MAYER | BROWN

November 23, 2020

Legal Update

SEC Report Underscores the Interconnectedness of the U.S. Residential Mortgage Credit Markets

When John Donne wrote the famous book, *No Man is an Island*, he most certainly wasn't thinking about residential mortgage credit. But the idea of interconnectedness has universal applicability and lies at the heart of the SEC's newly released report titled "U.S. Credit Markets Interconnectedness and the Effects of the COVID-19 Economic Shock." This report, issued on October 14, 2020, describes in detail the stresses experienced by the credit markets immediately following the shutdown of the U.S. economy in early March 2020 in response to COVID-19. The report is thorough and data driven. It identifies a cohort of approximately $54 trillion of credit issued and outstanding in the U.S. financial system at the end of 2019 and traces the flow of that credit through various intermediaries during the period of time studied by the report. The data in the report supports a widely-held view that credit markets are interdependent, directly linked through a myriad of complex, interconnected transactions.

The report studies several different markets to illustrate their level of interconnectedness, namely, (i) short-term funding markets, (ii) corporate bond markets, (iii) leveraged loans and CLO markets, (iv) municipal securities markets, (v) residential mortgage markets and other consumer lending markets and (vi) the commercial mortgage markets. With respect to each of these markets, the report examines COVID-19-induced stresses of different types, which fall into three categories.

1. *Short-term funding stresses*: These are stresses caused by a sudden and immediate demand for liquidity in the short-term funding markets.
2. *Markets structure/liquidity-driven stresses*: These are stresses caused by an elevated demand for financial intermediation in the context of constrained capital and risk limits. Liquidity constraints were a limiting factor in the volume of trades that regulated intermediaries (specifically broker-dealers) could undertake when trading volumes spiked during the initial COVID-19 shutdown hindering their ability to be a countercyclical force in the market.
3. *Long-term credit stresses*: These are longer-term stresses from COVID-19, which may still be unfolding. Examples are building stress in the commercial real estate and leveraged loan markets. The health of financial intermediaries, which have significant holdings of these assets, will be highly correlated to the ultimate performance of these assets.

For this alert, we have chosen to focus on the aspects of the report that discuss the residential mortgage credit markets.

A. Changes in the Mortgage Credit Markets

As many of us who observe the residential mortgage credit markets know, the early days of the March 2020 COVID-19 lockdown produced tremendous challenges for non-bank entities that owned residential mortgage credit in the form of securities and loans and that depended on short-term funding to finance their assets. Mortgage REITs were impacted heavily by these market conditions, but so were non-bank mortgage originators and private credit funds, which originate and invest in residential mortgage credit.

The SEC report highlights the evolution of the non-bank mortgage intermediaries as a key reason for the COVID-19-related stress in the mortgage credit markets. Currently, 70% of mortgage loans are originated by non-bank mortgage originators. While banks have access to liquidity from deposits to fund their mortgage origination activities, non-bank mortgage originators do not have that source of liquidity and, therefore, must depend on the short-term repo markets for funding. Similarly, mortgage credit assets are increasingly held by mortgage REITs, which grew significantly after the 2008 subprime credit crisis from $168 billion in assets in 2009 to almost $700 billion in assets in 2019. The concentration of mortgage credit assets in the hands of mortgage REITs and other entities that depend on short-term repo funding to fund long-term assets exacerbated the impact of the COVID-19 shocks in the mortgage credit markets. The SEC report also points out that changes in the value of highly leveraged credit-linked securities, or "CRT," which are owned by many mortgage REITs, were directly correlated to the negative performance of the mortgage credit markets, potentially increasing the severity of the stress experienced by the mortgage credit markets in March 2020.

B. COVID-19 as a Triggering Event

In the early days of the COVID-19 crisis, the lack of certainty about future economic conditions and the scattered consumer payment relief policy initiatives among federal, state and local regulators that were often in conflict with one another drove severe and sharp declines in the value of mortgage credit assets. In an effort to deliver assistance to U.S. consumers who were increasingly losing their jobs and being furloughed as employers scaled back or shut down operations, the federal government and state governments announced legally mandated forbearance periods for the enforcement of residential mortgage loans. These legislative initiatives and executive orders were intended to bring quick and immediate relief to affected borrowers, providing very few hurdles for borrowers seeking relief to qualify for the various forbearance programs. As a result, anticipated and actual mortgage delinquencies increased quickly, causing the mark-down of mortgage credit assets. At about the same time, the Federal Reserve restarted a quantitative easing program to deliver stimulus to the economy and increase liquidity to the credit markets during a time of sudden need. Many of the bond purchasing programs created in the 2008 subprime credit crisis were reactivated, increasing demand for credit securities and, therefore, rapidly raising prices for those securities, including mortgage-backed securities issued or guaranteed by the Government Sponsored Enterprises ("GSEs") Fannie Mae and Freddie Mac, as well as by Ginnie Mae (collectively, "Agency MBS").

Along with mortgage REITs, the non-bank residential mortgage loan originators immediately felt the impact of these two events. Mortgage loans made and held in inventory by non-bank mortgage originators pending securitization or delivery to GSEs were marked down by the lenders that financed those loans on short-term repo facilities, triggering margin calls. When the Federal Reserve bond buying programs were resurrected causing prices of Agency MBS to rise rapidly, hedging arrangements used by these non-bank mortgage originators to hedge their pipeline of mortgage loans immediately dropped in value. This produced a separate set of margin calls that, when combined with the margin calls on the short-term warehouse facilities for mortgage loans, produced a sudden liquidity crisis for the non-bank mortgage originators.

Requests for relief, although reasonable, were difficult for repo lenders and hedge counterparties to grant, because they, too, were experiencing similar margin calls or write-downs of mortgage credit positions on their books, illustrating the interconnectedness of the mortgage credit markets. Although broker-dealers, for example, were sympathetic to non-bank mortgage originators' requests for more time to meet margin calls on hedging arrangements, they were unable to grant the requested extensions because of corresponding and interconnected transactions they had entered into. Similarly, mortgage REITs, facing margin calls, tried to convince their repo lenders to forego or reduce margin calls until the mortgage credit markets were able to reach more certainty on the true impact of the COVID-19-related forbearance initiatives. For margin calls made and enforced, the credit impact of the write-downs created a negative feedback loop; as holders of mortgage credit sold securities and loans into an illiquid market to meet margin calls, they drove prices lower, increasing the margin calls. The SEC report acknowledges this phenomenon and attributes additional stress to the lack of buyers in the Agency MBS market. Agency MBS buyers and market-makers are predominantly broker-dealers. However, the SEC report suggests that liquidity requirements, among other constraints, limited their trading capacity and their capacity to build inventories, which significantly undermined their ability to serve as market-makers at a time when large quantities of mortgage credit assets were being sold into the market. This is why the Federal Reserve's bond buying program was so important, even though it caused short-term stress on the non-bank mortgage originators that hedged their pipelines of mortgage loans.

Interestingly, the SEC report only gives passing mention to non-bank residential mortgage servicers, which have a unique role in the mortgage markets. Not only are they tasked with the responsibility of processing mortgage payments and working out COVID-19-related forbearance plans with borrowers, they are also mortgage credit holders to the extent that they own mortgage servicing rights and fund mortgage servicing advances. This is an interesting dynamic not replicated in other service industries. Mortgage servicers must not only be excellent operators, but they must also be astute financial managers. Mortgage servicing rights represent the right to a fixed payment on each mortgage loan in a pool of serviced mortgage loans. This right to payment is in excess of the cost of servicing and, therefore, has value and trades in the market. Because mortgage servicers don't receive payment of this amount on delinquent loans but are still required to service them, the value of mortgage servicing rights can drop severely in anticipation of a long period of elevated mortgage delinquency. An expectation of elevated delinquencies that reduces the value of mortgage servicing rights can produce liquidity strains for servicers, many of which depend on short-term funding arrangements to finance their ownership of mortgage servicing rights.

Similarly, mortgage servicers are responsible for making advances of principal, interest, taxes, insurance and other payments on delinquent mortgage loans in order to keep MBS payments current and to protect the related mortgaged properties from losses and claims. These advancing obligations generally are first supported by prepayments on other mortgage loans in the pool of serviced mortgage loans for principal and interest advances, but, to the extent that prepayments are insufficient to fund the monthly payments on delinquent mortgage loans, the mortgage servicer must come out-of-pocket or turn to third-party financing sources to fund advances. Funding advances on Agency MBS with third-party lenders is especially complicated, requiring the cooperation of the GSEs.

C. Conclusions of the SEC Report and Possible Solutions

The SEC report does not propose solutions to these past, present and emerging problems. It was not written to do so. It was intended to demonstrate the interconnectivity of the financial markets and, as a result, the exponential impact that a shock like COVID-19 can have throughout the system. The credit markets are analogous to a collection of interconnected circuits that may individually function but can produce an overall system failure if one or more of the circuits in the system malfunction. This result is magnified from the 2008 subprime credit crisis because of changes in the size, structure and function of the U.S. credit markets, which now depend more heavily on non-bank owners of credit and financial intermediaries. This is particularly true for the mortgage credit markets. The SEC report notes that, as of August 20, 2020, 7.4% of residential mortgage loans were in forbearance (although this percentage has been dropping recently) and concludes that, if mortgage delinquencies increase from that level going forward (which could happen as government support programs for small business, in particular, expire), it would escalate the financial stress for non-bank mortgage originators, owners of mortgage credit assets and non-bank mortgage servicers, and that stress would flow through the financial system given its interconnectivity.

The SEC report is rightly complementary of the bond buying programs restarted by the Federal Reserve to mute the impact of the stress in the credit markets, particularly the short-term funding markets. The report identifies securitization as a strength of the mortgage credit markets because it eliminates the mark-to-market and extension risk of short-term repo funding. This is an accurate observation, but it only holds true to the extent that those mortgage-backed securities ("MBS") are not themselves funded with short-term repo financing, which is how most non-bank holders of MBS, such as mortgage REITs and credit funds, finance their holdings of MBS.

Bond buying programs and other similar measures that add liquidity to the interconnected credit markets when it is most needed are an effective way to address temporary market dislocations of the type experienced shortly after the COVID-19 shutdown. Situational problems require situational solutions, such as the bond buying programs, that can be easily calibrated to the duration and severity of the problem. Unimaginative and inflexible solutions, like imposing leverage limits on mortgage REITs, for example, are attractive in theory but not ideal. They are blunt tools that may prevent future liquidity challenges, but, at the same time, they may unintentionally stunt the growth of the mortgage credit markets at a time when banks have exited the markets and non-bank capacity is needed to support consumer demand.

We think, however, the role the non-bank mortgage servicers play in the mortgage credit market was underplayed by this report. These are the entities tasked with the frontline work of collecting payments and working out forbearance plans with affected consumers, but, at the same time, they do not get paid for this work, because servicing fees are not paid on delinquent, non-remitting mortgage loans. Non-bank mortgage servicers now make up more than half of the mortgage servicing market, which is a significant change from the 2008 subprime mortgage crisis. Non-bank mortgage servicers use the mortgage credit markets to fund the financial obligations that go along with mortgage servicing, namely, owning mortgage servicing rights and making advances for delinquent loans. Creating and developing coordinated government crisis support programs to help non-bank mortgage servicers fund mortgage servicing rights and advances is necessary for the stable and proper functioning of the residential mortgage credit markets going forward, particularly following an economic shock similar to COVID-19. Expecting the banks to jump back in to pick up the slack, absent significant regulatory reforms, doesn't account for their regulatory capital impediments to holding mortgage servicing rights and their general hesitation to own them again as a result of the losses and reputation or harm they suffered from the asset during the 2008 subprime credit crisis.

We applaud the SEC's effort to put the data out in a comprehensive report and expect that this first step will lead to further action toward mitigating the effects of a future economic shock similar to COVID-19. The report intentionally leaves its readers with the open question of how contingency plans should be made for future events given the changing nature of the credit markets and the increasing participation by non-bank intermediaries. Over the coming weeks and months, we expect that market observers, regulators, including the Financial Stability Oversight Council, and participants will attempt to answer these and other questions posed by the report.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Andrew Olmem
+1 202 263 3006
aolmem@mayerbrown.com

Anna Pinedo
+1 212 506 2275
apinedo@mayerbrown.com

Laurence Platt
+1 202 263 3407
lplatt@mayerbrown.com

Jon Van Gorp
+1 312 701 7091
jvangorp@mayerbrown.com

The Free Writings & Perspectives, or FW&Ps, blog provides news and views on securities regulation and capital formation. The blog provides up-to-the-minute information regarding securities law developments, particularly those related to capital formation. FW&Ps also offers commentary regarding developments affecting private placements, mezzanine or "late stage" private placements, PIPE transactions, IPOs and the IPO market, new financial products and any other securities related topics that pique our and our readers' interest. Our blog is available at: www.freewritings.law.

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our "one-firm" culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Any tax advice expressed above by Mayer Brown LLP was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. federal tax penalties. If such advice was written or used to support the promotion or marketing of the matter addressed above, then each offeree should seek advice from an independent tax advisor.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices") and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies"). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown. © 2020 Mayer Brown. All rights reserved.