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REENGINEERING NONBANK SUPERVISION

Chapter Three: Overview of Nonbank Mortgage

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About This Paper

This paper, *Reengineering Nonbank Supervision*, serves two primary purposes. First, it is a stakeholder awareness document covering state supervision of the nonbank marketplace, and second, it is a change document, or roadmap, to assist state supervisors in identifying the current state of supervision and making informed changes to state supervisory processes. The paper is comprised of several standalone chapters that together will cover the industry supervised by state nonbank financial regulators, the existing system of supervision for nonbanks and the challenges and opportunities for state supervisors in "reengineering" that system.

In this chapter, CSBS covers the nonbank mortgage industry and supervision of the industry.

State financial regulators are the primary regulators of nonbanks operating within the United States. As the financial services ecosystem grows larger and more complex, state regulators are working together to leverage technology and their collective intelligence and resources to provide a robust regulatory structure that preserves local accountability. The result will be a more efficient, data-driven and dynamic state regulatory system – one that can respond quickly to changes. This paper contributes research and engages discussion on possible actions that might be taken.

This and future chapters will be available on the CSBS website here.

Acknowledgements

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The Conference of State Bank Supervisors (CSBS) is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia and the U.S. territories. State regulators supervise state-charted banks and are the primary authority governing nonbank financial services providers, including mortgage providers, money services businesses, consumer finance companies, payday lenders, check cashers and debt collection firms. Created in 1902, CSBS has for more than a century given state regulators a national forum to coordinate supervision and develop policy, provide training to state banking and financial regulators and represent its members before Congress and federal financial regulatory agencies.

Chapter Three

Overview of Nonbank Mortgage

Key Findings

- The U.S. single-family housing market is now valued at $36 trillion, with U.S. residential mortgage debt of $11.8 trillion and home equity at roughly $22 trillion.
- The current mortgage market relies almost exclusively on backing from the federal government, with funding and guarantees from federally supported entities (Fannie Mae, Freddie Mac and Ginnie Mae/FHA/VA) accountable for almost all new home loans.
- With roughly two-thirds market share, nonbank financial services companies are now the primary source of mortgage originations, a departure from prior eras in housing finance, and they also represent a growing source of mortgage servicing.
- Compared to depositories, nonbanks present different kinds of risk to financial regulators such as, but not limited to, greater dependence on third parties for liquidity, lower operating capital and lack of asset diversification.
- The Covid-19 pandemic presented unique economic characteristics, including surging home prices, high levels of unreported serious payment delinquencies, and a refinance boom that increased cash and capital positions for nonbanks
- State financial regulators oversee the mortgage industry through their statutory powers to license and supervise mortgage companies and, where necessary, take enforcement actions against bad actors

Overview of the Mortgage Industry

The category of nonbank mortgage companies covers an array of industry participants facilitating different parts of the residential[1] mortgage loan process. These participants can be categorized by a combination of business types and license types. The industry can be confusing because a single company may fit into several categories or may have affiliates or subsidiaries that fit into different categories.

A mortgage is defined as a secured loan collateralized by real property, such as land or a house. In a purchase transaction, the property is titled in the name of the purchaser/borrower, and a security interest is given to the lender in exchange for a purchase-money loan that is repaid in installments over time based on the terms of a promissory note. This enables borrowers (mortgagors) to use property sooner than if they were required to pay the full value of the property upfront, with the end goal being

[1] From this point forward, the term “residential” has been deleted for brevity.

that the borrower eventually comes to fully and independently own the property once the mortgage is paid in full. (Diffen, n.d.)

At the highest level, nonbank mortgage companies can be identified into the very broad sectors or functions of originator, servicer and investor. A short discussion of each follow:

Originator

An originator is the mortgage company that originates the loan, and in many cases, makes or funds the loan. This category encompasses the activity from the time a borrower applies for a loan until just before the borrower starts making payments on the loan. Commonly, an originator may solicit or advertise for the loan, take the application from the borrower and process the application documents to get them ready for approval, underwrite the borrower and loan application and approve the loan for funding, and fund or make the loan, which occurs through a process known as closing the loan, whereby legal documents are signed and monies change hands to complete the transaction.

When an originator serves all these capacities, it will do so through employees known as loan originators, processors, underwriters and sometimes closers. However, some companies may only provide part of the service associated with originating the loan. For example, a mortgage broker may employ loan originators and processors who perform all the services necessary for a loan package to be submitted to a lender for underwriting and approval. The transition of the loan application from company to company is efficient and, in many situations, the borrower may not even realize they are being serviced by two or more companies in the origination process. A deeper discussion of originators follows.

LEAD GENERATORS

Lead generators are intermediaries that collect customer information and forward it to suitable lenders. Lead generators typically collect and pass on customer personally identifiable information. They are compensated by the lender. They have no continuing interest in any specific transaction but may receive compensation tied to the quality of leads provided and may be paid on funded loans.

Servicer

A servicer is the company responsible for the administration of the loan right after closing and continuing until the loan is paid off and the lender's security interest in the property is released or cancelled. A servicer is responsible for collecting borrower payments including principal and interest, as well as taxes and insurance, then remitting or forwarding those payments to investors. If a borrower is late (delinquent) on payments, the responsibility falls to the servicer to do everything it can to collect the payment and any late fees or penalties authorized under the original loan contract. Servicers are also responsible for loss mitigation, initiating foreclosure proceedings when a borrower reaches a certain stage of delinquency, as well as a variety of administrative responsibilities including accounting, record keeping, investor reporting and advancing unpaid amounts to investors, taxing authorities and insurance providers. Servicers are discussed in greater detail in later pages.

Investor

An investor is a person or organization that purchases and holds assets, in this case mortgage loans. Investors include investment firms, insurance companies, government sponsored entities (GSEs) and others, such as correspondent or wholesale lenders that fund or buy mortgage loans from originators or sellers (possibly another investor). Investors may invest in single or whole loans, pools of mortgage loans packaged into a mortgage-backed security (MBS) or residential mortgage-backed security (RMBS), a type of asset-backed security (an "instrument") that is secured by a mortgage or collection of mortgages.

At the end of Q1 2021, there were 19,655 active[2] and inactive nonbank mortgage companies employing 185,301 active and inactive mortgage loan originators (MLOs), identified in the Nationwide Multistate Licensing System (NMLS). Due to the nature of the state system, which requires each company and individual to hold a license in each state where they conduct business, there are far more licenses held than the actual number of companies and MLOs [see table below].

State Licensed Entities

Licensee Type	Unique Entities	Annual Growth, Entities	Licenses	Annual Growth, Licenses
Company	19,655	9.0%	53,147	11.0%
Branch	27,103	8.0%	85,492	19.7%
Individual	185,301	18.5%	712,821	34.0%

(Source: NMLS Q1 2021)

For the purposes of this paper, mortgage originators will be classified into specific categories of license type falling under state nonbank mortgage regulator supervision. (Therefore, investors, other than wholesale lenders and investors in mortgage servicing rights, are not discussed further in this chapter).

Mortgage Lenders

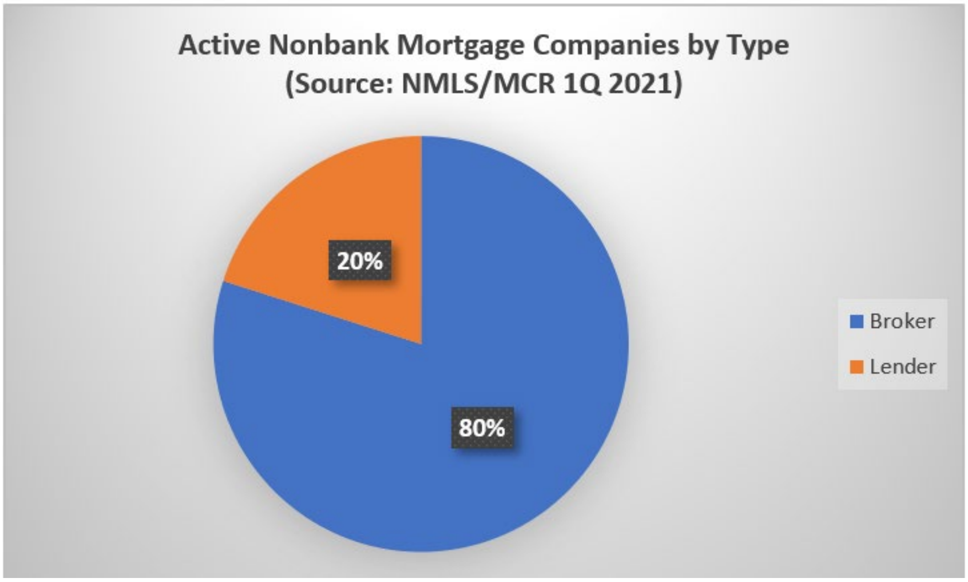
Mortgage lenders are companies that loan money for mortgages. The mortgage lender may be an originator, meaning that they perform all or some of the functions of an originator, or a wholesale lender who provides the funding to a mortgage lender/originator and then takes possession of the loan and books it as an asset. In order to be classified as a mortgage lender, the company must make the loan itself by providing either its own funds or the funds of a warehouse lender that the mortgage lender has borrowed on a short-term basis. A crucial difference between a mortgage lender/originator and a wholesale lender is that the wholesale lender will not have any interaction or direct relationship with

[2] "Active," meaning origination activity reported to NMLS during the quarter.

the borrower unless the wholesale lender ultimately becomes the servicer of the loan. Other names or types of companies that are included in the mortgage lender category are mortgage banker, retail lender, direct lender or portfolio lender. Some of these types are discussed below.

Mortgage Brokers

Mortgage brokers are intermediaries that broker, or source, loans for a mortgage lender. Typically, a mortgage broker will act as the primary interface between the prospective borrower and the lender. A mortgage broker will advertise or solicit mortgage loans from consumers, assist the consumer through the application process, shop for the best rate and fees, advise on the best loan for the consumer's needs and process the application documents and borrower information for the mortgage lender's underwriter who will review the loan for approval. The crucial difference between a mortgage broker and a mortgage lender is that the mortgage broker does not make or fund the loan.



Wholesale Lenders

Wholesale lenders or correspondent lenders do not deal directly with consumers. They make loans through third parties such as mortgage brokers or small banks that do not have the capacity or desire to make the loan. Wholesale lenders might be large regional or national banks that may also originate loans directly for consumers through separate business lines. When a wholesale lender makes a loan, the loan will be made in the name of the wholesale lender, not the lender that took the borrower's loan application. Correspondent lenders are differentiated by the relationship they have with an investor to buy the closed loan originated in the name of the correspondent.

Warehouse Lenders

Warehouse lenders differ from wholesale lenders in that they don't fund or make the loan to the consumer. Instead, the warehouse lender provides lending facilities or credit lines to mortgage lenders who make the loan, sell the loan to investors and then pay the warehouse lender back, usually very quickly.

Portfolio Lenders

Portfolio lenders originate and fund mortgage loans with their own money and hold the loan in their own portfolio (on their balance sheet) as an investment. This type of lender often makes specialty kinds of loans such as very large, or jumbo loans, or loans for rental properties. Hard money lender refers to a type of lender that is typically a private individual or small business that lends money based on the value of the collateral and not on a borrower's ability to repay. These loans are typically made at high rates of interest and are also called asset-based lending. These lenders will often make mortgage loans to consumers or small businesses that cannot obtain mainstream financing.

Mortgage Loan Types

Mortgage lenders and brokers may originate and fund several different types of mortgage loans. Some of the terms used to describe mortgage loans are joined together to further describe the product. For example, loans may be described by the lien position (i.e., the order in which loans are paid) and by purpose, purchase, refinance, home equity, etc. But since a purchase or refinance will almost always be in first position and the home equity in second position, it is typically not necessary to describe the loan as a first lien purchase mortgage. Some of these types of loans are:

First Lien Mortgage Loans

This is the primary market for mortgage loans, and as the term implies, the holder of the mortgage loan is in first position (gets paid first) when a loan is paid off or in the event the mortgage is foreclosed. First lien mortgage loans are used either to purchase a property or to refinance existing debt.

Purchase Loans

As the name implies, purchase loans are used to purchase a home. The loan is typically made as a percentage of the purchase price of the home, with the difference provided as a down payment by the borrower. For example, a $500,000 home purchase may involve a 10% down payment ($50,000) and a 90% loan ($450,000).

Refinance Loans

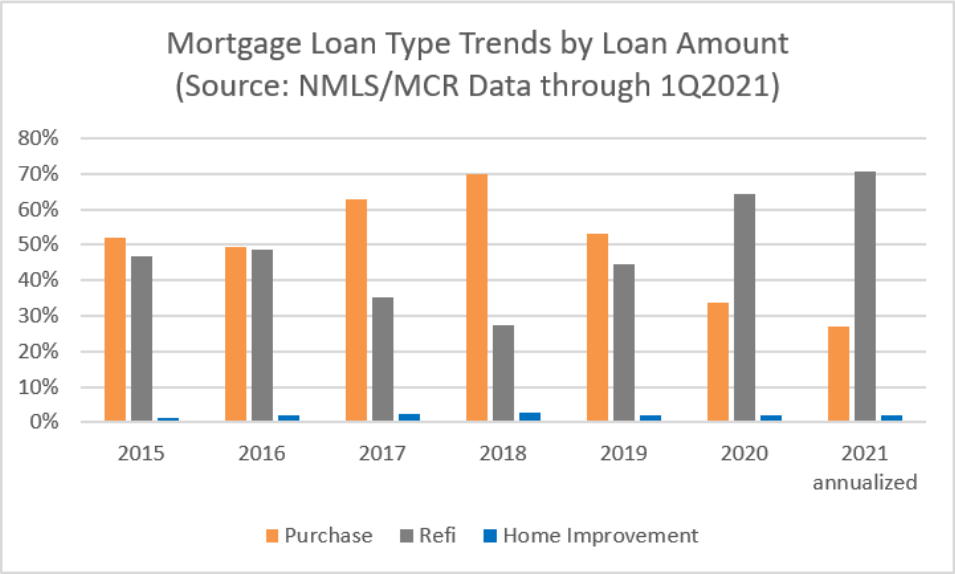
Refinance loans are a type of first lien mortgage loan where a borrower refinances (by taking out a new loan) their home to pay off an existing mortgage loan. Refinances are most often used to get a lower interest rate and lower payment or to acquire additional funds for other purposes, referred to as a cash-out refinance.

Second Lien Mortgage Loans

A second lien mortgage loan, or a second, allows a borrower to take out another loan secured by whatever equity remains in the property after securing the first lien mortgage loan, subject to combined loan-to-value (CLTV) limits. As the name implies, these loans will be repaid after the lender in the first position is paid at payoff or liquidation. Second lien mortgage loans include closed-end home equity loans and home equity lines of credit (HELOC), explained below. It is possible either of these could be in first position if there is not a first lien mortgage loan already in place, or they could move into first position if the first lien loan is paid off after obtaining a second lien loan.

Home Equity Line of Credit

The HELOC is a line of credit secured by the borrower's residence. It can be drawn upon as needed, like a credit card, and the balance will increase and decrease depending upon use and payment. One of the most popular types of second lien mortgage loans is the home improvement loan made to improve the borrower's property in some way (e.g., add a deck, replace a roof, etc.).



Conventional Loans

A conventional loan is any non-government insured or guaranteed loan (see below) used for purchase or refinance. A conventional loan may be conforming (eligible for sale to government sponsored entities, GSEs, – see below) or non-conforming (e.g., jumbo). A jumbo loan is a loan with a principal amount greater than the GSE conforming loan limits, which in 2021 is $548,250 for one-unit properties (up to $822,375 in some counties with higher home prices).

Government Insured/Guaranteed Mortgage Loans

Typically, Government Insured/Guaranteed Mortgage Loans are Federal Housing Administration (FHA) [see insert] or U.S. Veteran's Administration (VA) loans that conform to the requirements set by the U.S. Department of Housing and Urban Development (HUD) or VA and are insured (FHA) or guaranteed (VA) by the federal government. FHA/VA loans are most often purchase or refinance; however, there are some government home equity products available such as FHA Title 1 home improvement loans.

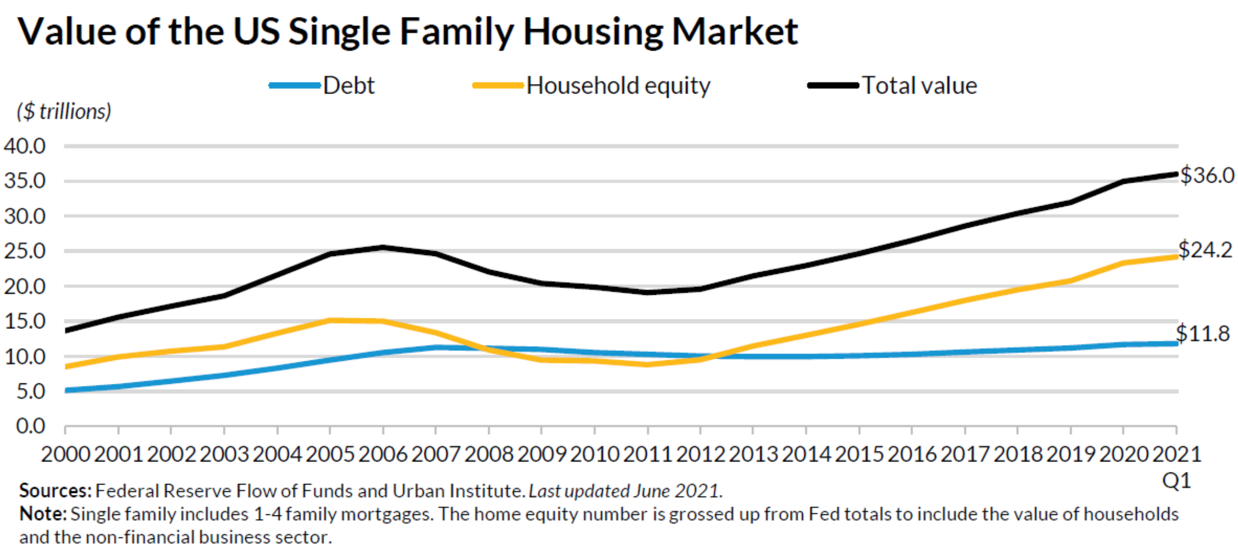
Reverse Mortgage Loans

These loans convert the equity in a homeowner's property into usable funds where the loan is not repaid until the death of the borrower or some disqualifying event. Most reverse mortgage loans are home equity conversion mortgages (HECMs), a product originated by private lenders under terms established by the FHA and insured by the federal government.

Most loan types described above can be made under various loan terms including type of interest rate, length of loan, and structure of payment. Terms most common to consumers are: 30-year, 15-year, fixed-rate mortgage (FRM), adjustable-rate mortgage (ARM), jumbo loans, qualified mortgages (QM) and balloon loans. Some of these are discussed later in this chapter.

The Nonbank Mortgage Origination Market

The mortgage market begins with the purchase of homes using credit (mortgage loans) and continues or expands with refinances and second mortgages. To understand the size of the mortgage market we need to look at the size of the housing market (by the value of homes) and the amount of equity consumers hold in those homes. The difference between the two is equal to the size of the mortgage market or the debt on the homes. The Urban Institute helps put this picture into perspective.



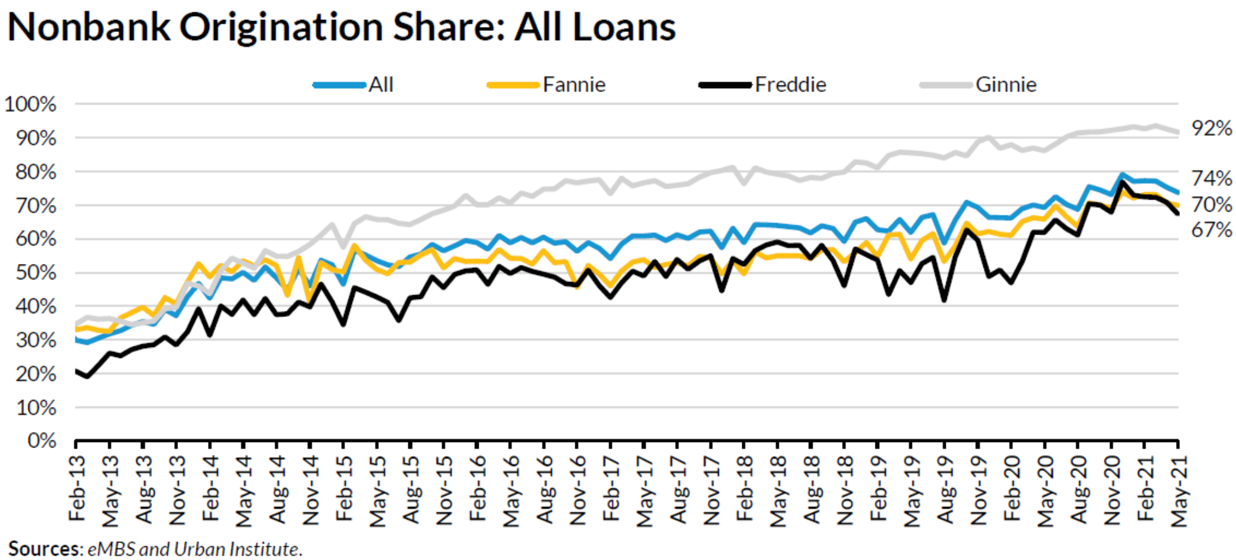
Source: Urban Institute Housing Finance Policy Center Housing Finance at A Glance, June 2021

The above chart reflects the size of the entire mortgage market -- both banks and nonbanks. As the chart shows, the housing market is very large, and homeowners currently have far more value in their homes than what is owed. However, this has not always been the case, as can be seen from roughly 2007 through 2012, from the financial crisis start to the recovery, when borrowers owed more money than they had in house equity due to a heavy runup in housing credit and a collapsed housing market that temporarily devalued homes.

The amount of debt in the housing market has risen to about $11.8 trillion (Federal Reserve Flow of Funds and Urban Institute), with the steady increase in post-finance crisis home equity accelerating in 2020 due to the COVID-era spike in home prices and substantially reduced supply of homes available for sale.

The chart above based on Federal Reserve Bank data reflects a mortgage market that has eclipsed the high-water mark of 2008, just before the financial collapse.

Since the dollar amount of debt includes loans from nearly 30 years ago, we can’t estimate the amount of today’s debt that was originated or made by nonbanks. Looking at more recent data, we can see how much lending volume has been originated by nonbanks since 2013 (see Urban Institute below).



Source: Urban Institute Housing Finance Policy Center Housing Finance At A Glance, June 2021

Importantly, nonbank origination share has increased 45 percentage points in the last eight years, with nonbanks now controlling almost three-fourths of new agency loan volume, and in some cases completely dominating the market (i.e., Ginnie Mae issuance).

Nonbank mortgage companies assist all types of borrowers, from prime borrowers (those deemed most likely to make loan payments on time because of good credit history) to those who are credit-challenged or want a more streamlined mortgage experience, that is not always available from the consumer's bank or credit union. Like other nonbanks, they operate without funding from customer deposits, but in most respects, the nonbank mortgage companies originate mortgage loans in the same way as depository institutions (banks and credit unions). The primary difference is that a depository institution will frequently rely on its own, or its depositors' funds to make the mortgage loan,[3] whereas a nonbank mortgage company will typically obtain funds for making loans from a larger financial institution or other investor through credit facilities such as a warehouse line of credit.

As an alternative to a bank, a nonbank may offer a faster and more efficient loan process and less restrictive underwriting requirements, much of it online.[4] Once major players in the mortgage industry, the biggest banks have backed away from a large portion of the business, especially FHA-insured

[3] Depository institutions also have access to the Federal Home Loan Bank system, established by the Federal Home Loan Bank Act of 1932 as a government sponsored enterprise to support mortgage lending and related community investment. It is composed of 11 FHLBanks, with more than 8,000-member financial institutions. Each FHLBank is a separate, government-chartered, member-owned corporation.

[4] Nonbanks do not have the ability to set the underwriting criteria for loans sold into the secondary market and rather originate and fund loans under standards set by others. Further in this section we point to data supporting loans made with lesser restrictions by nonbanks. For reasons not fully known, for at least the last five years, banks appear to be originating loans with more restrictive underwriting requirements than nonbanks.

lending, citing low profit margins and high legal risks, a result of the enhanced regulatory environment that followed the 2008 housing meltdown (Hal M. Brundick, 2017). While still major players in the mortgage market, large banks currently have a smaller footprint of origination activity than nonbanks.

Nonbanks are successful in the mortgage space because banks are lending less and nonbanks are typically smaller and nimbler than many giant bank competitors. On the flip side, since nonbanks do not have deposits as a source of funds, they pay higher rates to secure funding from another lender. Therefore, nonbank mortgage originators (unlike servicers) do not have the principal-agent risk-taking concerns behind much of bank regulation. Nonbank mortgage lenders have significant, almost real-time oversight by their warehouse lenders that in many ways mimics supervision, in addition to the supervisory overlays of state nonbank regulators that may not apply to banks. In short, bank and nonbank mortgage businesses are regulated differently for various reasons including risk characteristics that are inherently different.

FEDERAL HOUSING ADMINISTRATION

The Federal Housing Administration, generally known as FHA, provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single family and multifamily homes including manufactured homes and hospitals. It is the largest insurer of mortgages in the world, insuring over 47.5 million properties since its inception in 1934.

FHA mortgage insurance provides lenders with protection against losses as the result of homeowners defaulting on their mortgage loans. The lenders bear less risk because FHA will pay a claim to the lender in the event of a homeowner's default. Loans must meet certain requirements established by FHA to qualify for insurance. (U.S. Department of Housing & Urban Development, n.d.)

Mortgage Origination History

The nonbank mortgage industry had several historical drivers: the immigrant factory workforce, the farming industry in the West and the invention of the automobile.

By the Industrial Revolution in the late 1700s, many mortgages were provided by independent companies because immigrant factory workers wanted to purchase homes, but banks historically loaned primarily to their depository customers.

During the 1850s, a few nonbank mortgage companies started in the Midwest farming industry. The industry did not grow substantially in number and size until the 1870s, when agricultural development pushed further West. Most mortgage companies evolved out of the business of successful individual loan agents, but a few were organized by eastern entrepreneurs who recognized the rewards associated with more formally organizing the inter-regional flow of mortgage funds. By the 1880s, the increased popularity of the Western mortgage companies prompted state legislators in some Eastern markets to require these individual mortgage companies to apply for a license and file annual or semiannual financial statements (Snowden, 2014).

FEDERAL NATIONAL MORTGAGE ASSOCIATION, AKA FANNIE MAE

Fannie Mae was first chartered by the U.S. government in 1938 to help ensure a reliable and affordable supply of mortgage funds throughout the country. Today it is a shareholder-owned company that operates under a Congressional charter and is currently under federal conservatorship. It is a leading source of financing for mortgage lenders, providing access to affordable mortgage financing in all markets. Its financing provides sustainable homeownership and workforce rental housing for millions of Americans via the popular 30-year, fixed-rate mortgage. (Fannie Mae, n.d.)

The predecessor of the Mortgage Bankers Association, the Farm Mortgage Bankers Association of America, was formed in 1914 to support lenders making loans secured by farmlands, excluding associations and individuals dealing in city mortgages. As the demand for farm loans was lessening by the mid-1920s, the association changed its name to the Mortgage Bankers Association of America in 1926 ("America" was dropped in 2003).

With the advent of the automobile, people started moving from the city to the suburbs and needed housing loans. As a result, mortgage companies traveled to the suburbs and some farms by horse, buggy and cars to sell mortgages.

In the early part of the 20th century, mortgages were still difficult for the average person to obtain from mortgage companies or savings and loan institutions (S&Ls), a type of depository or bank [see insert]. The Great Depression and its historically high unemployment rates led to an unprecedented wave of loan defaults. The surge in homes lost to foreclosure further depressed housing values and the nation's overall economy.

The answer was to form a new national mortgage market, and in 1934 Congress passed the National Housing Act. The Act created the Federal Housing Administration (FHA) [see insert] to provide government insurance backing home loans during the New Deal Era to help resuscitate the U.S. housing market and protect lenders from mortgage default. As a national mortgage loan insurance program, it gave greater incentive to banks, building and loan associations and other institutions to make loans to Americans.

Together, these federal agencies transformed the standard mortgage product. At the start, FHA loans were short term, requiring refinancing every five years. It later changed to self- amortizing and long-term loans, e.g., 30 years, which reduced monthly payments over the amortization[5] schedule. While the percentage of payment toward interest was very high at the beginning, the lower payment placed more people into homes. The goal of the new market was to take home ownership from Wall Street to Main Street, as it was believed home- ownership built wealth.

[5] Amortization is the action or process of reducing or paying off a debt with regular payments at a stated rate of interest.

But a 30-year asset was difficult for banks to hold because of the nature of their business model, as it reflected a long-term asset funded by short-term debt or customer deposits. As a result, banks started selling to third parties, and Fannie Mae started soliciting nonbank loans. Third parties began originating mortgages, competing with banks. This continued the system of independents, which had begun in the 1800s. These companies were privately owned, closely held and operated with small amounts of capital relative to the volume of loans they originated and sold. Forward commitments from their lending partners, which gave them access to short-term bank credit that they used to produce and hold inventories of loans, were key to their business model (Snowden, 2014).

As stated by Richard K. Green of George Washington University and Susan M. Wachter of the University of Pennsylvania in their 2005 publication *The American Mortgage in Historical and International Context*: "Home mortgages have loomed continually larger in the financial situation of American households." In 1949, mortgage debt was equal to 20% of total household income; by 1979, it had risen to 46% of income; by 2001, it was 73% of income (Bernstein, Boushey and Mishel, 2003). Similarly, mortgage debt was 15% of household assets in 1949 but rose to 28% of household assets by 1979 and 41% of household assets by 2001. This enormous growth of American home mortgages has been accompanied by a transformation in their form as they are now the distinctively different from mortgages in the rest of the world. For example, according to Research Institute for Housing America, the United States has an unusually high proportion of long-term fixed-rate mortgages as well as an usually high use of securitization in the financing of housing.[6] In addition, the growth in mortgage debt outstanding in the United States has closely tracked the mortgage market's increased reliance on securitization[7] (Cho, 2004). Prior to the 1930s, mortgage loan terms in America featured

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION, AKA GINNIE MAE

Ginnie Mae is a self-financing, wholly owned U.S. government corporation within HUD and the primary financing mechanism for all government-insured or government-guaranteed mortgage loans. Ginnie Mae guarantees investors the timely payment of principal and interest on MBS backed by federally insured or guaranteed loans — mainly loans insured by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs. Ginnie Mae securities are the only MBS to carry the full faith and credit guaranty of the U.S. government. (Ginnie Mae, n.d.)

[6] http://business.sdsu.edu/_resources/files/real-estate/research/10122_Research_RIHA_Lea_Report.pdf

[7] Converting mortgage loans to tradeable securities instruments.

WHAT ARE S&LS?

Savings and loans (S&Ls) have their origins in the social goal of pursuing homeownership. The first S&L was established in Pennsylvania in 1831. These institutions were originally organized by groups of people who wished to buy their own homes but lacked enough savings to purchase them. In the early 1800s, banks did not lend money for residential mortgages. The members of the group would pool their savings and lend them back to a few of the members to finance their home purchases. As the loans were repaid, funds could then be lent to other members. S&Ls, sometimes called thrifts, are generally smaller than banks, both in number and in the assets under their control. But they were nevertheless important conduits for the U.S. mortgage market. In 1980, there were almost 4,000 thrifts with total assets of $600 billion, of which about $480 billion were in mortgage loans (FDIC). That represented half of the approximately $960 billion in home mortgages outstanding at that time. (Federal Reserve System, 2013)

variable interest rates, high down payments and short maturities; Americans typically renegotiated their mortgage loans every year.

In 1970, Freddie Mac [see insert] was created to further expand the secondary market for mortgages in the United States. Along with Fannie Mae, Freddie Mac bought mortgages, pooled and sold them as mortgage-backed securities to investors on the open market. This secondary mortgage market increased the supply of money available for mortgage lending and increased the money available for new home purchases.

A variety of complex factors from market forces to Congressional action led to a growing nonbank mortgage industry from the early 1900s through the 1980s and 1990s that ushered in state licensing laws and supervisory authorities. The 1980s demise of the savings and loan footprint in mortgage lending and servicing is a well-documented[8] event. Increasing lender reliance on securitization of mortgages through the GSEs and Ginnie Mae offered a stable source of liquidity for nonbank mortgage lenders seeking to originate loans and replenish capital for additional lending. Concurrently, the S&L crisis [see Savings and Loan Crisis box], which cost taxpayers hundreds of billions of dollars in bailouts as these institutions failed, created market opportunity for nonbank mortgage lenders. Additionally, new technologies such as automated underwriting and electronic access to credit scores helped accelerate the pace of growth at the end of the 1980s. The modern iteration of the FICO score, based on credit files from the three credit bureaus – Equifax, Experian and TransUnion - was introduced in 1989 (TheStreet, 2015).

But growth did not stop there. The MBA cites housing statistics that reflect market share growth from 35% in 1990 to 56% in 1995 (Snowden). Although the nonbank mortgage market share has fluctuated over the last century, it was at nearly 50% just before the subprime mortgage crisis. According to the

[8] Follain, James R., and Peter M. Zorn. 1990. "The Unbundling of Residential Mortgage Finance." Journal of Housing Research, vol. 1(1):63-90.
Lacour-Little, Michael. 2000. "The Evolving Role of Technology in Mortgage Finance." Journal of Housing Research, vol. 11(2): 173-205.

Brookings Institution, “Nonbank mortgage companies were hit hard during the financial crisis, and many went out of business. The total number of mortgage companies (both independent and affiliated with banks) fell in half from 2006 to 2012 – a drop of nearly 1,000 companies.” (Brookings, 2018)

The financial crisis of 2007 – 2008 was a turbulent time for the mortgage industry. According to the Mortgage Lender Implode-O-Meter, a non-governmental website tracking mortgage company closures monitored by regulators and industry throughout the crisis, approximately 308 mortgage lenders shuttered from just 2006 through 2008.

FEDERAL HOME LOAN MORTGAGE CORPORATION, AKA FREDDIE MAC

Freddie Mac was chartered by Congress in 1970 as a private company to help ensure a reliable and affordable supply of mortgage funds throughout the country. Today it is a shareholder-owned company that operates under a congressional charter and is presently under federal conservatorship. Freddie Mac supports the housing market as well as renters, homebuyers and homeowners – across the entire country in all economic cycles. It operates in the secondary mortgage market: it does not lend directly to borrowers but buys loans from approved lenders. With the money that lenders receive in return, additional loans are made to other qualified borrowers. In securitizing pools of mortgages and selling the securities to investors, Freddie Mac shifts a significant portion of the credit risk associated with the loans it owns to private investors – away from taxpayers. (Freddie Mac, n.d.)

Through a combination of many factors following the financial crisis, the mortgage origination market has stabilized and grown, once again becoming a centerpiece of the U.S. economy. These factors included corporate failures, regulatory enforcement, new laws and rules, a new federal agency, safer products and the advent of the NMLS, owned and operated by CSBS. [For more on NMLS, see www.nmls.org] In 2020, banks and nonbanks together originated an estimated $4.1 trillion in loans (Urban Institute) and the current amount of mortgage debt in the United States (as of June 2021) stands at $11.8 trillion (St. Louis Federal Reserve Bank). Of the $4.1 trillion originated in 2020, nonbanks are estimated to be responsible for over 60% (NMLS, Urban Institute).

SAVINGS & LOAN CRISIS 1980 TO 1989

by Kenneth J. Robinson, Federal Reserve Bank of Dallas

In the 1980s, the financial sector suffered through a period of distress that was focused on the nation's savings and loan (S&L) industry. Inflation rates and interest rates both rose dramatically in the late 1970s and early 1980s. This produced two problems for S&Ls. First, the interest rates that they could pay on deposits were set by the federal government and were substantially below what could be earned elsewhere, leading savers to withdraw their funds. Second, S&Ls primarily made long-term fixed-rate mortgages. When interest rates rose, these mortgages lost a considerable amount of value, which essentially wiped out the S&L industry's net worth. Policymakers responded by passing the Depository Institutions Deregulation and Monetary Control Act of 1980. But federal regulators lacked sufficient resources to deal with losses that S&Ls were suffering. So instead they took steps to deregulate the industry in the hope that it could grow out of its problems. The industry's problems, though, grew even more severe. Ultimately, taxpayers were called upon to provide a bailout, and Congress was forced to act with significant reform legislation as the 1980s came to a close.

Subprime Mortgage Crisis 2007-2010

The expansion of mortgages to high-risk borrowers, coupled with rising house prices, contributed to a period of turmoil in financial markets that lasted from 2007 to 2010.

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How and Why the Crisis Occurred

The subprime mortgage crisis of 2007–10 stemmed from an earlier expansion of mortgage credit, including to borrowers who previously would have had difficulty getting mortgages, which both contributed to and was facilitated by rapidly rising home prices. Historically, potential homebuyers found it difficult to obtain mortgages if they had below average credit histories, provided small down payments or sought high-payment loans. Unless protected by government insurance, lenders often denied such mortgage requests. While some high-risk families could obtain small-sized mortgages backed by the Federal Housing Administration (FHA), others, facing limited credit options, rented. In that era, homeownership fluctuated around 65 percent, mortgage foreclosure rates were low, and home construction and house prices mainly reflected swings in mortgage interest rates and income.

In the early and mid-2000s, high-risk mortgages became available from lenders who funded mortgages by repackaging them into pools that were sold to investors. New financial products were used to apportion these risks, with private-label mortgage-backed securities (PMBS) providing most of the funding of subprime mortgages. The less vulnerable of these securities were viewed as having low risk either because they were insured with new financial instruments or because other securities would first absorb any losses on the underlying mortgages (DiMartino and Duca 2007). This enabled more first-time homebuyers to obtain mortgages (Duca, Muellbauer, and Murphy 2011), and homeownership rose.

The resulting demand bid up house prices, more so in areas where housing was in tight supply. This induced expectations of still more house price gains, further increasing housing demand and prices (Case, Shiller, and Thompson 2012). Investors purchasing PMBS profited at first because rising house prices protected them from losses. When high-risk mortgage borrowers could not make loan payments, they either sold their homes at a gain and paid off their mortgages or borrowed more against higher market prices. Because such periods of rising home prices and expanded mortgage availability were relatively unprecedented, and new mortgage products' longer-run sustainability was untested, the riskiness of PMBS may not have been well-understood. On a practical level, risk was "off the radar screen" because many gauges of mortgage loan quality available at the time were based on prime, rather than new, mortgage products.

When house prices peaked, mortgage refinancing and selling homes became less viable means of settling mortgage debt and mortgage loss rates began rising for lenders and investors. In April 2007, New Century Financial Corp., a leading subprime mortgage lender, filed for bankruptcy. Shortly thereafter, large numbers of PMBS and PMBS-backed securities were downgraded to high risk, and several subprime lenders closed. Because the bond funding of subprime mortgages collapsed, lenders stopped making subprime and other nonprime risky mortgages. This lowered the demand for housing, leading to sliding house prices that fueled expectations of still more declines, further reducing the demand for homes. Prices fell so much that it became hard for troubled borrowers to sell their homes to fully pay off their mortgages, even if they had provided a sizable down payment. *(continued)*

As a result, two government-sponsored enterprises, Fannie Mae and Freddie Mac, suffered large losses and were seized by the federal government in the summer of 2008. Earlier, in order to meet federally mandated goals to increase homeownership, Fannie Mae and Freddie Mac had issued debt to fund purchases of subprime mortgage-backed securities, which later fell in value. In addition, the two government enterprises suffered losses on failing prime mortgages, which they had earlier bought, insured, and then bundled into prime mortgage-backed securities that were sold to investors.

In response to these developments, lenders subsequently made qualifying even more difficult for high-risk and even relatively low-risk mortgage applicants, depressing housing demand further. As foreclosures increased, repossessions multiplied, boosting the number of homes being sold into a weakened housing market. This was compounded by attempts by delinquent borrowers to try to sell their homes to avoid foreclosure, sometimes in "short sales," in which lenders accept limited losses if homes were sold for less than the mortgage owed.

In these ways, the collapse of subprime lending fueled a downward spiral in house prices that unwound much of the increases seen in the subprime boom.

The housing crisis provided a major impetus for the recession of 2007-09 by hurting the overall economy in four major ways. It lowered construction, reduced wealth and thereby consumer spending, decreased the ability of financial firms to lend, and reduced the ability of firms to raise funds from securities markets (Duca and Muellbauer 2013).

Steps to Alleviate the Crisis

The government took several steps intended to lessen the damage. One set of actions was aimed at encouraging lenders to rework payments and other terms on troubled mortgages or to refinance "underwater" mortgages (loans exceeding the market value of homes) rather than aggressively seek foreclosure. This reduced repossessions whose subsequent sale could further depress house prices. Congress also passed temporary tax credits for homebuyers that increased housing demand and eased the fall of house prices in 2009 and 2010. To buttress the funding of mortgages, the Congress greatly increased the maximum size of mortgages that FHA would insure. Because FHA loans allow for low down payments, the agency's share of newly issued mortgages jumped from under 10 percent to over 40 percent.

The Federal Reserve, which lowered short-term interest rates to nearly 0 percent by early 2009, took additional steps to lower longer-term interest rates and stimulate economic activity (Bernanke 2012). This included buying large quantities of long-term Treasury bonds and mortgage-backed securities that funded prime mortgages. To further lower interest rates and to encourage confidence needed for economic recovery, the Federal Reserve committed itself to purchasing long-term securities until the job market substantially improved and to keeping short-term interest rates low until unemployment levels declined, so long as inflation remained low (Bernanke 2013; Yellen 2013). These moves and other housing policy actions—along with a reduced backlog of unsold homes following several years of little new construction—helped stabilize housing markets by 2012 (Duca 2014). Around that time, national house prices and home construction began rising, home construction rose off its lows, and foreclosure rates resumed falling from recession highs. By mid-2013, the percent of homes entering foreclosure had declined to pre-recession levels and the long-awaited recovery in housing activity was solidly underway.

Troubled Times

The secondary market was a primary driver in the creation of the modern mortgage market. An expanding marketplace drove innovation, creating products for specific niches and people with different credit needs. Oftentimes, products with logical beginnings and honest intentions were sold to borrowers in illogical ways and with dishonest and harmful outcomes.

While the market-making role of the GSEs was cemented in the prime lending market, banks and nonbanks together pioneered non-agency (non-GSE) loan products that were sold in increasing volume into private-label securitizations. The market change accelerated in the early 2000s, spreading to the GSEs and eventually contributing to the financial crisis that began in early 2007 and continues to profoundly impact the mortgage servicing market today.

In the early 2000s, the growth in nonbank mortgage lending and servicing was directly tied to the proliferation of non-agency products such as those seen in the subprime and Alt-A markets targeting credit-impaired borrowers[9], products that by and large were securitized through private-label (non-agency) securitizations sponsored by investment banks and depositories[10].

From the early days of subprime home improvement and second-lien lending in the 1980s to the home-equity lending in the 1990s, nonbank mortgage companies dominated subprime lending and servicing.[11] Its roots were in the branch network of finance companies that offered unsecured loans as well as loans secured by virtually any type of collateral, from sides of beef and satellite dishes to automobiles and home improvement loans and debt-consolidation first lien mortgages. Servicing was retained in-house and oftentimes performed at the branch level. This early model, epitomized by companies such as Associates First Capital Corp., Commercial Credit Corp., Household Finance and Beneficial, would be challenged by the wholesale home-equity lending model that gained popularity using brokers to source loans nationwide and fueled by securitization as a financing vehicle with the assistance of investment banks. In turn, subprime home-equity lending grew out of the 1980s model of closed-end second mortgage lending[12] that had given rise to widespread allegations of predatory lending[13].

By the end of 2002, nonbank originators still controlled at least 58% of the subprime[14] origination market[15], even after the 1998 subprime shakeout in the wake of the Long Term Capital Management derivatives bailout and recapitalization, and even after the 1999 repeal of the Glass-Steagall Act

[9] McElravey, John N., Banc One Capital Markets, Inc. July 22, 2002. "An Introduction to Residential ABS."
[10] Dagher, Jihad C. and Ning Fu, International Monetary Fund. 2011. IMF Working Paper: "What Fuels the Boom Drives the Bust: Regulation and the Mortgage Crisis."
[11] Glass, Rick, Mortgage Banking Magazine. April 1996. "Newcomers to Nonconforming."
[12] Lembke, Anthony and Peter DiMartino, Salomon Brothers. May 1994. "'B' and 'C' Borrowers: A New Frontier in the Nonagency Market."
[13] Hudson, Michael, Alicia Patterson Foundation. 1992. "Loan Scams." Accessed at https://aliciapatterson.org/stories/loan-scams.
[14] Note that nonbanks are not subprime lenders. Historically, both bank and nonbank conventional mortgage lenders often offered subprime loans, and some of these lenders became specialists known as subprime lenders.
[15] Inside Mortgage Finance. 2003. "Top 25 B&C Lenders in 2002."

encouraged banks to jump into new markets and begin competing with traditional investment banks. That drove up demand, as an example, for securities volume backed by subprime and Alt-A loans. By the end of 2006,[16] the names would mostly be the same, but volumes had tripled, and nonbanks slightly increased their origination market share.[17]

An example of a product that was popular with subprime lenders is the short-term hybrid adjustable-rate mortgage (ARM) [see insert], which allowed consumers to acquire a home loan or refinance an existing loan with an initial low, fixed interest rate for a defined period of time (see discussion of “2/28” and “3/27” ARMs below) that can change over the life of the loan. This type of loan gives consumers the option to prepare for what will generally be higher mortgage payments over time, with the intention of being able to afford the payments with their increased earnings. But in the years leading up to the crisis, ARMs were sometimes sold as fixed-rate mortgages (FRMs) or marketed in other deceptive ways, and often coupled with other risky features such as reduced income or employment verification, alternative amortization structures, and high LTVs or CLTVs. Additionally, new types of hybrid products that combined the features of ARMs and FRMs were created and sold to naïve or unsuspecting consumers,

The dangerous and expensive 2/28 and 3/27 loans that forced so many subprime borrowers into default or foreclosure are gone. Until very recently, these adjustable-rate loans were the most common type of mortgages offered to borrowers with bad credit, accounting for three out of every five subprime loans.

The idea was to provide borrowers with a two- or three-year introductory interest rate that was lower than any fixed-rate subprime loan for which they could qualify. By making all their payments, borrowers were told they could raise their credit scores and refinance into a far more affordable FRM before their ARM reset to a higher interest rate.

Mortgage brokers told borrowers they shouldn't worry about the reset because they'd never have to deal with it -- or the dramatically higher payments. (Interest.Com, 2008)

often with confusing names such as “2/28” or “3/27,” where over 30 years, the first number was the years an initial rate and payment would be fixed, and the second number was the adjustable-rate period of time.

Perhaps the most vilified product in mortgage history, the payment-option ARM, had an appropriate consumer audience when it was first created. With a payment-option ARM the consumer could:

1. Pay the fully amortized payment each month to finish repaying the loan by the stated maturity.

[16] Inside Mortgage Finance. 2007. “Top 25 B&C Lenders in 2006.”
[17] The Financial Crisis Inquiry Commission. January 2011. *The Financial Crisis Inquiry Report*.

2. Pay the interest only and nothing on the principal; or,
3. Pay a minimum monthly payment that covered neither interest nor principal, thus incurring negative amortization and increasing the unpaid principal balance upon which monthly interest was calculated in the following month.

This was a cash flow management product designed for very sophisticated borrowers who understood the product and its risks and limitations. In some cases, it could still be an appropriate choice today. But in the early 2000s, these loans were increasingly sold to unsophisticated borrowers who could not handle the abrupt and oftentimes early recasting of payments, sometimes doubling from one month to the next once negative amortization limits triggered the fully amortizing payment. Today, consumers would be hard-pressed to find any lenders that still offer them except in very unusual situations that would not involve a primary residence as collateral.

Adjustable-rate mortgages are 'like a neutron bomb'

About 1 million homeowners face situation beyond help of rate cut
BOB IVRY and JODY SHENN, Bloomberg News Published 6:30 am CST, Monday, February 11, 2008

Joe Ripplinger took out a $184,000 mortgage in 2006 and makes his payments every month. Now he owes $192,000. The 66-year-old Minneapolis house painter has a payment-option adjustable-rate mortgage. It allows him to write a check for $565 a month even though he owes $1,300. The difference is added to the mortgage, and when his total debt reaches $212,000, or after five years have passed, he said his monthly minimum could jump to about $2,800, which he can't afford.

"We're barely making it right now," Ripplinger said.

The estimated 1 million homeowners with $500 billion of option ARMs are beyond the help of interest-rate cuts by Federal Reserve Chairman Ben Bernanke. While subprime borrowers face an average increase of 8 percent or less when their adjustable-rate mortgages reset, option ARM homeowners may see their monthly payments double after their adjustments kick in.

"We call them neutron loans because they're like a neutron bomb," said **Brock Davis**, a broker with **U.S. Express Mortgage**Corp. in Las Vegas. "Three years later the house is still there and the people are gone."

Once option ARM borrowers' loan balances reach a predetermined limit, called a negative amortization cap, usually 110 percent to 120 percent of the mortgage amount, their payment rates immediately increase. They also automatically rise after five years. Otherwise, increases typically are capped at 7.5 percent of a borrower's initial payment per year.

'Real Liar Loans'
"These could be called long-fuse, exploding ARMs," said Kathleen Keest, former assistant Iowa attorney general and now senior policy counsel at the Center for Responsible Lending in Durham, North Carolina. "I've heard people say they are the most complicated product ever offered to consumers. They are the real liar loans."

The loans accounted for 8.9 percent of the almost $3 trillion in U.S. home loans made in 2006, up from 8.3 percent in 2005, according to an estimate by industry newsletter Inside Mortgage Finance. Originations of option ARMs fell 50 percent during the first nine months of last year, the newsletter says.

One in five option ARMs packaged into bonds last year required less than 10 percent down payment and no proof of a borrower's income, according to a Jan. 22 report by New York-based analysts at UBS.

Delinquency rates on option ARMs tend to be low in the early years, misleading some investors to think they will remain safe, said **Sean Kirk**, a debt trader at Seaport Group, a New York-based securities firm focused on bonds of distressed or restructured companies.

Four kinds of home buyers typically get option ARMs. Speculators, who plan to sell the property quickly, made up 12 percent of all option ARMs packaged into bonds last year, according to UBS. That included only borrowers who identified themselves as investors and not residents, who get lower mortgage rates. The wealthy have used the loan for its flexibility, according to Thornburg Mortgage in Santa Fe, N.M.

The rest either took out the loans as an "affordability" product to buy more expensive homes, according to Standard & Poor's, or borrowers may have been misled about the terms, according to regulators.

In 2010, Congress fully recognized the risks within these alternatives as compared to conventional or government products, and through the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), attempted to return the market to more mainstream, safer lending.

Today's Origination Market

As noted above, Dodd-Frank rebalanced the market to a place of safer lending. In addition to significant new controls and a new federal regulator, the Consumer Financial Protection Bureau (CFPB), the law established a safe harbor product called the qualified mortgage, or QM loan [see What is a Qualified Mortgage? box]. With a QM loan, a lender needs to be certain that the borrower can repay the loan, and in exchange, the lender gets certain legal protections when it can show that it made sure the borrower had the ability to repay the loan. Today, other than QM loans, there are few options for home financing. Most of the harmful products originated before and during the crisis appear to be of limited availability.

Through a combination of many factors during and coming out of the financial crisis of 2007-2008, the mortgage origination market has stabilized and grown, once again becoming a centerpiece of the U.S. economy. These factors included corporate failures, regulatory enforcement, new laws and rules, a new federal agency, safer products and the advent of the NMLS. [For more on NMLS, see Chapter Two – Overview of Nonbank Supervision] For

WHAT IS A QUALIFIED MORTGAGE?

A qualified mortgage is a category of loans that have certain, more stable features that help make it more likely that you will be able to afford your loan. A lender must make a good-faith effort to determine that you have the ability to repay your mortgage before you take it out. This is known as the "ability-to-repay" rule. If a lender loans you a Qualified Mortgage it means the lender met certain requirements and it is assumed the lender followed the ability-to-repay rule.

Generally, the requirements for a qualified mortgage include:
Certain risky loan features are not permitted, such as:

- An interest-only period, when the borrower pays only the interest without paying down the principal (the amount of money borrowed).
- Negative amortization, which can allow the loan principal to increase over time, even though the borrower is making payments.
- Balloon payments, which are larger-than-usual payments at the end of a loan term. The loan term is the length of time over which the loan should be paid back. Note that balloon payments are allowed under certain conditions for loans made by small lenders.
- Loan terms that are longer than 30 years.
- A limit on how much of a borrower's income can go towards debt, including a mortgage and all other monthly debt payments. This is also known as the debt-to-income ratio.
- No excess upfront points and fees. If you get a qualified mortgage, there are limits on the amount of certain up-front points and fees your lender can charge. These limits will depend on the size of your loan. Not all charges, like the cost of an FHA insurance premiums, for example, are included in this limit. If the points and fees exceed the threshold, then the loan can't be a Qualified Mortgage.

Certain legal protections for lenders. Your lender gets certain legal protections when showing that it made sure you had the ability to repay your loan. Even with these protections, you may still be able to challenge your lender in court if you believe it did not make sure you had the ability to repay your loan. (Consumer Financial Protection Bureau, 2017)

2020, as discussed above, banks and nonbanks originated an estimated $4.1 trillion in residential mortgage loans (Urban Institute) and the current amount of mortgage debt in the United States (as of June 2021) stands at $11.8 trillion (St. Louis Federal Reserve Bank).

Despite stabilization of the mortgage origination market, concern exists over a growing demographic of borrowers being financed primarily by nonbank lenders today. There is some trending data on this issue, indicating nonbanks may lend further down the credit spectrum than banks. For example, nonbanks provide more FHA loans, which have higher delinquency rates [see chart page 43. Today, FHA is "the" nonprime product, which is a loan granted to a borrower with limited funds for a down payment, with a lower-credit score or other characteristics and who may not be approved for most conventional mortgages. Currently, there is virtually no other loan program for prospective borrowers of modest means with anything less than excellent credit. Since many large banks no longer offer FHA loans, nonbanks have been able to further expand with that product. In addition, high housing prices make loans less affordable, so there is pressure to design products borrowers can more easily afford, which carries more risk. The Urban Institute chart on page 10 shows that nonbanks originated 92% of loans backing Ginnie Mae issuance (primarily FHA and VA loans) in May 2021.

The nonbank mortgage sector has grown due to innovation and a decline in mortgage lending by banks. Nonbank mortgage companies existed long before federal regulation, even though the federal backstop for the mortgage industry is largely responsible for its growth and acceptance. During and subsequent to the financial crisis, however, Freddie Mac and Fannie Mae aggressively exercised their remedies, especially requiring repurchase, for defects found in loans that had been sold to them and had either gone into default or critical defects found in the underwriting, sale or servicing of a loan. The uncertainty around loan repurchase liability is one reason banks have been re-considering their commitment to the mortgage industry, in addition to increased regulation and the low profitability of mortgages as compared to other products. To address such concerns and provide greater certainty to the primary mortgage market, both Fannie Mae and Freddie Mac initiated multi-year efforts to improve their representation and warranty framework with the goal of enhancing liquidity without sacrificing compliance with their respective seller and servicing guides.

In the decade subsequent to the financial crisis, nonbanks have successfully built market share as banks pulled back from the origination market [see graph below]. However, they face the same problems banks face concerning mortgage loan quality with added liquidity risk due to their heavier use of leverage to operate a capital-intensive business without a deposit base. It remains to be seen if nonbanks can buck historical trends and retain market share when the economy inevitably goes through a correction, but for the near-term, nonbank market share continues to expand in an increasingly competitive market marked by tighter margins.

The Impact of the COVID-19 Pandemic on the Mortgage Industry

Perhaps nothing could have prepared the mortgage industry, or the country overall, for the dramatic changes wrought by the COVID-19 pandemic. The timeline of events18 shows not only the rapid spread of virus infections around the world but also the speed at which all of what we took for granted in our country would be challenged by an unknown and terrifying pandemic.

The first known case of the 2019 novel coronavirus, or COVID-19, in the United States was reported in the state of Washington on Jan. 21, 2020. From this point, events unfolded very rapidly with the World Health Organization and the U.S. Secretary of Health and Human Services declaring public health emergencies internationally and in the United States.

By March 11, with infection rates and deaths climbing worldwide, the WHO characterized COVID-19 as a pandemic, and two days later on March 13 President Donald Trump declared a state of national emergency in the United States due to COVID-19, retroactive to March 1.[19] On March 19, California became the first state to declare a statewide "stay at home" order, effectively shutting down the country's largest state economy due to rapidly spreading COVID-19 cases, with dozens of states and localities following with similar orders thereafter. [20]

Much of the government support to the economy during this period focused on very large stimulus initiatives to provide liquidity and funding to markets, businesses and individuals in the face of an uncertain future given the nationwide shutdown of the economy during late March and April. Arguably, the most dramatic impact to the mortgage industry during this period was the Federal Reserve's aggressive quantitative easing that cut Treasury rates to near zero. Mortgage rates followed, albeit more slowly, but by mid-July 2020 the Freddie Mac Primary Mortgage Market Survey 30-year fixed rate had decreased to 2.98%, an approximate 50 basis points drop since the Fed began easing monetary policy in late February 2020. The drop in interest rates triggered a significant rush to refinance and boon to industry in this uncertain period.[21]

On March 27, Congress passed the first major piece of legislation in response to the COVID-19 national emergency, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), providing roughly $2 trillion in government relief as well as mandating major programmatic support to provide support to

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[18] For timeline references, see Federal Reserve of St. Louis, "Timeline of Events Related to the COVID-19 Pandemic," https://fraser.stlouisfed.org/timeline/Covid-19-pandemic#14.
[19] "Proclamation on Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID-19) Outbreak." March 13, 2020. Accessed at https://trumpwhitehouse.archives.gov/presidential-actions/proclamation-declaring-national-emergency-concerning-novel-coronavirus-disease-Covid-19-outbreak/ and https://www.govinfo.gov/content/pkg/CDOC-116hdoc108/pdf/CDOC-116hdoc108.pdf .
[20] Centers for Disease Control and Prevention. Sept. 4, 2020. "Timing of State and Territorial COVID-19 Stay-at-Home Orders and Changes in Population Movement – United States, March 1-May 31, 2020." Accessed at https://www.cdc.gov/mmwr/volumes/69/wr/mm6935a2.htm.
[21] Black Knight. March 2020. Monthly Mortgage Monitor. Accessed at https://cdn.blackknightinc.com/wp-content/uploads/2020/05/BKI_MM_Mar2020_Report.pdf.

individuals, families and businesses.[22] Among other provisions, the CARES Act sought to provide immediate and sustained assistance through numerous provisions that impacted the mortgage industry: amending the Fair Credit Reporting Act to suspend negative credit reporting for any accommodation to a borrower affected by COVID-19; during the period of the COVID-19 national emergency, mandating servicers of federally-backed mortgages provide immediate forbearance at the request of a borrower for up to twelve monthly payments based on an assertion of a COVID-related hardship; and imposing a moratorium on initiating or advancing any foreclosures on federally-backed mortgages for at least 60 days beginning March 18, 2020.

The uncertainty around what percentage of borrowers would request forbearance combined with dramatically accelerating prepayment speeds due to booming refinancing applications combined to send servicing valuations plummeting. The unusual dual condition of spiking forbearance and delinquencies mirrored by historically high refinance volume due to low mortgage rates created a very unusual set of circumstances that prompted new strategies at originators and servicers.[23]

Despite record unemployment claims that had not been reach since the Great Depression of the 1930s and forbearance volumes reaching almost 4.8 million loans, or roughly 9% of loans outstanding, by late May 2020 the low mortgage rates prompted by massive Federal Reserve MBS purchases drove record origination volumes and profitability at mortgage lenders throughout 2020. This was also aided by underwriting and appraisal flexibilities implemented for federally-backed mortgage originations in March 2020.

During this crisis, unlike the financial crisis of 2008, credit quality is much higher thanks to the Ability-to-Repay/Qualified Mortgage rule.[24] Also, unlike 2008, going into March 2020, 65% of the mortgage market was federally backed and thus enormous control could be exercised over the servicing of these loans by the federal government, making the mandated forbearance and foreclosure moratorium components of the CARES Act a much more significant piece of legislation than would have been the case in 2008.

The increased use of technology such as digital mortgages, use of Application Programming Interfaces (APIs) provided by a host of new vendors utilizing technology to streamline the mortgage application process, greater acceptance and use of remote online notarizations, and an ability to conduct remote closings in a secure manner all contributed to a period of extreme productivity and profitability in the mortgage industry, despite a country in lockdown.

As mortgage lenders pivoted to new business models during the COVID-19 pandemic, not only was industry greatly assisted by the near-zero interest rate policy of the Federal Reserve but also by state and federal regulators who provided significant flexibilities allowing remote work and work-from-home

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[22] https://www.congress.gov/bill/116th-congress/house-bill/748
[23] See generally MCT Trading Blog. Sept. 22, 2020. "MSR Forbearance in 2020: Challenges and Recommendations." Accessed at https://mct-trading.com/msr-forbearance-in-2020-recommendations/ .
[24] https://www.consumerfinance.gov/rules-policy/final-rules/ability-to-pay-qualified-mortgage-rule/#:~:text=The%20Ability%2Dto%2DRepay%2F,loan%20according%20to%20its%20terms.

to proceed. At the same time the federal housing agencies provided significant and ongoing flexibilities allowing originations to proceed and limiting the financial pain of CARES Act-mandated forbearance.

The changes to the mortgage industry in response to COVID-19 have been profound and will continue to play out as the country emerges from the shadow of the pandemic. Numerous references to these changes will be evident in the data presented throughout this paper and will be highlighted where relevant.

Industry Perspective - Mortgage Origination Going Forward

The future of mortgage lending is an extremely complex topic with far too many political, market and technology variables for any accurate prediction. According to interviews with industry subject matter experts, the future of the nonbank mortgage industry is likely secure. Their reason is simple: people will continue to want to own homes, and very few of them will have the money to purchase them outright. In fact, the number of millennials is approximately the same as the baby boomer generation upon which the mortgage industry was built. While millennials may purchase homes later due to economic reasons (e.g., student loan debt), or social reasons (e.g., starting families later), surveys show 90% of millennials want to eventually purchase a home. They will soon be aging into the 35-year-old cohort who buy homes, producing a potentially huge demand for purchase mortgages.

The industry believes that in general, future regulation of the nonbank mortgage industry will be similar to today's environment -- in their words, "regulated aggressively." It will continue to be driven by specialists, and newcomers may avoid entry because of the high cost of potential noncompliance.

Technology will continue to expand and improve the nonbank mortgage origination industry, but some subject matter experts believe concerns that fintech companies will take over the mortgage business in the coming years are overstated. While consumers will be better able to take advantage of mobile technology to submit applications and obtain the information they need to make decisions, this does not translate to a technology takeover of a business line requiring specialized knowledge and adherence to complex rules, guidelines and consumer protections.

The Nonbank Mortgage Servicing Market

The business of mortgage servicing, also called loan administration, has evolved from an in-house accounting function at primarily depository institutions as recently as the 1980s to today's complex business activity that also encompasses multiple assets attracting a variety of bank and nonbank market participants and investors.

At its most basic level, mortgage servicing involves the activity that is the lifeblood of a healthy mortgage market: the collection and recording of routine payments from mortgagors and application of those funds to the applicable principal and interest balances, as well as disbursement of funds to pay insurance and taxes, where applicable. Embedded in this function is investor and insurer or guarantor reporting, and remittance of payments to the applicable investor (loan owner).

Other primary responsibilities of mortgage servicers include the following duties:

- Loan boarding and transfers (from one system to another)
- Cash management
- Customer service and billing
- Delinquency management and collections
- Loss mitigation and default management
- Managing foreclosed properties
- Maintaining adequate technology and systems
- Vendor oversight

Many factors have led to the evolution of this sector of the mortgage market that in the 1970s was the province of domestic thrifts and banks focused on an originate-and-hold model. Since then it has been transformed by technology, growth of the secondary markets, specialization of roles and the regulatory and legal landscape both pre- and post-crisis, as well as demographic and market shifts.

While basic operational functions of a mortgage servicer are the foundation of the business, this sector has transformed into today's market that includes companies engaging not only in the day-to-day business of servicing mortgage loans, but also those providing specialized component services (e.g. default special servicing) to mortgage servicers, those providing a variety of financing and hedging options to mortgage servicers, and others investing in and buying mortgage servicing rights (MSRs) as a separate and complex financial instrument. Market participants include traditional banks and thrifts but also a variety of nonbank lending, servicing and investing entities participating in this market with a range of business models.

What are Mortgage Servicing Rights?

In basic terms, a Mortgage Servicing Right is the contractual right to service a mortgage loan; according to accounting standards[25], entities owning MSRs must perform a valuation analysis and appropriately recognize the value of the MSR portfolio on the company balance sheet. Effectively, an MSR is an asset if the net present value of the cash flows exceeds the cost of the servicer's obligations to service the associated mortgage loans and a liability if the cash flows do not exceed the cost to service. The MSR valuation is adjusted on a periodic basis to recognize changes in fair

NONBANK LIQUIDITY

Nonbank liquidity is the cash and available funding from credit lines or other sources of debt that a lender/servicer has available to operate their business and pay ongoing operating expenses.

[25] Financial Accounting Standards Board, December 2009. Accounting Standards Update No. 2009-16, "Transfers and Servicing (Topic 860), Accounting for Transfers of Financial Assets," Sec. 860-50-25-1 and 3.

value based on portfolio and market conditions. For example, when mortgage rates rise, MSRs become more valuable as refinancing opportunities decrease and cash flows from MSRs have a longer life than under a lower-rate environment. The converse would be true when rates decrease (or prepayments increase, whether through refinancing or an increase in defaults).

Excess servicing refers to the surplus cash flow over the base cost to service and is a servicer's profit on the contractual administration of a portfolio. Post-crisis this has become an important source of financing for servicers seeking additional liquidity and sources of funding.

Base servicing compensation has always been defined as a component of the interest charged on any given loan, and typically expressed in basis points (1 BP = 1/100th of 1%) applied to the unpaid principal balance. For example, GSE servicing pays 25 basis points (.25%) annually, so on a $200,000 loan the annual servicing fee earned would be calculated as $200,000 x .0025, or $500. The monthly servicing fee paid would simply be one-twelfth of this amount, or $41.67. As the unpaid balance on the loan decreases, so does the monthly servicing compensation. In this example, if this loan was made as a 30-year, 4% fixed rate loan, in month two the calculation would be: $199,712 x .0025/12, for a monthly servicing fee of $41.61.

MSRs began to be recognized as a separate asset on financial statements in 1996 when the Financial Accounting Standards Board published accounting and financial disclosure requirements and allowed treatment of MSRs as a separate asset[26]. This seemingly arcane accounting change not only acknowledged the evolving structure of the mortgage market, but also presciently anticipated the growing mortgage market and importance of disclosing the size and valuation of this asset.

Mortgage Servicing History

Widespread attention to mortgage servicing and its evolution over time has often come in times of flux (the shift away from a thrift and bank-dominated industry to mortgage companies with the rise of securitization in the 1980s and 1990s) or high-profile challenges and scandal in the industry (predatory lending and servicing issues in the late 1990s and the credit crisis of the mid-2000s).

The 1980s demise of the savings and loan footprint in mortgage lending and servicing, discussed under the origination section of this paper, together with new legislation[27] created a market opportunity for not only nonbank mortgage lenders, but servicers alike as thrifts exited the business.

The 1990s and early 2000s saw an increase in the use of technology in mortgage lending and servicing that sped the processes of each, facilitating the growth and concentration of servicing market share in

[26] Financial Accounting Standards Board, May 1995. Statement of Financial Accounting Standards No. 122, "Accounting for Mortgage Servicing Rights (an amendment of FASB Statement No. 65)."
[27] Primarily the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

mega-servicers seeking to achieve economies of scale and lower servicing costs[28],[29] [30]. Between 1989 and 2003, the share of the overall servicing market concentrated in the top ten servicers (both banks and nonbanks) increased from 16%[31] to approximately 51%[32], with nonbank servicers accumulating volume through product expansion and the growing nonprime market.

As previously described, nonbank mortgage lenders dominated the market sector of "non-traditional" (or "non-conforming") mortgage products such as subprime and Alt-A, or more broadly, non-agency, lending. Many nonbank originators such as Countrywide Financial Corporation, Ameriquest Mortgage Company and Option One Mortgage Corporation, also retained the servicing while building a wholesale origination machine that was reliant on secondary market sales and securitization to fuel the financing and growth of the business on the lending side.

Between 1996 and the first quarter of 2003, total subprime servicing more than doubled from approximately $280 billion[33] to $585 billion[34], and by the second quarter of 2007 at the onset of the subprime crisis had almost doubled again to $1.05 trillion.[35] Throughout this time period, the dominance of nonbank mortgage lenders and servicers was validated by two acquisition waves: the first beginning in the mid-1990's by depositories (Barnett, First Union, Citi, Nationsbank, HSBC and National City, to name a few) and in an overlapping and longer wave into the 2000s of "vertical integration" efforts by many of the major investment banks involved in the acquisition and securitization of subprime and Alt-A loans (Lehman Brothers, Bear Stearns, Morgan Stanley, Goldman Sachs, Merrill Lynch, Barclays and Credit Suisse). By the second quarter of 2007 at the onset of the crisis, nonbank servicers still controlled roughly 60% market share,[36] despite significant gains by bank-owned servicers, especially those servicers that at one point had been independent mortgage companies before the mergers and acquisitions waves.

Concurrent with the rise of securitization, the mortgage industry saw an unbundling of functions and rise of industry specialization. MSRs were routinely separated from the mortgage loan and developed as a separate asset to be actively managed, hedged, valued and traded. In a secondary market transaction, the servicing strip and contractual principal and interest could be sold either servicing retained or released. When a loan is sold servicing-released, the originator receives a Service Release Premium (SRP) that is a discounted monetization of the servicing income estimated for the loan over the projected duration of the loan. When a loan is sold servicing-retained, the originator foregoes the upfront cash payment but monetizes the servicing fee over the life of the loan, which can vary significantly when

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[28] Cutts, Amy Crews and Richard K. Green, 2004. "Innovative Servicing Technology: Smart Enough to Keep People in Their Houses?" Joint Center for Housing Studies, Working Paper Series.
[29] Federal Reserve Bank. 2016. "Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets."
[30] Mortgage Bankers Association and PwC. 2015. "The Changing Dynamics of the Mortgage Servicing Landscape."
[31] Follain and Zorn.
[32] Inside Mortgage Finance. 2004. "Top 30 Mortgage Servicers in 2003."
[33] Inside Mortgage Finance. 1997. "Top 25 B and C Servicers in 1996."
[34] Inside Mortgage Finance. 2004. "Top 25 B and C Servicers in 2003."
[35] Inside Mortgage Finance. 2008. "Top 20 Subprime Servicers in 2007."
[36] Ibid.

compared to the SRP, depending on a variety of factors influencing ancillary income, the cost to service and prepayment speeds[37].

The dramatic growth of nonbank servicers leading up to 2007 led to an equally dramatic post-crisis shrinkage of the nonbank footprint in servicing, contracting from an estimated high of, by one estimate, 33% of all servicing in 2006 to 6% by 2010[38]. During this time period, private-label securitization and the proliferation of subprime and Alt-A mortgage products all but disappeared from the market in the aftermath of the market crash of 2007-2008[39], wiping away the nonbank market share that had grown so dramatically on the wave of nonprime lending of the 1990s and early 2000s.

By 2011, large bank servicers controlled up to 94% of the mortgage servicing market but had been exposed as unprepared and unable to manage the high-touch servicing required by the credit crisis. This led eventually to a forced nationwide moratorium on foreclosures in the fall of 2010 due to faulty processing of the immense volume of defaulted loans. Consent orders with federal banking regulators in April 2011, combined with the National Mortgage Settlement in early 2012 with 49 states and the U.S. Department of Justice and HUD, compelled the large banks to begin selling non-performing loans as well as MSRs on delinquent, defaulted and high-risk loan pools in bulk.

[37] Federal Home Loan Bank of Des Moines. February 24, 2017. "Understanding the Benefits of Servicing Released vs Retained." Accessed at https://www.fhlbdm.com/products-services/mortgage-partnership-finance/understanding-benefits-servicing-released-vs-retained/.

[38] Kaul, Karan and Laurie Goodman, Urban Institute. 2016. "Nonbank Servicer Regulation." Accessed at http://www.urban.org.

[39] Urban Institute. January 2019. "Housing Finance at a Glance – A Monthly Chartbook; Origination Volume and Composition, First Lien Origination Volume." Accessed at http://www.urban.org.

2012 National Mortgage Settlement

In April 2012, the five largest bank mortgage servicers signed individual consent judgments with 49 state financial regulators and Attorneys General, the U.S. Department of Justice and the U.S. Department of Housing and Urban Development settling allegations of widespread violations of law in the mishandling of mortgage accounts of distressed borrowers in the wake of the financial crisis of 2007-2008. Banks that signed consent judgments were Bank of America, JP Morgan Chase Bank, Citi, Wells Fargo Bank and Ally Bank/GMAC (the "Bank Parties"). Collectively, the consent judgments required the Bank Parties to a) pay $5 billion to state and federal governmental entities and foreclosed borrowers, b) provide $20 billion in relief to distressed borrowers still in their homes through loan modifications and principal forgiveness, short sales, or refinancing, and c) agree to a set of over 300 comprehensive servicing standards intended to uniformly reform the business of mortgage servicing. By 2016 when the five original settling Bank Parties had fulfilled their obligations under the respective consent judgment, gross consumer relief documented by the settlement's independent monitor totaled over $50 billion to over 640,000 homeowners. The servicing standards governed the industry and established a foundation for new servicing rules promulgated by the CFPB in January 2014.

The role of state nonbank regulators is often overlooked in this landmark settlement against banking institutions. The effort began as an investigation into what became known as "robo signing", the signing off on documents without reviewing them for accuracy. However, as a result of the state regulatory examination conducted by eight states of GMAC, a nonbank mortgage company that merged with Ally Financial, the full scope of the consumer harm came to light and provided the evidence that laid the basis for the significant fines and consumer restitution in the case. The case also launched the implementation of mortgage servicing standards, which were later promulgated through rule by the CFPB. (Joint State-Federal National Mortgage Servicing Settlements, n.d.)

OFFICE OF MORTGAGE SETTLEMENT OVERSIGHT, ORIGINAL SERVICERS' FINAL COMPLIANCE UPDATE 13 (March 3, 2016) (Monitor of the National Mortgage Settlement, 2016)

Nonbank "specialty" servicers, focused on troubled loans, stepped in to take over this business, typically buying large bulk portfolios of MSRs or entire servicing platforms directly from banks. In 2014, the Urban Institute estimated that "the volume of loans managed by nonbank specialty servicers has grown in recent years at a remarkable rate—between 30% and 350%—while servicing by the largest bank servicers has stagnated or declined."

The Current State of Mortgage Servicing

As bank servicers were beginning to shed mortgage assets in the wake of the credit crisis, regulatory changes added momentum to the changing dynamic within the industry and accelerated the nonbank participation in the servicing market.

In 2013, new capital requirements for depository institutions were implemented through the Basel III Accord meant to limit the holdings of MSRs relative to bank equity. While studies by the Federal Reserve

Bank indicate that a relatively small number of banks hold MSRs in excess of the new limit of 10% of Common Equity Tier 1 Capital, banks appear eager to avoid regulatory capital deductions and are focused on building capital. This has ensured a flow of MSRs into the market and given nonbanks the opportunity to expand portfolios beyond simply special servicing of distressed loans. This dynamic may change, however, with the 2019 simplification of the capital rule targeting banks with under $250 billion in total assets (see section below titled "Could Banks Come Back").

Another development has been the emergence of Real Estate Investment Trusts (REITs) and private equity in the mortgage sector. REITs are passive owners that receive favorable tax treatment if they distribute 90% or more of taxable income annually to shareholders. In 2013, coinciding with the initial implementation of the Basel III rules for banks, the Internal Revenue Service issued a private letter ruling expanding the definition of a mortgage servicing asset that is a qualifying asset for a REIT to include excess servicing[40] (see definition of "excess servicing" above). This has fueled heightened investment in MSRs by REITs since the date of the letter ruling, and investors have become active players in the MSR market and their own in-house servicing companies. REITs also rely on third-party servicers to perform sub-servicing on their portfolios of MSRs.

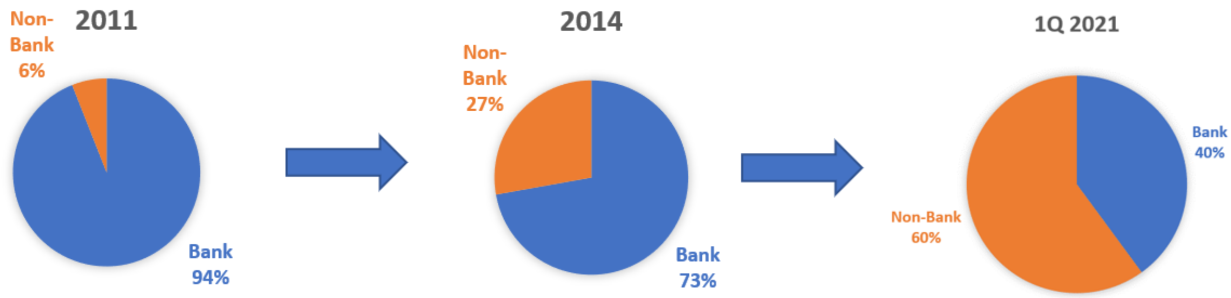
Private equity firms also have been active in the nonbank sector since the crisis in many aspects of the mortgage business, from purchasing non-performing loan pools to origination and servicing as well as buying MSRs. Numerous large market participants have or currently still are affiliated with private equity firms or funds or are managed by advisory firms affiliated with private equity firms. This affiliation often represents the most important source of liquidity for the affiliated nonbank servicers and originators, which obtain credit facilities and securitization outlets from their private equity family of companies.

The upshot as of 2021 is an MSR market with virtual parity between bank and nonbank owners of MSRs, with nonbanks administering approximately 24 million of 52 million outstanding loans.[41] The gains by nonbanks in the agency servicing market, covering the GSE and Ginnie Mae markets, is even more stark. The evolution has followed the crisis-era consolidation within bank to post-crisis movement to nonbanks, and now to the growing presence of passive MSR investors utilizing subservicers. The impact of the new loan volumes during the COVID-19 pandemic are evident with gains accruing to those nonbank lenders that during 2020 shifted from selling servicing-released to retaining servicing and utilizing subservicers. COVID-era market share shifts away from bank and MSR investors in favor of nonbank originators retaining and booking low-cost MSRs has reshaped the contours of the servicing market. The following charts show this evolution:

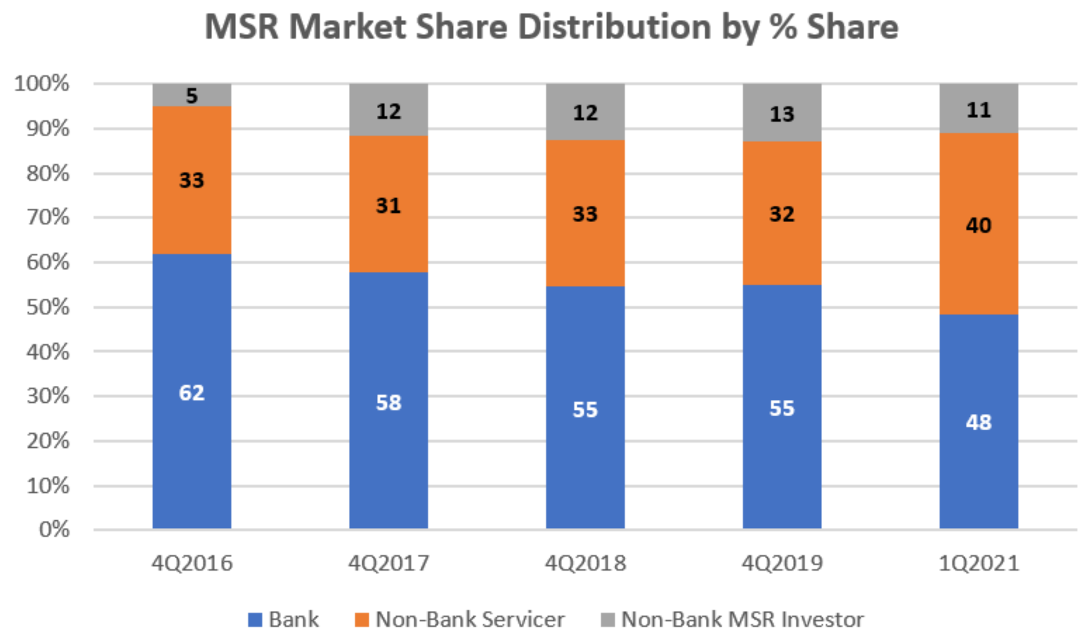
[40] Internal Revenue Service. May 24, 2012. Ltr. Rul. 105442-12.

[41] Nonbank servicing based on 1st quarter NMLS Mortgage Call Report data, Loans Serviced under MSRs and Subservicing for Others. Total outstanding loans: Black Knight. July 7, 2021. "May 2021 Mortgage Monitor", page 20 – "Total Active Count." Accessed at https://www.blackknightinc.com/black-knights-may-2021-mortgage-monitor/ .

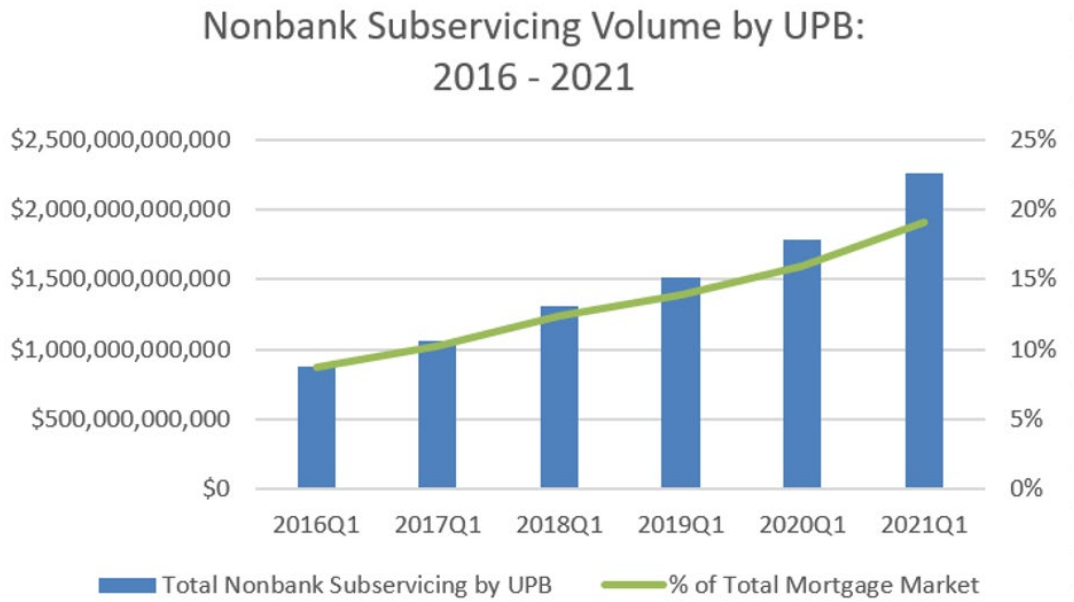
Bank vs Nonbank Share of Agency MBS Servicing Market



Sources: Inside Mortgage Finance Publications, Inc. Copyright ©2021;
Report to Congress on the Effect of Capital Rules on Mortgage Servicing Assets, Federal Reserve, June 2016.



Sources: Calculations from Inside Mortgage Finance, Inc. data, Copyright ©2021; NMLS data.



Sources: NMLS Mortgage Call Report data; Urban Institute *Housing Finance at a Glance*

The nonbank subservicing market is also highly concentrated, with the top ten nonbank subservicers administering 90% of the total nonbank subservicing volume by UPB as of the end of March 2021, based on NMLS Mortgage Call Report data, which is up from 80% administered by the top 10 at the end of March 2016.

The Future State of Mortgage Servicing

Today's MSR market appears deep and liquid, with primarily Fannie, Freddie and Ginnie Mae collateral being traded in the virtual absence of a non-agency market,[42] a dynamic that only intensified after the onset of the COVID-19 pandemic and the flight to quality from March 2020 forward. MSR and advance financing also appears to remain plentiful despite a gradual post-pandemic slowing in the origination market and uncertainty over the longer-term impact of COVID-related forbearances and resulting delinquencies.

However, numerous potential trends in the market bear attention in the coming months and years:

Interest Rate Volatility and Economic Cycles

With increasing concentration of nonbanks in the servicing sector, interest rate volatility and economic cycle downturn could threaten the often-thin capital cushion at such nonbanks. Monitoring the liquidity

[42] Kroll Bond Rating Agency. March 19, 2019. "U.S. Residential Mortgage Bank Update: Mergers and Dispositions."

and leverage of nonbank servicers as they grow market share is crucial to preparedness in protecting businesses and consumers from any future market dislocation.

Since the late 1990s, nonbank participation in the mortgage and MSR markets has followed economic cycles: in periods of expansion, nonbanks grow market share. In periods of contraction, especially the dramatic realignment during the crisis years of 2008 to 2012, nonbank market share shrinks. We are presently in a period of expansion and the cycle will inevitably turn; nonbanks that are well-capitalized will have a much better chance of maintaining their market standing, retaining customers and realigning to address the next cycle.

Could Banks Come Back?

In September 2017, the Basel Committee on Banking Supervision published a proposed new rule that would significantly loosen the restrictions on MSR holdings above that in the Basel III rule.[43] The final rule, published in the *Federal Register* and in a bulletin by the Federal banking regulators,[44] allows banks with under $250 billion in total assets to hold over twice the percentage of capital in the form of MSRs as previously allowed under Basel III (25% of common equity tier 1 capital vs 10% for larger banks). The potential impact of this rule would be two-fold: limiting the sale of MSRs by banks as they elect to retain the MSR asset and increasing the number of participants in the MSR market as certain banks seek to grow their MSR holdings through portfolio acquisitions. This could provide a significant source of competition for the nonbanks and REITs presently gaining market share and slow the nonbank growth in the MSR market Evidence as of mid-2021, however, shows continued gains in market share by nonbank servicers, especially in the higher-risk Ginnie Mae portfolios where nonbanks control almost 78% of all servicing.[45]

Rapidly Emerging Threats: Climate Change and Cyber Attacks

While the entire mortgage ecosystem must address threats posed by climate change and cyber-attacks, mortgage servicers are particularly challenged given their ongoing management and administration of loan portfolios, possession of extensive nonpublic personally identifiable information and reliance on multiple systems of record and vendors.

Threats posed by extreme weather conditions have elevated mortgage servicer's disaster preparedness and response functions to a new level of importance given rapidly evolving conditions. In 2021 alone,

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[43] Basel Committee on Banking Supervision. September 27, 2017. "Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996." Accessed at https://www.fdic.gov/news/news/financial/2017/fil17045.html.
[44] See OCC Bulletin 2019-34, *Simplifications to the Capital Rule*, July 22, 2019, accessed at https://www.occ.gov/news-issuances/bulletins/2019/bulletin-2019-34.html.
[45] Ginnie Mae. June 2021. "Global Markets Analysis Report", page 44.

extreme heat, wildfires, drought and water shortages[46] have reached historic levels and threaten some of the country's most populous areas and growing housing markets,[47] especially in western states. The extreme conditions seen in 2021 challenge the habitability of certain areas, and how population mobility and geographic priorities evolve in the face of the extreme weather and climate changes will undoubtedly present continued and elevated risks to mortgage industry participants.

Similarly, cyber-attacks have been occurring with increasing frequency, especially during the COVID-19 pandemic and have been targeted across the financial services ecosystem. Federal Reserve Chair Jerome Powell named cyber risks and attacks as the risk that most concerns him,[48] an assessment shared by the country's largest bank executives who made a similar assertion in Congressional testimony.[49]

State Nonbank Mortgage Supervision

This section discusses state supervision of the mortgage industry. However, the states share this supervision responsibility with others, including CFPB, as well as non-regulatory business counterparties such as Ginnie Mae, FHFA and others. For more on these shared responsibilities see Chapter Two – Overview of Nonbank Supervision.

State supervision of the mortgage industry is a complex undertaking. As explained in the industry section, the nonbank mortgage segment is bifurcated into two main categories: origination and servicing. Regulation and supervision of these categories is likewise divided by state statutes governing specific areas of mortgage business. While some states may have a single overarching statute for nonbank mortgage, many

THE IMPACT OF THE SAFE ACT

Title V of P.L. 110-289, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 ("SAFE Act"), was passed July 30, 2008. The new federal law gave states one year to pass legislation requiring the licensure of mortgage loan originators according to national standards and the participation of state agencies on the Nationwide Mortgage Licensing System and Registry (NMLS). The SAFE Act is designed to enhance consumer protection and reduce fraud through the setting of minimum standards for the licensing and registration of state-licensed mortgage loan originators. Mortgage loan originators work for an insured depository or its owned or controlled subsidiary that is regulated by a federal banking agency, or for an institution regulated by the Farm Credit Administration, are registered. All other mortgage loan originators are licensed by the states.

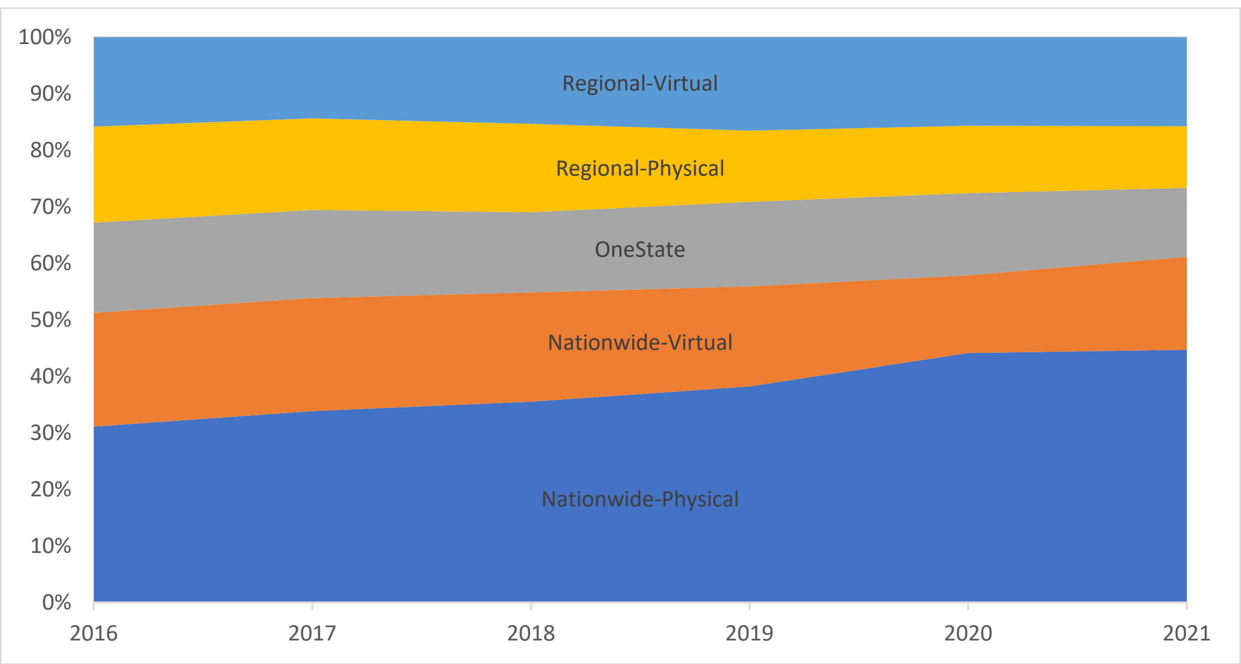
[46] Booth, Michael. The Colorado Sun. July 13, 2021. "The Colorado River is drying up faster than federal officials can keep track. Mandatory water cuts are looming." Accessed at Drought drains Colorado River reservoirs, forces states to cut water usage (coloradosun.com) .
[47] Smith, Hayley. Los Angeles Times. July 12, 2021. "California hit by record-breaking fire destruction: 'Climate Change is real, it's bad.''" Accessed at California wildfires outpacing 2020, the worst on record - Los Angeles Times (latimes.com).
[48] CBS News. April 11, 2021. "Jerome Powell: Full 2021 60 Minutes Interview Transcript." Accessed at https://www.cbsnews.com/news/jerome-powell-full-2021-60-minutes-interview-transcript/ .
[49] Zetter, Kim. New York Times. July 3, 2021, updated July 20, 2021. "Hacking Wall Street." Accessed at https://www.nytimes.com/2021/07/03/business/dealbook/hacking-wall-street.html.

states will have two, three or more statutes covering the industry (e.g., mortgage brokers, mortgage lenders, home equity lenders, mortgage servicers, reverse mortgage lending, mortgage fraud).

Supervision of the mortgage segment, like other nonbank areas, is comprised of licensing, examination, investigation and enforcement, and complaint handling. Each of these examination functions were discussed broadly in Chapter Two – Overview of Nonbank Supervision. In the remainder of this section, supervision is discussed specific to the mortgage industry.

The ability to capture individual company licensing and operational data through the NMLS has empowered state supervisors to better understand the market. Understanding the makeup and operations of the market supports more advanced risk-based examination scheduling and scoping. By identifying characteristics of the industry as a whole and then comparing individual companies to their peers, supervisors can identify outliers, companies operating on the margin, or unsustainable business models. For example, by monitoring a mortgage servicer's capital and liquidity position over successive quarters, regulators are able to proactively address a downward trending path that could lead to reduced consumer protections or company failure.

The following charts developed from NMLS MCR data provide state supervisors with information about the makeup of the industry, tracking various metrics for different sizes and business models.



The chart above shows that nationwide companies with a physical or branch presence originate the greatest number of loans. As expected during the widespread office closures during the COVID-19 national emergency of 2020 and 2021, originations by companies with a physical or branch presence leveled off in favor of lenders with virtual offices.

Licensing

Prior to 2008, most states licensed mortgage brokers and lender companies. Few states licensed individual MLOs (people), and even fewer states licensed mortgage servicers. With the passage of the federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act), followed by individual state SAFE acts, the landscape of mortgage changed rapidly. By 2010, all states were licensing MLOs. Further, as a result of the crisis, states turned the spotlight on mortgage brokers, lenders and servicers and the ranks of those required to hold a license grew significantly. [see The Impact of the SAFE Act]

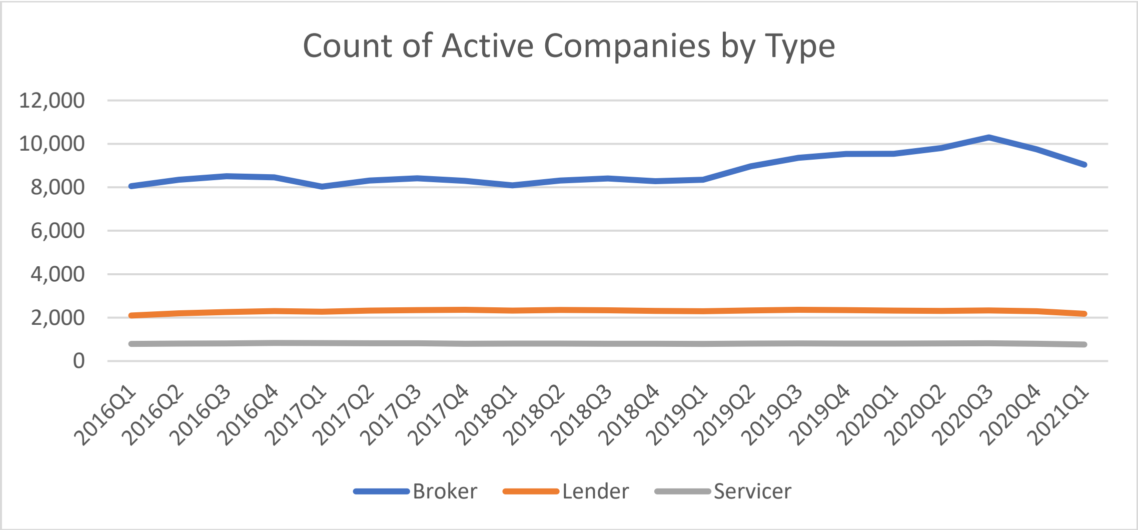
The launch of NMLS in 2008 was a game changer for state mortgage licensing efforts and for the industry itself. Never had a single system been available and required by both federal and state law as a national system of record for all aspects of mortgage licensing. But NMLS quickly proved to be more than just a system of record for information. By 2010, all states, the CFPB, all companies, all depositories and all MLOs were using the system for every aspect of the licensing and registration process, including:

- Backroom operating system for license applications, reviews, approvals and issuance
- System of record for all companies and MLOs (including depositories and registered MLOs)
- Mortgage Call Reports (MCRs) are collected quarterly reflecting transaction and financial information
- Fulfillment of testing and education requirements
- A record of formal enforcement actions
- A company and individual MLO "lookup" – https://www.nmlsconsumeraccess.org/

State and federal mortgage regulators, license applicants and consumers all use NMLS. Licensing authority resides solely with each individual state; however, the functions are performed directly through the system, creating an efficient supervisory environment. The history of NMLS (renamed Nationwide Multistate Licensing System), the use and functionality of the system and its future are discussed in Chapter Two – Overview of Nonbank Supervision.

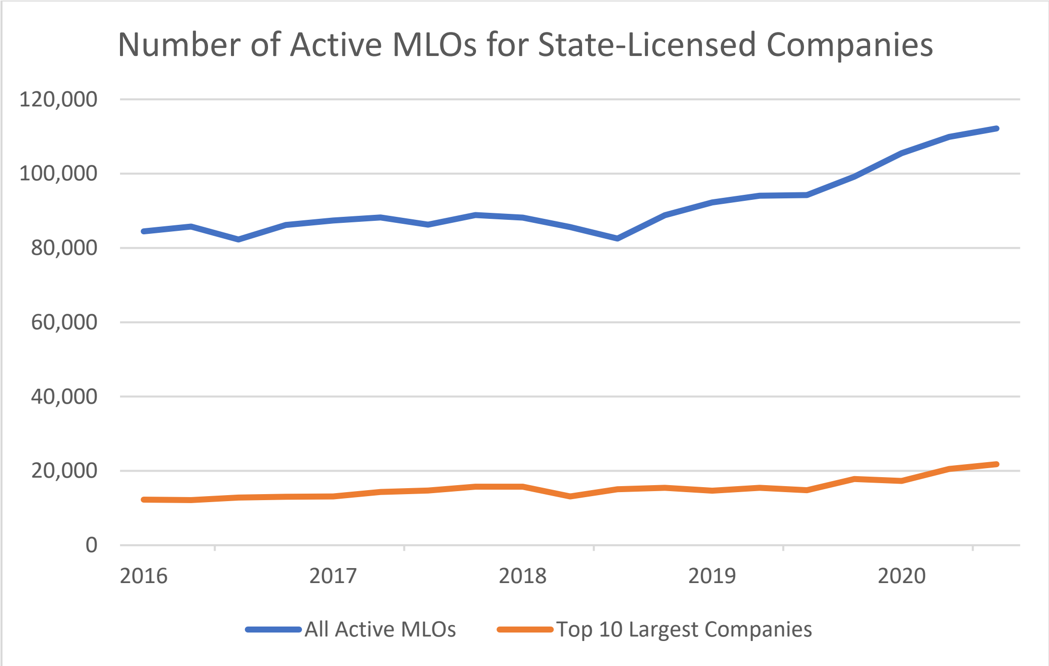
Observations on the Size of the Nonbank Mortgage Segment

In 2012, national mortgage licensing was in full swing, but the number of licensed companies had declined dramatically due to failures and voluntary closures as the mortgage industry recoiled from the system shock in the 2008 financial crisis. According to the Mortgage Lender Implode-O-Meter, a non-governmental website tracking mortgage company closures monitored by regulators and industry throughout the crisis, approximately 308 mortgage lenders shuttered from 2006 through 2008. Despite the growth of companies reflected in NMLS, from 2012 through year end 2015, a downward trend in active (those reporting business activity during the quarter) companies continued. By year end 2015, only 10,269 active nonbank mortgage originators existed in the system – a decline of almost 7% from 2012. From 2016 forward, the total number of active companies in the state system was relatively stagnant across types of licensees until early 2019 when a sustained refinancing boom commenced that only accelerated during the COVID-19 national emergency.



Source: NMLS

The story for active MLOs appears to essentially parallel that of the companies for which they work. While there was a steady increase from 2012, the following graph of active MLOs shows a period of relative stagnation between 2016 and late 2018 when the numbers began increasing. By early 2019, the number of active MLOs was noticeably spiking, a trend that accelerated during the sustained refi boom and record originations seen during 2020 and 2021.



(Source: NMLS/MCR)

Gatekeeping in The Mortgage Industry

The table below shows the volume of applications received and approvals for licenses in 2020. Clearly companies and individuals are still entering the industry, and the role of license screening or gatekeeping continues to be an important part of the state regulator mission.

Application for both company and individual MLO license requires background checks, including criminal background and credit checks, and education and testing for MLOs and certain company responsible individuals. Company approval includes evidence of a valid surety bond for each state in which the company seeks license and financials confirming net worth requirements.

2020 License Activity (Source: NMLS)

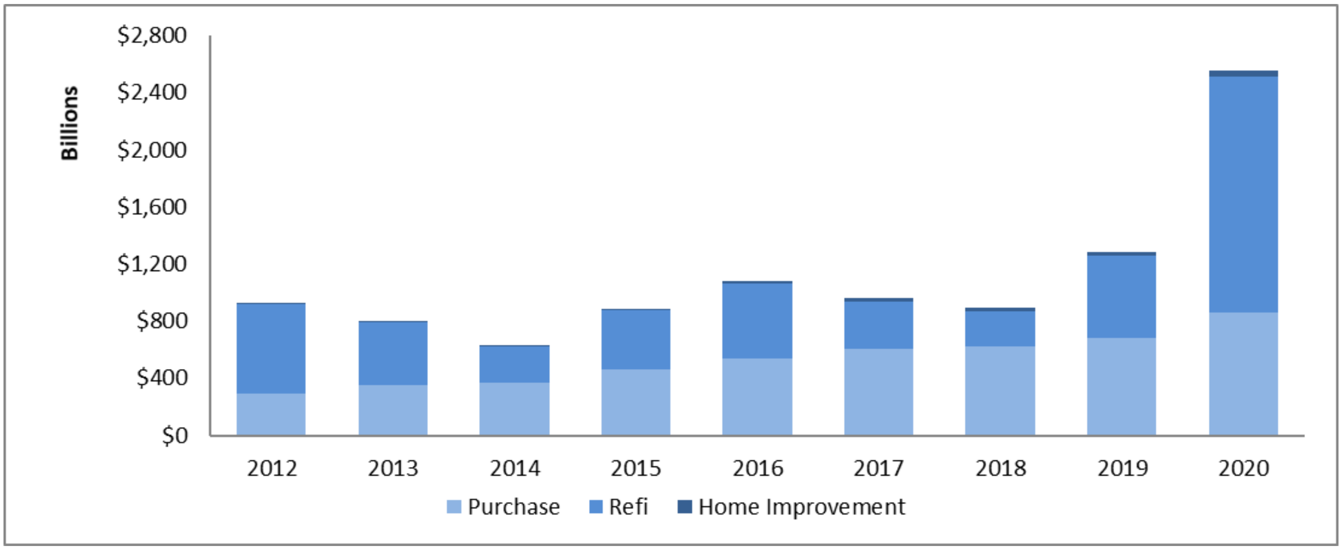
License Type	Applications	Approvals	% Approved
Individual (MLO)	224,277	209,128	93.2%
Company	8,363	7,122	85.2%

Both company and MLO licenses must be renewed on an annual basis. The renewal process includes confirmation that the licensee continues to meet the requirements necessary for obtaining a license, including timely and accurate filing of MCR data.

Observations on Nonbank Mortgage Originations

Although the market bounced around from refinance to purchase dominance between 2012 and 2018, this changed with lower mortgage rates beginning at the very end of 2018. After the onset of the COVID-19 pandemic, Federal Reserve actions pushed mortgage rates below 3% and added rocket fuel to a refinancing boom that has lasted well over two years and counting as of summer 2021 (see table below)

MCR TRANSACTION DATA



(Source: NMLS MCR data)

Despite an increasing market share for nonbank entities, nonbank MLOs overall are originating an increasing number of loans and in increasing dollar volumes, with the average dollar amount of each loan also increasing. The acceleration of these trends after 2019 are notable reflections of the COVID-era refinancing boom, increasing nonbank market share as well as increasing home values and mortgage amounts.

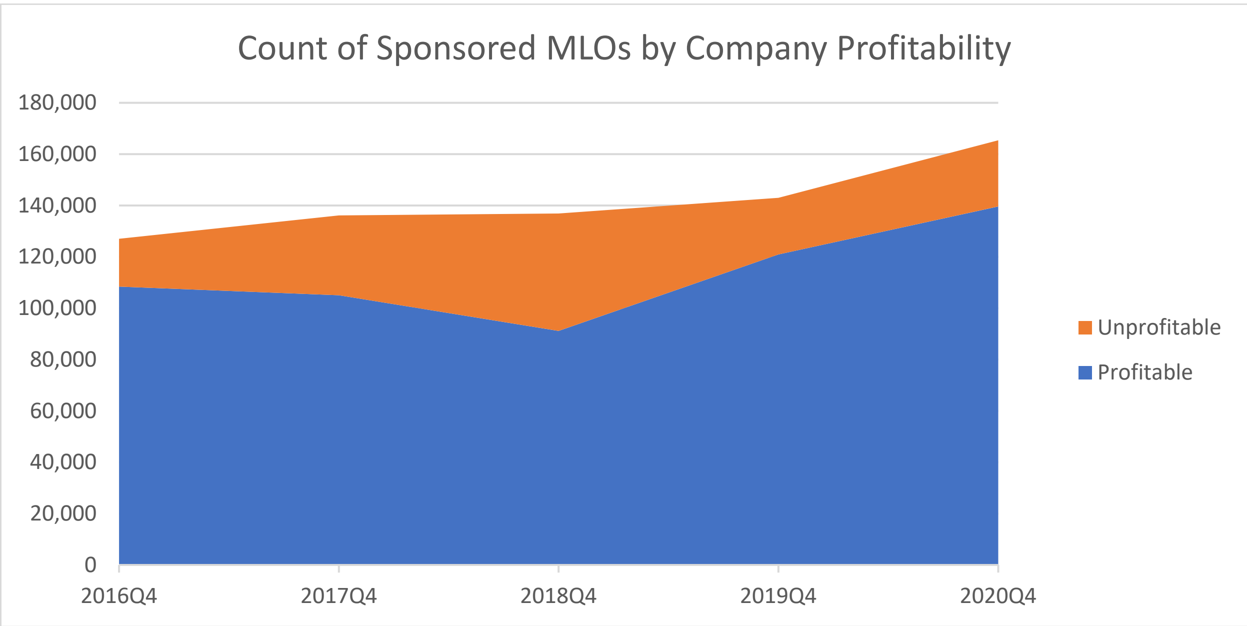
	2017	2018	2019	2020
Loan count per MLO	39.9	32.1	42.1	72.0
$ originated per MLO (in millions)	8.8	8.0	11.5	20.4
Loan amount	$221,628	$249,099	$272,391	$283,396

(Source: NMLS MCR data)

Profitability over time

Profitability refers to profit margin (net income divided by total revenue over the last 12 months) and is calculated using quarterly data from the MCR analytics model. Companies with no reported revenue or income are counted as unprofitable unless otherwise stated.

As shown in the charts below, from the fourth quarter of 2016 through year-end 2018, the number of MLOs sponsored by profitable companies had decreased substantially. On a percentage basis, only 67% of MLOs were sponsored by profitable companies at the end of 2018, down from 85% two years earlier.[50] The trend reversed with the refi boom starting in early 2019 that accelerated through the 2020-2021 COVID-19 national emergency, with both an increasing number of MLOs as well as the number and percent of MLOs sponsored by profitable companies, which was restored to just over 84% by year-end 2020.



Risk in the Origination Market

As part of its mission to serve first-time homebuyers, FHA insures loans that typically have greater risk characteristics than conventional conforming (GSE) loan borrowers (see below: FHA Carries Greater Risk at Origination). This fact makes sense given the FHA purpose of providing financing and home ownership for those homebuyers who may not have the larger down payment typically required in the GSE conforming market. FHA has also traditionally served a greater proportion of low to moderate income and minority borrowers. In fact, greater risk in the system translates to greater fulfillment of this public policy goal. From a purely supervisory view, the fact that nonbanks are originating 92% of the loans backing Ginnie Mae securities, including FHA-insured loans, translates to an industry that is accepting

[50] All data and calculations drawn from NMLS Mortgage Call Report data.

higher amounts of borrower risk at origination. Even though FHA insures these loans, and the credit risk is borne by the Mutual Mortgage Insurance Fund (MMIF), servicers of loans in Ginnie Mae securities have PITI advancing obligations until a delinquency is cured in addition to higher operational costs to service due to the elevated delinquency rates compared to GSE loans.

The primary borrower credit risks tracked by both industry and the regulators are:

- Credit score: Typically measured by the Fair Isaac Corporation (FICO®) score[51], one indicator of borrower credit worthiness, with scores ranging from 300 to 850; the lower the credit score the higher the risk.
- Loan to Value (LTV): The percent of loan to the property's value made to a borrower or conversely, the percent of down payment made (purchase) or equity held by the borrower (refinance); the higher the LTV, the higher the risk.
- Debt to Income (DTI): The amount of the borrower's monthly debt divided by the borrower's monthly income; the higher the DTI, the higher the risk.

	GSEs		FHA	
Characteristics	First-time	Repeat	First-time	Repeat
Loan Amount ($)	307,229	325,375	244,480	262,965
Credit Score	749	758	676	674
LTV (%)	87	80	95	94
DTI (%)	34	35	43	44
Loan Rate (%)	2.93	2.87	2.98	2.95

FHA RISK

Lower FICO Score

Higher LTV

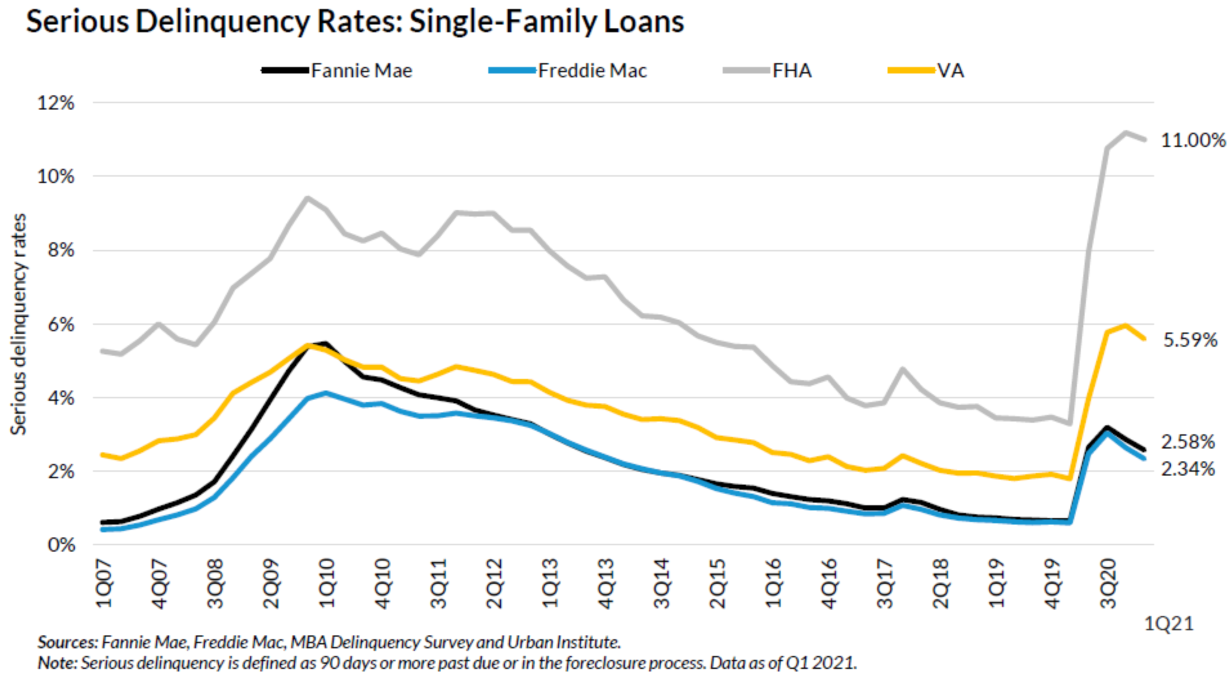
Higher DTI

Sources: eMBS and Urban Institute.
Note: Based on owner-occupied purchase mortgages originated in April 2021.

Source: Urban Institute Housing Finance Policy Center Housing Finance at A Glance, June 2021, and CSBS

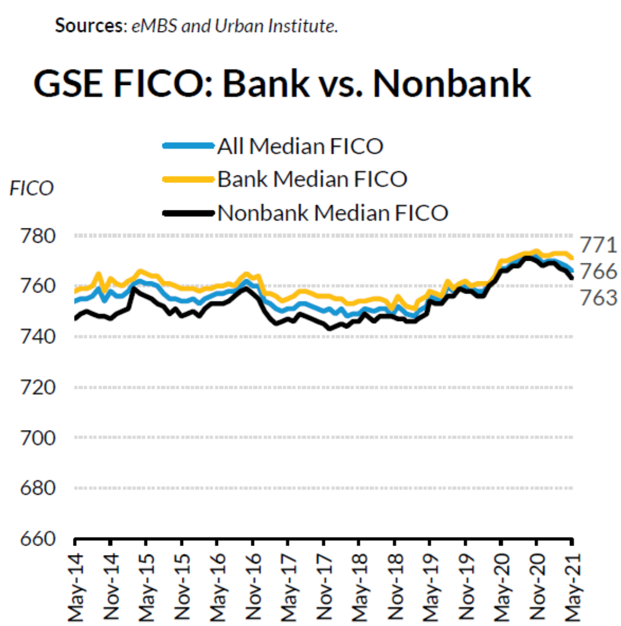
And as evidenced in the chart below, this risk translates to greater delinquencies or a borrower's failure to make payments as required. This dynamic has been highlighted and exacerbated by the dramatic difference in COVID-era forbearances and delinquencies shown in this chart from Ginnie Mae.

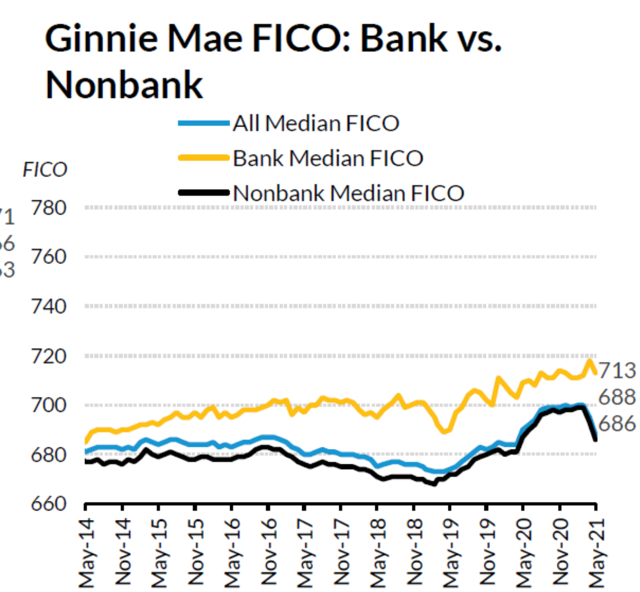
[51] FICO® Scores are the most widely used credit scores. Each FICO® Score is a three-digit number calculated from the data on your credit reports at the three major credit bureaus—Experian, TransUnion and Equifax. Your FICO® Scores predict how likely you are to pay back a credit obligation as agreed. Lenders use FICO® Scores to help them quickly, consistently and objectively evaluate potential borrowers' credit risk. https://ficoscore.com



Source: Ginnie Mae Global Markets Analysis Report, June 2021

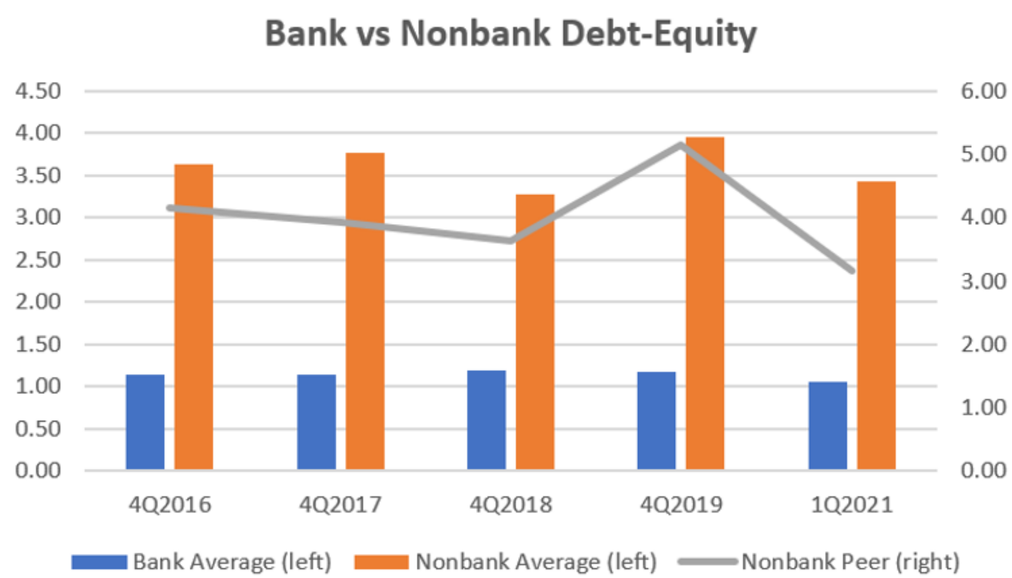
Within the higher risk Ginnie Mae space itself, nonbanks originate loans with higher risk characteristics than do banks. The tables below reflect very similar average GSE FICO scores, but with greater disparity for Ginnie Mae.





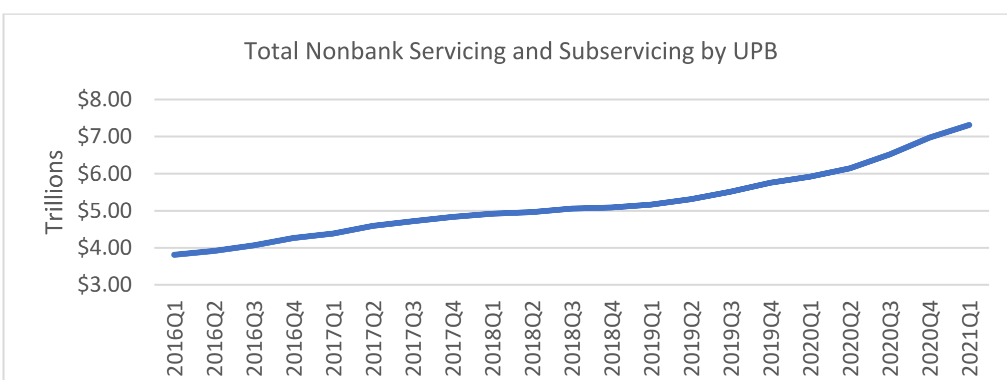
Source: Urban Institute Housing Finance Policy Center Housing Finance at A Glance, June 2021

To state mortgage regulators, increased acceptance of borrower risk does not in itself mean that nonbanks inherently pursue greater risk, as can be seen by similar credit risk in conventional conforming loans. Rather it may very well mean that nonbanks are performing a public service that banks may be unwilling to undertake at this time due to economic or regulatory factors. Lending risk is perhaps better measured by the number and severity of consumer complaints, and the adequacy of the entity's compliance management system (see Chapter Two – Overview of Nonbank Supervision). But these measures are only valid at an individual company level. Financial condition risk of the industry segment can be observed more broadly with the aid of MCR data. In general, nonbank mortgage originators operate on thinner capital margins and more leveraged liquidity than their bank counterparts as evidenced, for example, by the significantly higher debt carried by nonbanks compared to banks.



Sources: Ychart data for top bank servicers per Inside Mortgage Finance ranking, 1Q2021 ©. Nonbank data per NMLS Mortgage Call Report data.

Observations on Nonbank Mortgage Servicing



(Source: NMLS/MCR)

Nonbank mortgage servicing has grown steadily for the last several years. The graph above reflects servicing owned, subservicing for others and subservicing by others (some double counting may occur).

As stated previously, nonbank servicers are quickly approaching the point where they are servicing nearly the same volume of loans as their bank counterparts. Within the nonbank mortgage servicing market, MSR ownership and servicing is concentrated in the largest entities, which control nearly 80% of the nonbank servicing market. MSR ownership by master servicers has increased over the last three years, leading to an increasing reliance on subservicers. This may make the servicing industry more susceptible to market forces because subservicers are at the mercy of the MSR owner and could be terminated with relatively short notice, as happened just prior to the recent Ditech bankruptcy.[52]

Despite the growing size of nonbank servicers and their market share approaching near parity with banks, these institutions are not banks. They neither fit the profile of banks in terms of funding sources or stability in capital and liquidity. This lack of stability is the root of growing concern with state regulators.

Risk in the Nonbank Mortgage Servicing Market

State regulators have focused attention in recent years on the financial condition of nonbank servicers. These observations identify the following risk characteristics:

- **Reliance on short term funding for liquidity needs:** Where available data exists for the top five servicers, on Dec. 31, 2018, an approximate average of 70% of available liquidity was from unused credit facilities versus cash, and the MBA estimates that 90% of total nonbank liabilities have short maturities. While these credit facilities provide a ready source of funding in good times, they are provided by larger financial institutions and carry restrictive covenants (e.g., servicer must remain profitable) allowing them to be withdrawn, possibly when needed the most.
- **Nonbank servicers have fewer resources to draw upon when needed:** For the most part, nonbank servicers are considered mono-line companies. In other words, their revenue is primarily dependent on a single asset – income from servicing loans. Concentration in a specific asset area may compromise revenue generation when events impact that asset type adversely.
- **Servicing advance requirements negatively impact available liquidity:** Servicers are required to advance funds to investors and for the payment of taxes and insurance when borrowers stop making their monthly mortgage payments. Although advances are ultimately reimbursed either by the investor or through the sale of property, such advances, especially for Ginnie Mae secured loans, may be outstanding for long periods of time.
- **Servicing costs are higher for delinquent, in-foreclosure specialty servicing and Ginnie Mae pools where nonbanks have continued to increase their footprint**: Ownership and

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[52] Ditech Holding Corporation, Form 8-K filed January 24, 2019, accessed at https://www.sec.gov/Archives/edgar/data/1040719/000119312519016019/d687701d8k.htm.

management of Ginnie Mae MSRs has been subject to the bank to nonbank market shift discussed earlier, with nonbanks comprising 78% of total Ginnie Mae mortgage servicing outstanding in 2021 – an increase from 30% at the end of 2013.[53] This dramatic shift from banks to nonbanks in the Ginnie Mae program is expected to continue.

The chart below reflects that nonbank servicers, as opposed to banks, are heavily concentrated in a single asset, MSRs, that are subject to outside economic influence with little offset from capital. A similar comparison in asset concentration pre-COVID is observed where MSRs among the top five nonbank servicers accounted for 26% of total assets in 2018, compared to only 1.5% at the top five bank servicers. The impact of the COVID-era market dynamics – the sustained refinancing boom, soaring originations and profitability at nonbanks, lower MSR valuations due to accelerated prepayment speeds – lowered the MSR-to-total asset ratios at both banks and nonbanks alike, but the asset concentration differential between the two entity types remains stark:

MSRs to Total Assets

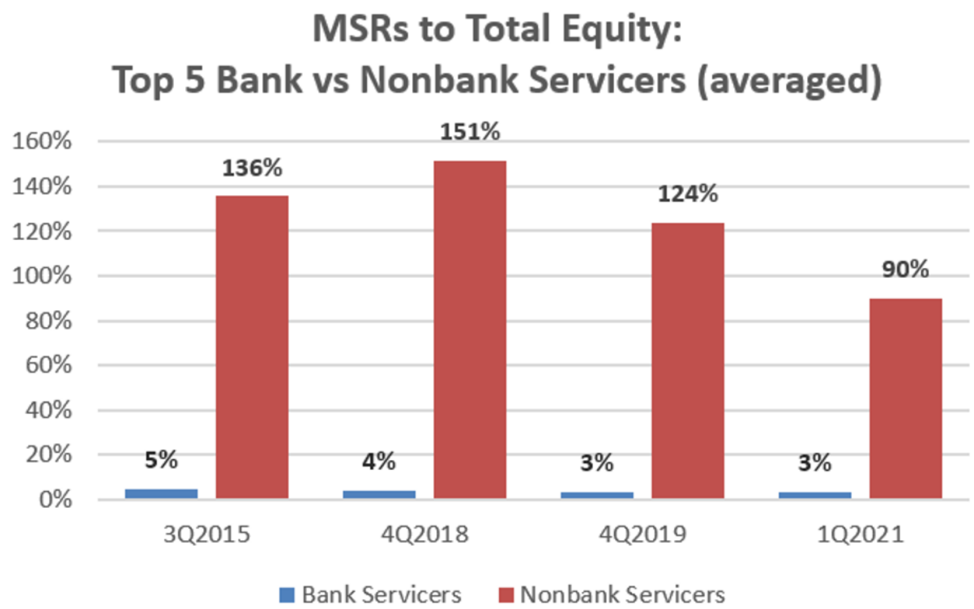
Description	4Q2018	4Q2019	1Q2021
Top Bank Servicers	1%	0.39%	0.31%
Top Nonbank Servicers	31%	19%	11%

Sources: NMLS Mortgage Call Report data; Bank investor reporting and SEC filings.

While state regulators acknowledge that such concentrations are typical for nonbank mortgage servicers, the combination of the nonbank risk characteristics heightens supervisory awareness and monitoring. As the post-pandemic market normalizes, heightened MSR asset concentrations are expected to also return to pre-pandemic levels.

Even with the increased profitability of the pandemic-era refinancing boom, the decrease in MSR valuations due to increased prepayment speeds still shows nonbanks with a significantly higher MSR-to-equity position as compared to banks and reflects a major concentration within this asset.

[53] Ginnie Mae, June 2021, *Global Markets Analysis Report*, page 44.



Sources: Urban Institute, "Nonbank Servicer Regulation", February 2016; Inside Mortgage Finance data; Company SEC 10-Q and 10-K filings; NMLS Mortgage Call Report data.

While state regulators acknowledge that such concentrations are typical for nonbank mortgage servicers, the combination of the nonbank risk characteristics heightens supervisory awareness and monitoring.

Focus on Nonbank Liquidity

The dramatic increase in the footprint of nonbank servicers and investors, and the different business models increasingly represented in this market, has led to guarantor, investor and regulatory interest in examining nonbank liquidity and financial capacity. This is especially true at Ginnie Mae, where nonbanks comprised 62% of total outstanding portfolio balances in 2018 – an increase from 10% in 2010[54]. After completing a series of liquidity reviews with its largest issuers in 2019, Ginnie Mae issued a Request for Input regarding a stress testing framework to further enhance its counterparty risk management to better understand and monitor risk of its nonbank issuers and servicers[55]. The Ginnie Mae counterparty risk initiative also dovetails with efforts regarding nonbank monitoring and prudential standards within the state regulatory system.

Increasingly, the issue of liquidity – cash to cover expenses – beyond the amount of funds for servicing advances is being scrutinized by state nonbank mortgage regulators. Servicers, like any other company, have cash needs to cover expenses related to facilities overhead, payroll or any other ongoing operating expenses. We refer to this liquidity need as the ability to "keep the lights on." The table below analyzes

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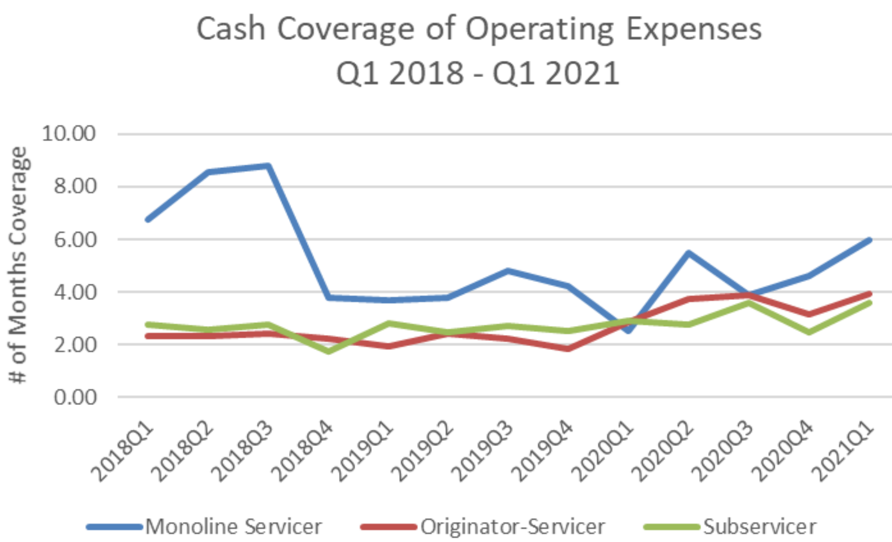
[54] Ginnie Mae, May 2019, *Ginnie Mae Report on Issuer Liquidity Meeting Series*, accessed at https://www.ginniemae.gov/newsroom/publications/Documents/issuer_liquidity_meeting_series_report.pdf.
[55] Ginnie Mae, July 2019, *Request for Input, Stress Testing Framework and Recommendations*, accessed at https://www.ginniemae.gov/newsroom/publications/Documents/ginniemae_rfi_stress_testing.pdf.

thirty large nonbank MSR servicers and subservicers (identified as "servicing for others") using a simple liquidity ratio of Cash/ (Monthly Operating Expenses + Monthly Interest Expense). Alternatively, the amount of monthly expenses that can be covered with liquid assets on hand. Note in this analysis 1 = one month's expense coverage.

Variation among business models is evident in this chart, and the impact of the COVID-19 refinancing boom is also clearly seen among all nonbanks reviewed, with all showing increased capacity to cover monthly expenses as of the first quarter of 2021 as compared to the pre-COVID date of Q4 2019. At that point, originator-servicers had, on average, less than two months of liquidity coverage of total operating expenses. The variation among companies even of the same business model is evident, with the low coverage at just over two weeks of operating expense coverage to a high of over five months of coverage.



Again, thin liquidity margins, especially when coupled with the other risks identified above, can put a nonbank in a sudden compromised position triggered by a reduction in revenues or other market or economic events such as volatile interest rates that can have significant impact on the value of MSRs.

While nonbank servicers currently appear to have adequate borrowing facilities available, such borrowing must typically be renewed on a regular basis and is subject to not only risk underwriting criteria, but ongoing covenants assuring that the nonbank will continue to operate as expected. Further compounding liquidity concerns is that these credit facilities are needed most when the ability to retain them is the most tenuous. In other words, as conditions in the market or within the company itself deteriorate, liquid funds from borrowing to cover servicing advances and to keep the lights on are needed even more; however, this is the very time when creditors are less willing to lend or renew credit lines.

Model State Regulatory Prudential Standards for Nonbank Mortgage Servicers

On July 23, 2021, the CSBS Board of Directors approved the Model State Regulatory Prudential Standards for Nonbank Mortgage Servicers (prudential standards or standards).[56] The approval established state policy following years of discussion and release of a proposal and request for comment in 2020. Transition from policy to requirement is expected to begin in 2022 as states formally begin to adopt the standards.

What institutions are covered by these standards?

All nonbank mortgage servicers with portfolios of 2,000 or more 1-4 unit residential mortgage loans serviced or subserviced for others and operating in two or more states, districts or territories, excluding whole loans owned and loans being "interim" serviced prior to sale, are intended to be covered by the standards.

Are there exemptions or exceptions?

- Depositories, not-for-profits and housing agencies are exempt.
- Financial condition requirements do not apply to servicers solely owning and/or conducting reverse mortgage servicing, not-for profit mortgage servicers or housing finance agencies.
- Corporate governance does apply to reverse mortgage servicers.
- The capital and liquidity requirements of the standards have limited application to entities that only perform subservicing for others due to reduced risk of payment advance requirements.

What are the prudential standards?

The standards are state approved policy intended for adoption by individual states. The standards include two major sections: financial condition (requirements for capital, liquidity and certain assets), and corporate governance (board oversight of the institution). The standards provide industry with a uniform set of state requirements while providing regulators with national requirements to examine against.

Why the standards now?

Nonbank servicers have grown tenfold in agency market share over the last decade and now are responsible for over 60% of this part of the market. State and federal examinations have shown a need for financial condition and corporate governance controls with these servicers. While program standards exist for participation in Fannie Mae, Freddie Mac, FHA and VA loan servicing, there are no private servicing standards and no national level regulatory requirements enforceable by states.

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[56] The standards and public comments along with additional material can be found at: https://www.csbs.org/policy/research-data-tools/nonbank-mortgage-servicer-prudential-standards

How are consumers protected?

Companies that operate in a safe and sound manner are much better positioned to fulfill the significant requirements associated with servicing mortgage loans and assisting customers with these important financial obligations. Much of the foreclosure problem that occurred during the financial crisis was due to servicers insufficiently staffed and poorly managed at a time when borrowers needed help the most. Safety and soundness are fundamental to consumer protection and the financial condition and corporate governance requirements in these standards form the basis for safe and sound operations.

Why are these standards good for industry?

Industry benefits from clear and transparent regulatory requirements that are consistent across all states. Further, these standards align closely with existing requirements at the federal level, mitigating regulatory burden while establishing guardrails for compliance within the state system of supervision that are complimentary rather than duplicative.

What are the financial condition requirements in the standards?

The states chose to align their financial condition standards with the capital and liquidity requirements imposed by the Federal Housing Finance Agency (FHFA, the regulator of Fannie Mae and Freddie Mac) for nonbank servicers seeking to participate in GSE servicing programs. The model law/rule states: "A covered institution that meets the FHFA Eligibility Requirements for Enterprise Single-Family Seller/Servicers for capital, net worth ratio, and liquidity, regardless of whether the servicer is approved for GSE servicing, meets the requirements [of this Act]." While the capital and liquidity calculations are the same, the standards apply the FHFA requirements to all loans serviced by the nonbank, not just GSE servicing.

Currently, the FHFA requirements are:

- Minimum net worth of $2.5 million.
- Tangible net worth divided by total assets > 6%.
- Base servicing liquidity requirement of 3.5 basis points of total servicing, excluding subservicing for others and reverse mortgage servicing.
- An incremental non-performing loan (NPL) charge of 200 basis points on NPLs greater than 6.0% of total servicing, excluding Subservicing for others and reverse mortgage servicing.

Additionally, the standards require that nonbank servicers pay greater attention to operating liquidity needs (the funds necessary to perform normal business operations beyond the servicing liquidity requirements), an area not directly addressed at the federal level.

What are the corporate governance requirements in the standards?

Corporate governance refers to the structure of the institution and how it is managed. It includes the corporate rules, and the practices and processes used to oversee and manage the institution. Corporate governance dictates how its board of directors and management balance responsibilities to shareholders, the public, regulators and its own employees. The standards include requirements for:

- A board of directors or similar structure responsible for all aspects of corporate oversight
- Internal and external audits
- Risk management

For the most recent information and tools related to the standards visit: https://www.csbs.org/policy/research-data-tools/nonbank-mortgage-servicer-prudential-standards

Mortgage Examination

There are two levels of examination in the state system of nonbank mortgage supervision: Individual state exams and multistate exams. Examination approaches and practices for both areas were discussed thoroughly in Chapter Two – Overview of Nonbank Supervision. In short, an individual state exam means a single state is examining a mortgage company for origination or servicing activity within that state. A multistate exam is a coordinated effort between two or more states and the company may be reviewed on a national level by an examination team representing other states. Most multistate exams are administered by a committee of state mortgage regulators, the Multistate Mortgage Committee or MMC (discussed below). However, states may join resources independent of the committee process, often on a regionalized basis (e.g., the New England states).

A multistate examination team will commonly examine the institution for compliance with applicable state and federal laws and regulations. Most states have specific authority within their mortgage statutes to examine for compliance with federal requirements. There are several federal regulations applicable to the mortgage industry, which creates a common ground for state regulators to supervise in a coordinated and cooperative fashion. Additionally, the multistate examination team will commonly examine the institution's financial condition, general risk management including the institution's compliance management system, and the quality and performance of the company's management team.

An individual state examination may or may not incorporate all the above areas of review. The determination to review for specific areas is governed by statute, regulation, practice, resources and a determination of company risk during examination scoping.

The MMC conducts origination and servicing examinations of the largest, most complex mortgage entities based upon agreed standards of examination procedures and process. In 2012, the MMC developed and published the MMC Mortgage Examination Manual, updated in 2019, 2020 and undergoing further updates in 2021 (MMC Examination Manual can be found here: https://www.csbs.org/mortgage-examination-supplements). The manual is intended to be a guide for both multistate and individual state examinations. It is also intended as a tool for mortgage companies to review their own compliance and readiness in advance of a state examination.

Multistate Mortgage Examination Objectives

A multistate examination takes into consideration all significant compliance, operational and financial factors. The overall objective of the examination process is to:

- Evaluate the institution's financial condition and quality of management
- Ensure compliance with state and federal laws and regulations
- Investigate possible consumer protection issues
- Assess the institution's compliance management system

Mortgage Examination Review Areas

The primary areas of review in a state mortgage examination include:

- Financial condition
- Board oversight and management
- Compliance program
- Violations of law and consumer harm

While a mortgage examination will incorporate the areas listed above regardless of the type of loans originated or serviced by a mortgage company, the types of loans originated require examiners to adjust their focus of review. Examinations can be categorized as follows, keeping in mind that a single examination of a large mortgage operation can include all the following types:

- Origination
    - Forward[57] first mortgage lending or brokering (purchase and refinance loans)
    - Second or home equity lending or brokering
    - Reverse mortgage lending or brokering
- Servicing
    - Forward mortgage servicing, including first and second loans
    - Reverse mortgage servicing

Efficiency and Effectiveness Through Multistate Examinations

Multistate examinations are conducted for the largest, most complex mortgage companies. These companies typically operate at the national level and are examined multiple times per year by individual

[57] The term "forward" is used to differentiate typical purchase and refinance business from "reverse" mortgage business. Some mortgage companies specialize in reverse mortgages while others offer reverse mortgages as an addition to their standard mortgage business.

states. The benefits of multistate exams for these companies is significant in terms of reductions in onsite time, reduced travel costs and reduced information requests.

MMC Examination Data: 2017 - 1st Half 2021

	2017	2018	2019	2020	1H2021
# of Multistate Exams	11	6	9	8	9
# of Individual States Participating	115	62	101	52	89
Average # of Participating States per Exam	10.5	10.3	11.2	6.5	9.9

Participation in multistate exams satisfies a state's requirement to conduct an individual exam. In 2017, the 11 multistate exams effectively satisfied approximately 115 individual state exams (or 115 exams that would have been conducted of these 11 companies if there had been no multistate exams). For 2018, the six multistate exams satisfied approximately 62 individual state exams. The 2020 examinations include three targeted financial condition exams conducted by one state each on behalf of the MMC, all of which – along with the 2021 exams – were conducted remotely due to COVID-19.

Multistate examinations provide another benefit seldom recognized by the industry. Nonbank mortgage companies are required to pay an hourly examination fee plus the travel costs of the examination team. Single-state exams will frequently require the engagement of two or more examiners. For large companies examined every year by 20 or more states, airfare, hotel and other costs are considerable. A multistate mortgage exam with 15 participating states will typically send a smaller representative examination team onsite. Where individual state exams of the company would likely involve dozens of examiners and their associated travel costs, a multistate undertaking may send only five or 10 examiners to the company's location, thereby saving the institution tens of thousands of dollars or more in travel costs alone.

Examination Findings

As stated above, mortgage origination examiners are authorized to examine for violations of both federal and state requirements. Findings in recent years reflect the following:

Mortgage Origination Common Federal Findings

- Cost estimates and disclosures not delivered within required time periods or containing inaccurate information
- Disallowed fees
- Ability to repay violations: Federal regulations set forth requirements for assuring borrowers will be able to repay their loan as agreed
- Illegal compensation paid to mortgage loan originators
- Kickbacks and unearned fees: Serious violation of federal regulation
- Advertising problems

Mortgage Origination Common State Findings

- Unlicensed business activity
- Disclosure violations and failures
- Net tangible benefit violations: Some states require that the loan have identifiable benefits for the borrower
- Interest rate lock violations
- Failure to submit or inaccurate MCRs
- Failure to maintain records as required
- Advertising issues
- Commingled trust funds /not using special account properly

Mortgage Servicing Common Federal Findings

- Improper error resolution procedures
- Failure to acknowledge receipts
- Inaccurate payoff statements
- Failures in timing of notice of transfer of loan servicing
- Violations in debt collection communication
- Collection activities on accounts in bankruptcy
- Improper notification of cancellation or termination of private mortgage insurance
- Inaccurate or incomplete billing statements
- Incomplete Notices of Transfer
- Bankruptcy discharge violations
- CARES Act violations involving forbearance processing and credit reporting

Mortgage Servicing Common State Findings

- Recordkeeping
- Failing to provide timely loan modification acknowledgement letters
- Disallowed fees charged
- Inaccurate reports to credit bureaus
- Improperly maintaining suspense accounts
- Improper payment of tax or insurance premiums
- Failure to provide timely/accurate payoff statements
- Failure to release lien
- Excessive late fees
- Unreasonable and excessive charges

Investigation and Enforcement

State nonbank regulators investigate matters and file enforcement actions against mortgage companies and MLOs thousands of times per year. Enforcement may result from:

- ➢ Investigations into consumer complaints or referrals of violations or bad practices from others.

- Examination findings: It is common for poorly rated institutions to resolve serious findings from an exam through an administrative consent order.
- Unlicensed activity: The unlicensed activity may occur at the company, branch or MLO level. Unlicensed activity is one of the most serious offenses mortgage entities can commit. Operating without the appropriate license means that the company or individual has not been approved to handle financial transactions with consumers. It also likely means that the company is operating without the appropriate bond and other protections necessary for the conduct of business.
- Failure to file reports (especially Mortgage Call Reports), pay fees or produce other information.
- Failure to fully produce books, records and other information often results in serious enforcement.

When practical and possible, states join in investigation and enforcement matters. Often a single state will identify problems or violations and share their findings with other states, which can trigger multiple individual actions or a single large multistate action. Multistate enforcement actions typically result from a poorly rated multistate examination; however, it is not uncommon for an individual state to refer a matter to the MMC and/or the Non-Depository Supervisory Committee (NDSC) where the matter is elevated to the multistate level.

Such multistate investigations and enforcement actions follow protocols and guides designed to facilitate efficient, effective and confidential communications. Multistate communication and information sharing are encouraged and protected through specific agreements such as the CSBS/American Association of Residential Mortgage Regulators Nationwide Cooperative Agreement and Protocol for Mortgage Supervision and the CFPB and CSBS Information Sharing Memorandum of Understanding. [These agreements can be found at https://www.csbs.org/cooperative-agreements]

In addition to sharing of information and joining enforcement resources between state nonbank mortgage regulators, sharing and coordinated action is robust and routine among the following:

- State bank and nonbank regulators
- State attorneys general
- Consumer Financial Protection Bureau
- U.S. Department of Housing and Urban Development
- U.S. Department of Justice

Historically, state nonbank regulators have joined forces among themselves and with others in major mortgage enforcement actions and settlements. Some of the most notable are:

- First Alliance Mortgage Company
- Household International/Household Finance
- Ameriquest Mortgage Corp.
- Countrywide Mortgage Corp.
- The National Mortgage Settlement (five large banks and a nonbank affiliate)

Since 2017 state nonbank regulators have been instrumental in the following multistate settlements:

- Ocwen Mortgage Servicing, LLC
- PHH Mortgage Corp.
- MLD Mortgage Inc.
- Nationstar Mortgage, LLC
- Aurora Financial Group, Inc.

Consumer Complaints

In 2020, the CFPB received 29,400 total complaints related to mortgage transactions, which includes both bank and nonbank mortgage entities.[58] There is currently no composite tracking of the number of mortgage complaints received by state regulators, however, state nonbank mortgage regulators routinely accept, investigate and resolve complaints filed by consumers against mortgage entities. State regulators typically investigate each consumer complaint, cite violations when detected and instruct specific steps to be taken to resolve the matter. Based on the findings of these investigations, state regulators frequently request, direct or order mortgage companies to provide restitution to consumers and undertake such actions as will make the consumer whole.

In September of 2020, functionality was added to the State Examination System (SES) to help agencies and companies coordinate on and resolve consumer complaints. With this functionality, an agency that receives a complaint from a consumer can enter key details of the complaint, log communications, and investigative research, and interact with the company to resolve the complaint, all in one, uniform system. By bringing complaints onto the same platform as exams and investigations, SES helps agencies network their supervision efforts internally and externally. Internally examiners have better, ready access to the complaints on companies they are supervising, while external agencies have limited access to complaint data nationwide that can be used to better risk-focus supervision.

Conclusion

The current value of the residential housing and mortgage markets is expansive - $36 trillion and at least $11.8 trillion[59], respectively. While historical trends have seen origination market share shift between banks and nonbanks, the current cycle is dominated by nonbanks in multiple product types and production channels. While banks remain significant players in the mortgage market, they no longer originate most loans and servicing volumes have dropped to near parity with nonbanks in respect to agency mortgages (mortgages purchased by the GSEs or backing Ginnie Mae securities). The significance of this for state supervisors is that they are acquiring prudential responsibility for an increasing share of this extremely large industry segment.

While purchase loans have dominated origination activity in recent years, falling interest rates have fueled a resurgent refinance market, supported by the generally strong equity position currently held by

[58] https://www.consumerfinance.gov/data-research/research-reports/2020-consumer-response-annual-report/
[59] Urban Institute. June 2021. "Housing Finance at a Glance.. Accessed at https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-june-2021 .

homeowners, creating especially ripe conditions for cash-out refinances. According to Black Knight, over 12 million borrowers can still refinance and lower their interest rates by at least 75 basis points and benefit from refinancing even after the record-breaking originations of 2020 and the first half of 2021.[60]Although a surging refinance market will continue to be a boon to the mortgage industry and certain consumers, the renewed dominance of cash-out refinances subsequent to 2016 and resurging in 2021 brings a sharper focus on loan terms and credit quality, which will likely dictate the long term stability for this segment of the economy given the key role that cash-out refinances played in the run up to the financial crisis of 2008.

State nonbank mortgage regulators are monitoring these changing dynamics and market conditions and are identifying areas requiring supervisory attention associated with the transition from banks (and federal supervision) to nonbanks (and state supervision). In this regard, state regulators point to specific observations that bear consideration by supervisors, the industry and policy makers.

Key Roles by Nonbanks

Nonbanks have stepped up to fill market voids left by banks exiting a previously troubled market with millions of foreclosures, followed by new regulations and federal banking agency concerns. These roles include:

- Virtually "making" the market today for housing policy interests focused on access to housing credit for low to moderate income, minority and veteran borrowers. As noted in this chapter, nonbanks are currently responsible for 85% of Ginnie Mae issuance and 66% of all mortgage loan originations.
- Assuming the role of "specialty" servicers for consumers making payments on previously troubled borrowings (e.g. subprime and Alt A loans made during the run-up to the crisis). These loans are more costly and difficult to manage than conventional, conforming loans, and state regulators point out that nonbanks have performed better in taking care of these consumers than many of their large bank counterparts did.

However, the performance of these vital roles must be balanced against risk, and state supervisors are working hard to identify and segment risk into appropriate categories that can be monitored and, where appropriate, mitigated. Risks identified to date include:

- Increasing volumes of loans in product categories that inherently carry more underwriting risk (i.e., FHA loans with lower credit scores and higher loan-to-value and debt-to-income ratios). Although the originate-to-sell model means that nonbank originators do not "book" this increasing risk, the risk itself is transferred to the servicing side of the market where much

[60] Black Knight. July 2021. "Mortgage Monitor, May Report." Accessed at https://cdn.blackknightinc.com/wp-content/uploads/2021/07/BKI_MM_May2021_Report.pdf .

higher delinquencies result in lower profitability and ultimately the potential for a less stable nonbank environment.
- Servicer balance sheets with thinner capital margins and less liquidity, coupled with concentrations in a single asset category that makes it more difficult for nonbanks to withstand shocks to the system or the individual company.

To clarify our risk concerns we offer the following explanation:

A greater share of an increasingly risky market should be supported by stronger financial condition as evidenced by adequate capital, strong earnings, reduced short term debt loads, and sufficient liquidity to not only fulfill contractual servicing obligations (i.e., required advances), but cover normal operating costs. What we are identifying may reflect just the opposite. We are seeing a trend toward large and growing nonbanks with concentrations in riskier loans, thin capital margins, significant short-term debt and insufficient cash to "keep the lights on" in the event of sudden declines in revenue, sharp increases in the cost of servicing loans, or other unexpected shocks.

Why does this matter? Because millions of consumers are relying on nonbank servicers to process their payments, make disbursements for taxes and insurance, and maintain accurate records of their home loans. The failure of a large nonbank servicer means that hundreds of billions of dollars in unpaid mortgage loans will be disrupted while new servicers capable of onboarding the portfolio are sought and approved. Such an event will adversely impact consumers, investors, regulators and the marketplace.

With the increasing concentration of nonbanks in the servicing sector, interest rate volatility, an economic cycle downturn or other events such as natural disasters, could threaten the often-thin capital cushion at these institutions. Monitoring the liquidity and leverage of nonbank servicers as they grow market share is crucial to preparedness in protecting businesses and consumers from any future market dislocation.

The ability to capture individual company licensing and operational data through the NMLS, all developed after the 2007-2008 crisis years, has empowered state supervisors to better understand the market. Understanding the makeup and operations of the market supports more advanced risk-based examination scheduling and scoping and facilitates a coherent and coordinated approach to regulation and enforcement.

State and federal mortgage regulators, license applicants and consumers all use NMLS, however licensing authority resides solely with each individual state, the functions of which are performed directly through the system, creating a more efficient supervisory environment.

The role of license screening or gatekeeping is the foundation for supervising the mortgage industry. Regulator identification and approval of who is transacting business with consumers, followed by a deep understanding, through company reporting and examinations, of how that business is conducted, establishes a sound supervisory relationship. Institution adherence to compliance and consumer protection requirements and maintenance of a strong financial condition completes the supervisory picture and enhances the mortgage market for all.