Ginnie Mae

Report on Issuer Liquidity Meeting Series

February – April 2019

TABLE OF CONTENTS

Executive Summary: Top Non-Bank Liquidity Reviews 3

Key Conclusions 3

Next Steps 5

Overview 5

General Observations 7

General Conclusions 10

EXECUTIVE SUMMARY: TOP NON-BANK LIQUIDITY REVIEWS

Ginnie Mae held liquidity meetings with its top 13 non-bank Issuers, representing 75% of the non-bank Ginnie Mae securities outstanding.

At Ginnie Mae's request, the top non-bank Issuers in our program presented Ginnie Mae with information on their current operational state, key priorities, corporate ownership and financial structure, and an evaluation of how their business would fare in a stressed scenario. This is critically important to Ginnie Mae because the agency is reliant on Issuer solvency as capital buffer behind the Ginnie Mae guarantee as a means to protect the agency's reserves and taxpayer liability.

This series of meetings was completed in conjunction with Ginnie Mae's efforts to evolve its counterparty risk framework with a focus on ensuring that the largest participants in the program have the liquidity and other resources necessary to operate through all economic cycles.

This report details our observations of the meetings and identifies the following key conclusions.

KEY CONCLUSIONS

1. **Current situation appears healthy; liquidity management standardization is still evolving.**

   The meetings did not provide indications of systemic liquidity challenges across the non-bank finance industry in the current economic state. While this provides comfort to some degree, we would expect that to be the case given the economic expansion over roughly the last decade.

   In general, there is a competitive market for financing and, though there are variations in analytic capabilities, Issuers have developed reasonable methods of evaluating the need for liquidity and are proactive about providing for it.

   That said, the growth-stage nature of the industry in recent years is evident in the lack of consistency in how liquidity issues are addressed from firm to firm. We would look for this to evolve as the post-crisis industry matures.

2. **No two non-bank Issuer business models are alike.**

   Given the attention to the bank/non-bank distinction, it is easy to overlook the wide variety of business approaches that are employed within the non-bank arena. This diversity in key areas such as origination/servicing, hedging, financing and MSR ownership strategies was highly evident throughout the meetings.

3. **Depositories have exited the direct lending mortgage business, yet they are the indirect backbone of the mortgage finance ecosystem.**

   While the composition of financial institutions in mortgage finance has clearly tilted toward non-bank, non-depository lenders since the 2008 financial crisis, there are two sub-trends that have emerged in the background. Investment funds and traditional banking financiers have become the predominant sources of funding for debt and equity capital among non-banks. Traditional depository banking institutions remain a pivotal part of the mortgage finance ecosystem by providing the warehouse or other facilities for Issuers.

4. **Continuing need to guard against incipient risk.**

   A healthy current state of industry liquidity is not, however, a sufficient bulwark against future disruption. Ginnie Mae understands that while the diversity of business models is to some extent a mitigant against widespread failure, the speed with which conditions can change must be held in mind, underlining the fact that additional efforts concerning recovery and resolution planning for large non-bank Issuers are necessary.

5. **MSR portfolio quality is of utmost importance.**

   While Ginnie Mae will continue to address risk/liquidity issues in a number of different ways, our paramount concern is the quality of the individual Issuer MSR portfolios that are the collateral for our guaranty. It is crucial we continue to closely monitor the quality of individual Issuer MSR portfolios as the valuations of these assets—which remain dependent on key economic factors such as interest rates—largely comprise the collateral for Ginnie Mae's guaranty coverage in the event that the agency was to extinguish an Issuer.

> **Traditional depository banking institutions remain a pivotal part of the mortgage finance ecosystem.**

6. **Opportunity for collaboration among governmental entities exists.**

   The liquidity meetings highlighted the need for collaboration among the mortgage agencies[1] and federal and state regulatory entities that have an interest in residential finance risk and liquidity. In the absence of a clearly defined and systemic regulator, these parties should align efforts to ensure a cohesive, commonly understood framework exists for the regulatory oversight and monitoring of liquidity sufficiency in the U.S. housing system.

1 Meaning Fannie Mae, Freddie Mac and Ginnie Mae, who, though not technically regulators, exercise significant authority over lenders and servicers through the administration of their respective MBS programs.

NEXT STEPS

Ginnie Mae considers this initial round of Issuer liquidity meetings to have been constructive to better understanding the current landscape, possible risks that could arise in a time of stress and current contingency plans for a downturn in the economy. This is likely the first of a regular (and more prescriptive, on the part of Ginnie Mae) exercise with the largest participants in the Ginnie Mae program.

From a policy perspective, Ginnie Mae will be providing a thorough update in the *Ginnie Mae 2020* progress report, which is expected to be released in early June 2019, ahead of the Ginnie Mae Summit.

OVERVIEW

Ginnie Mae's June 2018 white paper *Ginnie Mae 2020* outlined the strategic objectives which provided a multi-year management vision which continues to guide the agency's management and policy. The *Ginnie Mae 2020* report addressed the importance of ensuring adequate liquidity and funding capabilities for Ginnie Mae Issuers, primarily meaning the ability of the Issuers, whose securities Ginnie Mae has guaranteed, to access and maintain the capital needed to fulfill their responsibilities under the Ginnie Mae mortgage-backed securities (MBS) program. The paper cited concerns that the housing finance industry had become increasingly vulnerable to a liquidity crisis[2] as a result of changes to the composition of the firms that originate and service mortgage loans, particularly the loans that are insured or guaranteed by agencies of the federal government.

It is worth reiterating that the obligations in the Ginnie Mae program are, in most respects, greater than those of the government-sponsored enterprises (GSEs). The most fundamental Issuer obligation is the remittance of scheduled principal and interest payments to MBS investors on time and in full, even if the mortgage borrower fails to make the mortgage payment. There is no time limit on this obligation, and the only alternative to this advance requirement is to exercise the option to buy the loans out of pools after 90 days of delinquency.

In the interest of advancing Ginnie Mae's understanding of industry liquidity issues, Ginnie Mae's Chief Risk Officer sent a letter (see exhibit) to Ginnie Mae's 14 largest non-bank Issuers in October 2018, requesting a series of bilateral conversations focused on the topic of maintaining

2 See for example: Kim, You Suk, Steven M. Laufer, Karen Pence, Richard Stanton, and Nancy Wallace. 2018. "Liquidity crises in the mortgage market." BPEA Conference Draft, Spring 2018.

sufficient liquidity in a climate of worsened economic and housing market conditions. The letter identified specific strategies that would be reviewed in the conversation, including current operational priorities, financing structure and the ability to withstand a downturn.

The Issuer meetings, which were held in February and March 2019,[3] were informational and largely for the edification of Ginnie Mae. They were not predicated on any specific concerns beyond the general theme stated above, nor were they driven by a pre-existing policy agenda. Participation in the meetings included representation from Ginnie Mae's Office of Issuer and Portfolio Management, Office of Enterprise Risk, and Office of Securities Operations, as well as other leadership at the U.S. Department of Housing and Urban Development (HUD), namely from the Federal Housing Administration (FHA) and the Office of the Secretary.

In Ginnie Mae's view, the meetings accomplished their intended purpose by illustrating the thinking, planning and active management among its large non-bank Issuers in addressing the current mortgage industry landscape and liquidity needs across market cycles. In order to bring additional transparency to the process and the result of the sessions, this paper serves as Ginnie Mae's summary of observations and key outcomes from the meetings and is being published to increase broader awareness. From a policy standpoint, Ginnie Mae's direction will be covered in more detail in the *Ginnie Mae 2020* progress report paper that will be published in June, ahead of the 2019 Ginnie Mae Summit in Washington D.C.[4]

In general, our findings from the meetings were favorable and our intention is to make these a regular part of Ginnie Mae's risk management and Issuer relationship process. Only through such direct, ongoing engagement with the largest program participants can Ginnie Mae develop and maintain a robust understanding of the diversity of business models and practices within the MBS program. This engagement also illustrates that the MBS program is structured in a manner that permits and fosters a wide range of competitive models while providing MBS product offerings to investors that are attractive for their value, diversification and liquidity. The Ginnie Mae MBS guaranty model supports a diverse and competitive market in mortgage origination, securitization and servicing which translates into a tangible benefit for the borrowers the program was designed to serve.

This engagement also illustrates that the MBS program is structured in a manner that permits and fosters a wide-range of competitive models while providing MBS product offerings to investors that are attractive for their value, diversification, and liquidty.

3 There were 13 meetings in all, because one of the original 14 recipients was acquired shortly after. The basis for determining who received letters was purely the size of the outstanding Ginnie Mae MSR portfolio.

4 See https://www.ginniemae.gov/summit/Pages/default.aspx for more information on the Summit.

GENERAL OBSERVATIONS

1. **Model and Management Approach Diversity**

   In the attention given to the distinction between banks and non-banks, it is easy to overlook the wide variety of business approaches that are employed within the non-bank arena. This diversity was highly evident in the liquidity meetings. Among the more noteworthy examples:

   a. **Core business model.** The 13 firms vary widely in the extent to which their primary activities are allocated among loan origination activities, mortgage servicing rights (MSR) asset investment, and MSR asset servicing. These strategic business process decisions represent key drivers of the differences in the organization and business operations and mean that they will not be affected uniformly by the various risk scenarios that impact the residential finance industry.

      - Issuers were asked to address their ability to adjust expense levels in response to changes in origination volume. Some Issuers discussed steps they have recently taken to downsize their organization in response to volume decreases and margin compression experienced over the last twelve months. Other Issuers, by contrast, emphasized their reliance on a variable-cost business model in which volume was controllable by pricing, and could be rapidly curtailed if it became unprofitable or unpalatable from a cash-flow standpoint, with little impact on their organization.

      - At one end of the range of Issuer profiles are those whose focus is entirely the profitability of their MSR assets, and who are relatively immune to changes in market activity but may have even heightened sensitivity to interest rate movements.

      - Across the board, competition remains fierce. A majority of the participants noted that they are looking to acquire additional MSRs, potentially creating an opportunity for acquisitions of servicers that were too thinly capitalized. For Ginnie Mae, this was affirmation that these Issuers are likely to grow even larger. Ginnie Mae has been, and must remain, cognizant of the implications of heavy exposure to any one counterparty or a few mega counterparties.

   b. **Hedging.** Given the commonality of sizable MSR portfolios, the diversity of approaches to MSR hedging among the Issuers was noteworthy. To many of the Issuers, a full-scale hedging program was an integral aspect of their risk management program, while others only conduct limited purpose hedging or eschewed financial hedging altogether. The corollary to this is that the traditional “macro hedge” – relying on origination gains to offset MSR valuation losses, or vice versa – is central to some Issuers, and completely irrelevant to others. Some meeting participants made a point of noting that their profitability was more sensitive to their hedging operations than even origination or delinquency levels.

c. **MSR transacting.** An important point of distinction among the different Issuers is the varying extent to which they are dependent on being able to sell MSR portfolios to execute their business plans or improve liquidity in a time of strain. Among the Issuers included in the liquidity meetings, the spectrum ranged from the handful of those whose approach is to regularly transact from their portfolios (whether to adjust the portfolio profile or to raise cash) to at least one who does not ever expect to sell servicing, and would not be threatened by the disappearance of the secondary market for MSRs (beyond the difficulty of providing for portfolio growth).

2. Sources of Capital

A similar observation is that the changing bank/non-bank equation is more than just the swinging of the pendulum from dominance by commercial banks to dominance by mortgage banks that is commonly noted. Two sub-trends that were particularly apparent from the Issuer liquidity meetings are worthy of note and further examination.

a. **Investment funds.** As is evident from the ownership structure of the firms involved in these meetings, the trend toward non-bank dominance since the Great Recession has largely been financed by private equity or other types of investment funds, who have infused billions of dollars of capital through either direct ownership in the operating companies, or the financing/ownership of MSRs. This transformative shift in the industry's capitalization has been accomplished relatively smoothly thus far, and there is evidence of an enhanced level of rigor that appears attributable to sophisticated capital partners. That said, additional progress needs to be made in the ability of Ginnie Mae, and perhaps other governmental entities, to provide appropriate oversight of non-traditional ownership structures.

- Some non-banks are entirely or almost entirely a construct for fund investment in MSRs, for example. In several other cases, fund owners directly control the firm and oversee the current management team. Even among the firms that conduct a full range of activities using an owner/operator model, most have been the subject of substantial fund investment as a supplement to owner/operator capital. The few publicly held companies in this group are also marked by the ownership of significant share positions by large, sophisticated funds.

- Fund investments are often made through intermediary pools of capital that are segregated from one another even when they are traceable back to some form of common sponsorship. While this is a logical and efficient way of structuring investments from the standpoint of fund managers, it is also opaque and challenging from the perspective of governmental entities with oversight responsibility.

b. **Bank financiers.** Commonly cited figures (including by Ginnie Mae) showing trends in the allocation of market share among banks and non-banks are only part of the changing lender landscape. The commercial bank presence in residential finance overall has not shrunk as much as it might seem because, to some extent, it has merely transitioned from the form of direct origination/servicing/MSR ownership to the financing of these activities by non-banks. As the non-bank share of these activities has risen, so has the sum of warehouse lines and MSR/servicing advance facilities that are largely provided by commercial banks.

    - It would be useful to have an analysis of the extent to which commercial banks have merely shifted the form of their exposure to residential finance activities. Ginnie Mae has some valuable views into this subject, but presently lacks the ability to construct a useful understanding of it from a systemic standpoint.[5]

As a result of the critical financing role played by banks, bank regulators maintain a significant role despite the housing finance system having become increasingly dominated by non-banks. An erosion of credit standards, or a shift in the availability or relative terms of financing, might be most readily apparent through bank examination channels.

To summarize, the liquidity meetings brought into focus the fact that one way the bank to non-bank transition can be understood is as a shift in the financing of residential mortgage lending to a state that is now much more reliant on investment funds committing long-term capital in a variety of ways, partnered with commercial banks acting as generally secured lenders to the operating firms. Regulators and programmatic overseers should have this in mind as they shape future policy and enforcement frameworks.

5 "Liquidity crises in the mortgage market" asserted that "researchers…monitors and regulators…do not have the information needed to assess the risks of this sector."

GENERAL CONCLUSIONS

1. **Current Situation Appears Healthy; Liquidity Management Standards are Still Evolving**

   The meetings did not provide indications of systemic liquidity challenges across the non-bank finance industry in the current economic state. While this provides comfort to some degree, it is to be expected given the economic expansion over the last ten years. The expectation of a changing climate, coupled with Ginnie Mae's awareness that few of the meeting participants were of any meaningful size (or even in existence) during the financial crisis, was one of the main drivers of the meeting requests.

   In general, there is a competitive market for financing, and, though there are variations in their analytic capabilities, Issuers have developed reasonable methods of evaluating the need for liquidity and are proactive about providing for it. That said, the growth-stage nature of the industry in recent years is evident in the lack of consistency in how liquidity issues are addressed from firm to firm. We would look for this to evolve as the post-crisis industry matures.

   a. **Warehouse lending.** The state of warehouse lending is healthier than anticipated, particularly given the recent margin pressure on non-bank Issuers. Among the banks offering warehouse facilities, there is strong competition for providing this core (to originators) financing, and Issuers have diversified sources that they are managing effectively. Today, most Issuers have a half dozen or more lenders, staggered facility expiration, and considerable undrawn capacity. There has been some lengthening of facility durations (beyond one year), which is a plus, although opinions among the Issuers about the importance of this feature is varied. Lending covenants don't seem onerous although this is something Ginnie Mae and regulators should monitor so that the trend does not go too far in the accommodative direction.

   b. **MSR financing.** Ginnie Mae broadly defines MSR financing to include asset, advance and EBO financing. This is an area that has evolved meaningfully over the last five years, and credit facilities that are based on the value of the MSR asset are now commonplace for Ginnie Mae non-bank Issuers. Most noteworthy is the fact that the GMSR securitization structure, first deployed in 2017, now covers over 20% of the Ginnie Mae single family portfolio serviced by non-banks. The institutional investors that participate in this structure number in the dozens, with investment capital committed exceeding $2 billion and investment terms of up to five years. Ginnie Mae's efforts to support advance financing will be discussed in the *Ginnie Mae 2020* progress report. EBO (early buyout) financing likewise seems accessible to the extent necessary to execute buyouts of delinquent loans from Ginnie Mae pools.

c. **Best practices.** As mentioned, there is a lack of consistency in how firms seem to be evaluating their liquidity positions. Ginnie Mae did not stipulate specific topics to be covered at the meetings (other than at a very high level), or methods of presentation, and the materials provided in the meetings reflect the fact that there is little in the way of a common liquidity management framework that extends across Issuers. Developing best practices in this area should be a collaborative effort among industry and government in the coming phases of adjustment to the post-crisis environment.

2. Guarding Against Incipient Risk

A healthy current state of industry liquidity is not, however, a sufficient bulwark against future disruption. As a result of the liquidity meetings, Ginnie Mae offers three thoughts about sources of future risk.

a. **Business strategy.** In seeking to anticipate sources of counterparty stress or failure, Ginnie Mae believes that a likely cause of these, or at least a heavily contributing factor, will be poor strategic or tactical choices by individual Issuers, such as would be manifested in:

- Overleveraged or otherwise poorly-capitalized companies.
- Poor quality or poorly diversified MSR portfolios, or retention of too little servicing fee relative to the costs of servicing.
- Over-reliance on higher-risk business lines.
- Under-developed corporate governance and control functions.

On the program policy front, over the last 18 months, Ginnie Mae has made several modifications to its MBS Guide intended to illuminate areas it sees as potentially leading to excessive risk,[6] and support its efforts to preclude such risks from developing. Ginnie Mae expects this program policy development to continue.

b. **Changing market conditions.** Conditions can change rapidly and availability of liquidity can shrink with little warning. It was comforting to see that many of the firms participating in the liquidity meetings have begun to develop the ability to forecast how they would be affected by, and react to, stressed conditions, but as already noted these efforts take different forms and are largely unvetted by real-world occurrences. Ginnie Mae encourages similar efforts among the entire Issuer universe to understand the liquidity impacts of a period of greater stress. Ginnie Mae views this as one area where both Issuers and regulators should dedicate significant resources and develop enhanced analytic tools. For Ginnie Mae's part, an update will be provided on these efforts, particularly on stress testing, in the *Ginnie Mae 2020* progress report. It should not be underestimated how much work needs to be done on this front

6 Examples are the inclusion of acceptable risk parameter requirements and the imposition of a minimum servicing spread

c. **Need for recovery and resolution planning.** While perhaps unlikely in the current economic environment, the failure of any of the top Ginnie Mae Issuers would have significant impact on Ginnie Mae's operations, and, given the scale they have reached, potentially the housing finance market as a whole. In recent years, Ginnie Mae has dedicated significant resources to upgrading its capacity to handle Issuer failures. Just as the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) require systemically important financial institutions (SIFIs) to submit recovery and resolution plans, Ginnie Mae is moving toward developing requirements that would better position the agency to administer the threatened or actual failure of a large Issuer. This topic will be addressed at more length in the *Ginnie Mae 2020* progress report.

3. Top Focus: MSR Portfolio Quality

While Ginnie Mae will continue to address risk/liquidity issues in a number of different ways, our paramount concern is the quality of the individual Issuer MSR portfolios that are the collateral for our guaranty. For the health of the market, and ultimately to protect the government's interest in the event of a failure, these must have positive value. The program policy actions concerning risk alluded to earlier are intended to position Ginnie Mae to move rapidly when we see a deterioration in MSR values, and/or Issuer capitalization – or even just the threat of these. We will increase our emphasis on the relationship between the modeled value of an Issuer's MSR portfolio and its financial strength, and work to ensure that there is a greater understanding of this subject among our program participants. To this end, Ginnie Mae will focus on ensuring accurate and consistent data submission through MBFRF (the quarterly financial reporting system for mortgage bankers).

Our paramount concern is the quality of the individual Issuer MSR portfolios that are the collateral for our guaranty.

4. Collaboration Among Governmental Entities

The liquidity meetings highlighted the need for collaboration among the mortgage agencies and federal and state entities that have an interest in residential finance risk and liquidity. In the absence of a clearly defined and systemic regulator, these parties should align efforts so that a cohesive, commonly understood framework exists for managing risk and liquidity to the extent possible. One option may be for Ginnie Mae, FHFA and the consortium of state banking supervisors to coordinate in an advisory fashion within the FSOC framework. Ginnie Mae intends to be proactive about formulating approaches to foster a more integrated governmental approach.

Notwithstanding the differences in model and management approach, the liquidity meeting participants are all affected by the extent to which there is a liquid market for the transfer of MSRs. Ginnie Mae has a vested interest in working with the insuring/guaranteeing agencies whose loan programs are funded via the MBS program to ensure that their program terms support market liquidity to the extent possible.

5. Future Meetings

Ginnie Mae considers the 2019 round of Issuer liquidity meetings to have been a highly constructive and useful exercise. It is our intention to continue the practice, and likely in a more formalized fashion. Though no firm plans have been made, it is anticipated that such meetings would next occur in the spring of 2020. The 13 Issuers who participated in this year's session represent about 75% of the non-bank single family portfolio, and 50% of the single family portfolio as a whole – this level of coverage seems appropriate, and likely to be a basis for determining how many firms will be asked to participate in the future. With this year's meetings and presentations as a foundation, and given our plans for continued work on this subject over the remainder of 2019, it is likely that our meeting requests would be more prescriptive about material to be covered in 2020 than was the case this time.

Exhibit

Ginnie Mae
Our Guaranty Matters

Office of Enterprise Risk
425 3rd Street, SW, Fourth Floor
Washington, DC 20024
(202) 475-4914

Delivered via E-mail

October 31, 2018

[Addressee]
[Address]

[Sir/Madam]:

As Ginnie Mae's Chief Risk Officer, you don't often hear from me directly since your primary interface with our organization is the Office of Issuer and Portfolio Management. But as Ginnie Mae elevates its focus on counterparty risk, I am writing you (and your peer issuers) to begin a higher level of dialog between your organization and Ginnie Mae's Office of Enterprise Risk.

As you may have read in a recent blog I authored (available on our website), Ginnie Mae is increasing our focus on making sure our Issuers are positioned for success in any economic environment. This is a theme that was touched upon in our Ginnie Mae 2020 strategic paper authored by my colleague Michael Drayne (also available on our website). In Ginnie Mae 2020, Michael highlighted our underway Issuer stress testing initiative. This new analytical effort will generate its first set of Issuer level reports this winter. Our intention is to share the results with all of you and hope that these reports can generate fulsome discussions about your organization and how we can collaborate on ensuring your success under various economic environments.

To this end, given the challenging market we have already experienced in 2018, we expect that our Issuers are going through a similar internal exercise. As a means of laying the groundwork for our usage of a stress testing tool, we want to hear your thoughts about how your organization would adjust its strategies to deal with potentially decreasing origination volumes and gains, increasing delinquencies and potential interruptions to sources of liquidity. Within the next sixty days, we'd like you to prepare a report suitable for presentation, in person or over the phone, that highlights your thinking in these broad areas.

The discussion should at a minimum touch on the following topics:

- Strategies to right size expense levels commensurate with changes in origination volumes;
- Strategies to manage the liquidity demands that may arise from an increase in borrower delinquencies;
- Strategies to absorb realized losses resulting from uninsured exposures on insured loans (e.g. 60 days of interest on FHA loans, VA maximum claim amounts);

- Strategies to mitigate a potential lack of market liquidity for Ginnie Mae servicing rights; and
- Strategies to manage liquidity if existing lines of credit (including Warehouse, MSR, Early Buyout ("EBO") and Servicing Advances), secured debt and term loans are not renewed, not renewed at competitive rates or limits are reduced or held constant.

Please send your report to your assigned account executive. Given the pending holidays, we hope to schedule the meetings for some time in January. The meeting will include members of our senior team as well as the trusted faces you work with day to day as you navigate our program. Your account executive will work with you to schedule a time for the meeting.

We will use these presentations, and the dialogue about the initial stress testing modeling, as the basis for further policy development about risk and liquidity issues.

As always, we thank you for your partnership and look forward to a rich discussion. In the meantime, if you have any questions or concerns, please feel free to reach out to me at (202) 475-4918.

Sincerely,

Gregory A. Keith
Senior Vice President and Chief Risk Officer
Office of Enterprise Risk
Ginnie Mae