearance for federally backed mortgages is set to expire in the first quarter of next year.

Some Lessons Learned

Even as we take some comfort in these positive developments, we are also giving due consideration to the financial market vulnerabilities that were made evident in this crisis, and we are examining ways to address them. One prominent vulnerability, which I have described here today, relates to the funding and liquidity profile of mortgage companies. In different circumstances, the large-scale delinquencies and defaults we saw last spring could have caused some mortgage companies to fail, especially if the surge in origination and refinancing income had not materialized. Because many mortgage companies both originate and service mortgages, strains in these firms' servicing books could also weigh on their origination activities. As I noted a moment ago, any reduction in credit availability would be most acute for borrowers from traditionally underserved communities, where mortgage companies have a particularly high market share.

Even before the pandemic, regulators had widely recognized that the oversight and regulatory infrastructure for mortgage companies is much less well developed than for banks, and it could benefit from an update. To that end, Ginnie Mae announced new requirements for its servicers last year; the FHFA announced that it will propose updated minimum financial eligibility requirements for the GSE loan sellers and servicers; and,

[6] The data are from Mortgage Bankers Association (2020), MBA's Weekly Forbearance and Call Volume Survey, November 9.

more recently, the Conference of State Bank Supervisors proposed a set of prudential standards for state oversight of nonbank mortgage servicers.[7] And, finally, the Financial Stability Oversight Council has been working closely with regulatory agencies to analyze risks related to nonbank servicers and to facilitate coordination among agencies.[8]

An encouraging feature of all of these proposals is that they recognize the complexity of the mortgage company regulatory structure. The states are the primary regulators, but most large mortgage companies operate in multiple states and are also subject to counterparty requirements from the GSEs and Ginnie Mae. These proposals have all moved toward being more consistent with each other, which should reduce regulatory complexity and burden for mortgage companies and regulators.

The harder task, however, is thinking about what the overarching regulatory framework should be for mortgage companies. The risks that mortgage companies face are different from those that banks face. Mortgage companies will be more affected by shocks to the mortgage market than banks, which have much more diversified portfolios. As I have mentioned, mortgage companies have less access to liquidity than banks; at the same time, they do not pose the risk of a claim on the deposit insurance fund. These

---

[7] See Ginnie Mae (2019), "All Participant Memorandum (APM)," webpage (Washington: Ginnie Mae, August 22), https://www.ginniemae.gov/issuers/program_guidelines/Pages/mbsguideapmslibdisppage.aspx?ParamID=100; Federal Housing Finance Agency (2020), "FHFA to Re-Propose Updated Minimum Financial Eligibility Requirements for Fannie Mae and Freddie Mac Seller/Servicers," news release (Washington: FHFA, June 15), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-to-Re-Propose-Updated-Minimum-Financial-Eligibility-Requirements-for-Fannie-Mae-and-Freddie-Mac-Seller-Servicers.aspx; and Conference of State Bank Supervisors (2020), "Comments Requested: Prudential Standards for Non-Bank Mortgage Servicers" (Washington: CSBS, September 29), https://www.csbs.org/policy/research-data-tools/comments-requested-prudential-standards-non-bank-mortgage-servicers.

[8] See Financial Stability Oversight Council (2020), "Minutes of the Financial Stability Oversight Council: March 26, 2020" (Washington: FSOC), https://home.treasury.gov/system/files/261/March_26_2020.pdf.

factors suggest that the optimal regulatory framework for mortgage companies should differ from that of banks.

These are difficult questions, and a casual observer might wonder if it is really necessary to grapple with them, especially as the industry appears to have successfully weathered the strains of the past few months. But I would argue that this "success" was reliant on rising home prices, low defaults, and massive fiscal and monetary stimulus. But we certainly can't count on all of these factors being present in future periods of economic stress.

Around the world, regulators are deliberating about how to address a variety of nonbank entities that can pose systemic risks. In work published last week, the FSB highlighted the need for a macroprudential approach to nonbank financial intermediation.[9] Members of the FSB are not calling for bank-like regulation for nonbanks, but they recommend a framework of supervision and regulation that takes into account systemic risks that can be posed by nonbanks.

I would also note one lesson we learned in March, which is that conditions in financial markets can deteriorate very rapidly and unexpectedly. I'm paying close attention to the issues highlighted in my remarks today, and keeping an open mind. But I think it's clear, that doing the hard thinking and planning now—at a time when conditions afford us the time do so—is a very worthwhile investment. Our financial system and our mortgage market will be more resilient when they welcome and appropriately manage the risks associated with both bank and nonbank mortgage firms.

---

[9] See Financial Stability Board (2020), *Holistic Review of the March Market Turmoil* (Basel, Switzerland: FSB, November 17), https://www.fsb.org/2020/11/holistic-review-of-the-march-market-turmoil.