A COVID-19 crisis looms in the mortgage industry, experts warn

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Berkeley Haas Professors Nancy Wallace and Richard Stanton were some of the few voices to forewarn of the massive risk posed by shoddy practices in the mortgage industry prior to the 2008 financial crisis.

Unfortunately, history seems to be repeating itself.

More than two years ago, Wallace and Stanton again began raising the alarm that the mortgage landscape that emerged from the last crisis is dominated by "nonbank" lenders who operate with little of their own capital or access to emergency cash. It was another disaster waiting to happen, they warned, and called for increased oversight.

No one predicted a shock the size and speed of the coronavirus pandemic, but it's now upon us, and Wallace fears the worst. Millions of laid-off Americans won't be able to make mortgage payments, and have been given a temporary payment reprieve by the federal rescue package. This plummeting cash flow could quickly push fragile nonbanks into bankruptcy. And since so many of the loans they service are backed by the U.S. government, that's who will be left holding the bag.

"The $2.2. trillion (coronavirus relief act) was the largest in history, but we're talking about liabilities that are orders of magnitude bigger," Wallace says. "Solutions are going to have to involve trillions of dollars. It could be the bailout of all bailouts."

Wallace says this new crisis will begin to show itself within the next 30 days, as people forgo their monthly payments and the highly leveraged nonbanks face margin calls from the brokers they've borrowed from—commercial banks like JP Morgan Chase and Wells Fargo Bank and investment banks such as Morgan Stanley. They need cash to pay these lenders, and they don't have it. The nonbanks have already begun asking for a rescue.

We asked Wallace, who has studied real estate industry financial dynamics for the past three decades, to explain this looming mortgage crisis.

What are nonbanks, and who are the biggest players?

Mortgages are originated and serviced by two types of institutions. Traditional lenders are the highly regulated banks, funded with deposits or Federal Home Loan Bank advances. They tend to have multiple lines of business. Nonbank lenders, in contrast, are lightly regulated and get their funding through short-term credit. Usually their only line of business is originating and servicing residential mortgages.

Some of the biggest players are Quicken Loans, Mr. Cooper Group, and Freedom Mortgage. They include about 1,088 smaller companies as well.

When did you become aware of the risks posed by nonbanks?

The standard narrative of the 2007-2010 housing crisis centers on the collapse of the housing bubble that was fueled by low interest rates, easy credit, low regulation, and subprime mortgages. However, we found nonbanks played an overlooked role, defaulting on their credit agreements and contributing to the collapse.

Why and how have nonbanks grown?

After the financial crisis, the traditional banks were put under heavy regulation. Because of the stringent capital requirements and the fact that they lost a lot of money servicing defaulted mortgages, most of the big banks scaled back their residential mortgage businesses. A number of large banks sold off loan servicing rights, and the nonbanks stepped in. The growing market share of the nonbanks came about in part because they were very nimble with new platform lending technology—like Quicken, with the eight-minute mortgage.

Nonbanks originated 20% of single-family home loans in 2007, and that had grown to half of loans by 2016. Today they service about two-thirds of home loans. The bigger problem is they tend to have a high proportion of the riskier loans to low- and moderate-income people, which are backed by the U.S. government. We're talking trillions of dollars. As of February 2020 they originated 88% of the loans sold to Ginnie Mae, which is part of the Department of Housing and Urban Development and has a $2.1 trillion portfolio. And 61% of loans sold to the GSEs (government sponsored enterprises) Fannie Mae and Freddie Mac, which have a combined residential single family loan portfolio of about $4.9 trillion.

How do nonbanks get their money, and how big is their debt exposure?

They rely on short-term lending known as warehouse lines of credit. These credit lines are usually provided by larger commercial and investment banks. It's difficult to get data because most nonbank lenders are private companies which are not required to disclose their financial structures. That was the subject of our Brookings paper, which was the first public tabulation of the scale of warehouse lending to nonbanks. We found there was a $34 billion commitment on warehouse loans at the end of 2016, up from $17 billion at the end of 2013. That translated to about $1 trillion in short-term "warehouse loans" funded over the course of one year. As of year end 2019, there was $101 billion of warehouse commitments on the books of warehouse lenders.

Last year was a banner year. Nonbanks originated nearly a trillion dollars of mortgages that were securitized by Fannie Mae, Freddie Mac, and Ginnie Mae—the largest origination volume since 2006. However, the high levels of refinancing due to historically low interest rates had a significant negative impact on the value of the mortgage servicing rights held by nonbanks.

If nonbanks are so big and borrow so much money, why aren't they regulated like banks?

The simple answer is they have a very powerful lobby, the Mortgage Bankers Association. What the industry leaned on was that they were saving the mortgage market because the banks didn't want to hold mortgages anymore. Nonbanks were happy to promise that they would service 30-year loans and pay the bondholders, whether or not they received borrower principal and interest payments, but there are no mechanisms in place to hold them to that promise. They were gambling that the market wouldn't crash.

The nonbanks have actively resisted paying for any form of liquidity insurance or supporting any credible oversight similar to banks. Their regulator, the Conference of State Bank Supervisors (CSBS), does not have high-quality loan-level data for the mortgage industry. That's why they recently asked our team—Paulo Issler, Christopher Lako, Richard Stanton and me, here at the Real Estate and Financial Markets Lab in the Fisher Center for Real Estate and Urban Economics—to perform detailed data breakdowns and analysis for them. They do not have the data to perform this analysis themselves.

Did anything change after your 2018 paper, co-written with Federal Reserve economists, which called for greater oversight?

Ginnie Mae started trying to require higher capital and liquidity thresholds as well as stress tests, requiring them to show how they would handle an economic shock. They had an initiative called Ginnie Mae 2020, but they were getting major pushback from the industry. In addition, the Conference of State Bank Supervisors has been trying hard to standardize the reporting rules, but they have no data, and they have little power.

Under the $2.2 trillion emergency CARES Act (Coronavirus Aid, Relief and Economic Security), mortgage servicers are required to allow borrowers to delay payments for as long as a year. What do you expect will happen now?

I think the situation is extremely serious, a looming nightmare. We've had 16 million people file for unemployment in three weeks. We know that most Americans can't even withstand a $400 shock to their finances. Millions of people won't be able to make their mortgage payments. They've been told to call their lenders and tell them they can't pay, and the phones are ringing off the hook.

The immediate problem for the nonbanks is the risk to their warehouse lines of credit, and the fact that the nonbank loan servicers still have to make payments to the mortgage-backed security bondholders, even if people don't pay their mortgages. Margin calls have been in the level of tens of millions of dollars and the creditors are demanding cash. Not making your margin calls on lines of credit is a serious problem and could trigger default. Nonbanks are also facing millions of dollars of margin exposure from short sales of mortgage-backed securities. These onerous margin calls, some as large as $100 million for a single institution, are what's leading their lobbyists, the Mortgage Banking Association, to go to the Securities and Exchange Commission and demand that the brokers be forbidden from exercising their margin rights. It's ridiculous, because the brokers—big banks like Goldman Sachs and Morgan Stanley—have every right to play hardball. The SEC has turned down the request.

Why does this pose such a threat to the U.S.

government, and ultimately, to taxpayers?

Most of these loans are guaranteed by the U.S. government through Ginnie Mae, Fannie Mae, and Freddie Mac. The nonbank lenders have been given some forbearance, and will eventually receive compensation for the payment shortfalls they are experiencing, but they have a timing problem. In the meantime they still have to make timely payments of interest and principal—for 120 days to the Fannie and Freddie MBS bondholders, and, in the case of those who owe to Ginnie Mae mortgage -backed security bondholders, until they go bankrupt. I'm not sure some of them have the liquidity to last even 30 days, and many won't be able to do it for three months, much less a year. We are going to see bankruptcies, and substantial loss in lending capacity as we did in 2007, when we lost two-thirds of lending capacity. This might be worse because unemployment may be worse.

Will any of the stimulus measures passed so far help?

The nonbanks are already asking for a bailout, but none of the federal relief efforts so far have included them. The MBA tried to get some protection in the CARES Act, which had $450 billion in loans and loan guarantees from the Fed and Treasury. But they were excluded for a reason—because these firms have pushed every boundary and rejected every form of oversight. Thus far, they have also been excluded from the actions the Fed has been taking, including a new round of quantitative easing, and participation in the Term Asset-Backed Securities Loan Facility, which is a way to provide liquidity. Ginnie Mae has now created an assistance program to provide loans to its nonbank counterparties who are unable to cover the principal and interest payments to bondholders. Fannie Mae and Freddie Mac have refused to provide such assistance to their nonbank counterparties, because they are still under conservatorship status from the 2008 crisis and face their own capital shortfalls.

So some kind of bailout is nearly inevitable?

To save the market, the nonbanks will have to be bailed out either by the Fed or by the U.S. Treasury. This will be very difficult under restrictions put in place concerning nonbank bailouts under the Dodd-Frank Act. The cost is going to be very high. In my opinion, there has to be a quid pro quo from the industry in the form of significant future fees in return for such extraordinary support—they can't keep pushing the envelope and then expect to be rescued. They don't want to follow any of the rules that banks follow, and then they want to be treated like banks when liquidity shocks occur. It's just wrong.

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