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Opinion Mortgage credit markets need new government support programs

By Jon Van Gorp, November 10, 2020

A recent Securities and Exchange Commission report supports the conclusion that new programs are needed to better address the next event-driven mortgage credit crisis arising from future economic shocks similar to COVID-19. The data-driven report shows how the concentration of mortgage credit assets owned by nonbank entities exacerbated the impact of the COVID-19 market shock.

Currently, 70% of mortgage loans are originated by nonbank mortgage originators. Similarly, mortgage credit assets are increasingly held by mortgage REITs, which grew significantly after the 2008 subprime credit crisis, increasing from $168 billion in assets in 2009 to almost $700 billion in assets in 2019. This trend of mortgage credit moving away from banks will continue.

While the reactivated bond buying programs from the 2008 subprime credit crisis helped contain the COVID-19-related market dislocation, new programs are needed to better address the next event driven mortgage credit crisis that will likely occur when an even higher percentage of mortgage credit assets are owned by non-bank entities.

In the early days of the COVID-19 crisis, the federal government and the states announced legally mandated forbearance periods for the enforcement of residential mortgage loans. As a result, anticipated and actual mortgage delinquencies increased quickly, and mortgage loans financed on short-term repo facilities were marked down, triggering margin calls. Requests for relief, although reasonable, were difficult for lenders 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.

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 mortgage credit market stress to the lack of buyers in the market. In response, 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 Fannie Mae and Freddie Mac, as well as by Ginnie Mae.

The SEC report is rightly complementary of the bond buying programs that added liquidity to the credit markets when it was needed the most to address a temporary market dislocation. Situational problems require situational solutions that can be easily calibrated to the duration and severity of the problem.

Unimaginative and inflexible solutions to mute the impact of market dislocations, such as imposing leverage limits on mortgage REITs, for example, are attractive in theory but not ideal. They are blunt tools that may lessen future liquidity challenges from market dislocations, 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 growing consumer demand.

One of the biggest drivers of COVID-19-related market dislocation was the lack of clarity on and coordination of consumer payment relief plans at the federal, state and local level. Generally, states have had carte blanche to design their own uncoordinated forbearance and foreclosure laws and increasingly they use that unfettered authority, for example, to add consumer protection-type conditions to the commencement or finalization of foreclosure, generally increasing and adding uncertainty to the timeline for resolving defaulted mortgage loans. We must develop a coordinated national consumer credit relief program that can be activated like the bond buying programs for future economic shocks similar to COVID-19.

The SEC report underplays the role of the nonbank mortgage servicers in the mortgage credit market. 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, nonremitting mortgage loans.

Nonbank mortgage services use the mortgage credit markets to fund the financial obligations that go along with mortgage servicing, namely owning mortgage servicing rights and making advances. We must develop coordinated government crisis-support programs to help nonbank mortgage servicers fund mortgage servicing rights and advances. These programs are necessary for the stable and proper functioning of the residential mortgage credit markets going forward, particularly following an event driven economic shock.

Expecting the banks to jump back in to pick up the slack is not the solution. It doesn't account for their regulatory capital impediments to holding mortgage servicing rights and their general distaste for the asset as a result of the heat they took during the 2008 subprime credit crisis.

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