January 10, 2020

Risks related to nonbank mortgage lending in the United States

Highlights

- **Nonbank lenders are now big players in the US mortgage market**
- **They dominate the market for loans to low-income families guaranteed by the federal government**
- **These alternative lenders are subject to far less regulation than mainstream banks; they are heavily reliant on short-term funding and have only a slim cushion of resources to weather a shock**
- **They pose a financial stability risk—a systemic liquidity risk**
- **If a crisis hits, the taxpayer could be on the line—for considerable amounts**
- **Federal regulators are only beginning to become aware of the risk exposure**

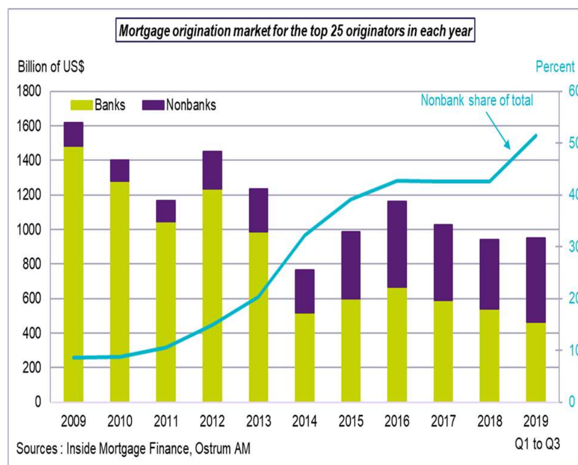
Increasing risk in the US leveraged loan market is on everyone's lips, but there has been little or no talk about the risks embedded in the dominance of nonbank lending in the US housing market. But, since the financial crisis, commercial banks have retreated from the market and these financial institutions—nonbank lenders—quickly stepped in to fill the vacuum. They are increasingly dominant, especially for loans to low-income households. This system works well in times of growth, but it has yet to be tested during periods of financial stress, a downturn in the real estate markets or a recession. As Federal Reserve Chairman Jerome Powell put it, the risk has shifted and is now outside the banking system.

The objective of this paper is to bring to light the systemic risk that arising from the outsize presence of nonbanks in US residential mortgage lending. We will first measure how big a presence they have in the market, before going on to review the vulnerabilities in their lending model and operating structures. Lastly, we will examine the risks to financial stability posed by these institutions.

Nonbanks have carved out a bigger market share since the financial crisis

Lending in the US real estate market has changed utterly since the 2008 financial crisis. **Nonbank lenders have gained significant market share and now originate more than 50% of mortgages:** 53.6% in 2018, according to the Home Mortgage Disclosure Act, up from just over 20% before the financial crisis. In 2018, six nonbank lenders were included in the Top 10 financial institutions that dominated mortgage origination for home purchase or refinancing. Leading the pack is Quicken Loans, followed by United Shore Financial Services LLC (in 3rd place) and Loan Depot (in 5th place). Wells Fargo bank was in the number 2 spot.

The following graph gives a clear picture of the extent of their gains. Of the 25 biggest lenders, nonbanks accounted for 51.3% of mortgage originations in the first three quarters of 2019, compared with a little less than 10% in 2009.



Nonbanks also grew their share of the mortgage servicing market to almost 50% in 2018. Loan servicing consists of collecting capital and interest payments from borrowers on behalf of the end investor, as well as collecting and paying taxes and insurance on the loan. According to the Conference of State Bank Supervisors (CSBS), the mortgage servicing market is 80% concentrated in the biggest nonbank players.

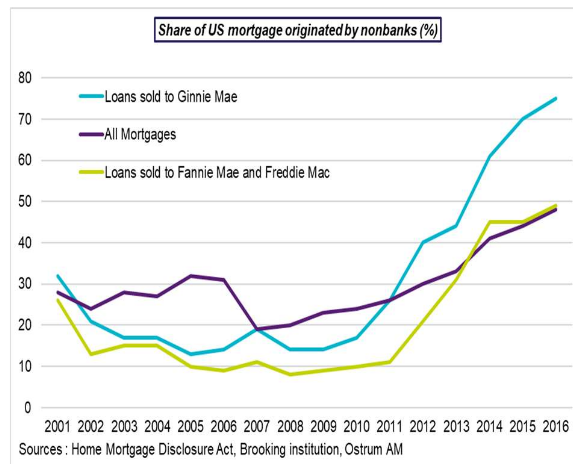
Nonbanks piled in as commercial banks disengaged

After the financial crisis, banks—especially the big banks—scaled back their presence in mortgage lending. There are several reasons for this development: the substantial costs incurred when the subprime crisis hit, arising primarily from forced loan redemptions in legal proceedings, and tougher regulations, including higher equity capital requirements. Banks either pulled out of housing loans or restricted mortgage lending to a more affluent clientele.
Enter the nonbanks. Some adopted new technologies to reduce distribution costs and capture more customers. Nowadays, borrowers can apply for a mortgage in a few clicks from the comfort of their own home.

Nonbanks have an outsize share of lending to households with weaker credit ratings

Nonbanks have substantially increased their presence in lending backed by mortgage guarantees offered by federal agencies, which are intended to keep lending flowing and to make home ownership an option for more people. Nonbank lenders play a big role in originating loans sold and securitized by federally backed agencies, Freddie Mac (58% in September 2019, according to data compiled by the Urban Institute) and Fannie Mae (55% in September 2019). These loans are implicitly guaranteed by the federal government against the risk of default, since Freddie Mac and Fannie Mae were taken over by the government in 2008.

Nonbank lenders' share of loans securitized and guaranteed by Ginnie Mae stood at 86% in September 2019, which is considerable and far higher than its pre-crisis level. These loans are granted to the most vulnerable households under a federal program and are, for the most part, guaranteed by the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA).



They are riskier: the loan-to-value ratio is high and households either have higher debt-to-income ratios and/or weak credit ratings. Investors have the advantage of knowing that the state guarantee will kick in if the borrower defaults.

Nonbanks' share of the mortgage servicing market for loans guaranteed by Ginnie Mae is higher than for lending backed by Freddie Mac and Fannie Mae.

Sources of vulnerabilities

Heavy reliance on short-term financing

Unlike banks, nonbank lenders do not hold deposits to tap to fund loans. **Instead, their loans are funded through lines of credit with commercial banks** with the mortgage as collateral. Funding is short-term, two-week loans for the most part, the time required to sell the mortgage on to investors (primarily federal agencies) and for securitization.

Nonbanks are also dependent on these credit lines to meet their obligations in their mortgage servicing activity, when the borrower falls behind in their monthly payments. In this case, nonbank lenders are required to advance funds to investors (interest payment) and to pay the taxes and insurance on the loan.
The level of liquidity held by nonbanks is much lower than that of banks. Generally speaking, the biggest players hold just enough cash and assets available for sale to cover a few months of ongoing expenses and interest payments.

Specialized in a single activity

Unlike banks, nonbanks derive their income only from loan origination and/or the mortgage servicing business, raising concerns about their vulnerability in the event of a shock or if the real estate market sours.

Poorly capitalized

Nonbank lenders have fewer resources to weather shocks. Their assets—the mortgage loan or the mortgage servicing rights—are very often used as collateral and could be seized by the banks if they get into difficulty. What's more, asset values could fall in a crisis scenario, squeezing liquidity. They have small amounts of capital and a large percentage of nonbanks would not be profitable.

Lighter regulation

In contrast to banks, nonbank lenders are not supervised by the Fed or the FDIC (Federal Deposit Insurance Corporation). Instead, they are overseen by State financial regulators, such as the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators. They also follow the rules set by government agencies. Stress testing by Fannie and Freddie is less exacting than the stress tests performed by the Fed. Ginnie Mae is working on developing a stress test framework to step up scrutiny of nonbank lenders and may call on third parties (the main rating agencies) to rate the biggest operators. The main problem for regulators is the scarcity of available data to evaluate risk, since nonbank firms are not listed on a stock exchange.

Risk of undermining financial stability in the event of a shock or a downturn

If there is a downturn in the real estate market, if economic growth stalls or a recession hits, nonbanks' mortgage loan origination for home purchase and mortgage servicing business leave them exposed to risk. As unemployment climbed as a result, households would be squeezed, and payment delinquency and default rates would rise.
Nonbanks are also exposed to the risk of a steep rise in interest rates on loan origination for mortgage refinancing. A sharp hike in interest rates would reduce demand for refinance loans, which would negatively impact on income streams for nonbanks and leave them more vulnerable. Nonbank lenders have fewer resources to draw on to weather a shock or a downturn.

Systemic liquidity risk

A paper by three Federal Reserve Board economists and two University of California, Berkeley professors,[1] draws attention to the systemic liquidity risk related to the size of the nonbanking sector in the United States mortgage market.
In a situation of heightened financial tension, recession, or a downturn in the real estate market, commercial banks could close off the credit lines granted to nonbanks and to move quickly to seize the collateral if terms are not met—precisely when nonbank lenders most need funding. But, as we pointed out above, besides short-term funding, nonbanks have few resources to ride out a potential shock.

Risk is more acute for the mortgage servicing business...

Nonbanks are even more vulnerable to liquidity pressures in their mortgage servicing activities. Loan servicers are required to continue making interest, tax and insurance payments when a borrower can no longer meet their monthly payments. Although the servicing nonbank will be reimbursed in the long run, either by federal agencies or by selling the asset, they still need to finance the advances in the intervening period, which may be difficult in case of shock.

… especially for securities backed by Ginnie Mae

Liquidity risk is greater for loans securitized and backed by Ginnie Mae: default rates are higher in this market and nonbanks are required to service the loans for a longer period before they eventually recoup the amounts from federal agencies (mainly the FHA and VA). They might also take a capital loss. Nonbanks play an outsize role in funding loans securitized and guaranteed by Ginnie Mae, which exposes them to greater liquidity and credit risk.

Risk of contagion to the entire nonbanking sector

Problems at one nonbank lender could generate fear about viability across the nonbanking sector, based on similarities in their funding structure and operating model.

No access to emergency liquidity from the Fed

Unlike commercial banks supervised by federal agencies, nonbanks can't access emergency liquidity from the Fed.

[1] "Liquidity crises in the mortgage market," Brookings Papers on Economic Activity, March 2018

Risk of massive nonbank failures

Cut off from short-term funding and unable to meet their obligations, **many lenders could face bankruptcy,** as happened during the subprime crisis, when half of all nonbanks collapsed.

A rise in default rates or in financial difficulties experienced by nonbanks could lead to tightening the flow of credit for borrowers, especially for the most vulnerable groups. Large-scale failures could also make it difficult for Fannie, Freddie and Ginnie to transfer loan servicing operations to other nonbanks. It is not certain that the banks could step into the breach, **which would disrupt the supply of credit in the mortgage market, amplify the recession and pose a financial stability risk.**

Partial exposure for banks

Commercial banks have exposure to nonbanks through the credit lines they grant to fund loan origination and servicing. According to the FDIC, bank loans granted to nonbanks increased seven-fold between 2010 and Q2 2019 to exceed $400 billion, which is less than 5% of banks' total loan book. Fewer than 11% of banks grant this type of credit. Banks could be hit by major losses on these short-term credit lines in times of financial stress—as we saw in 2008—but **the FDIC considers the risk to be relatively low**. These credit lines are backed by other collateral in addition to the mortgage loan. They include multiple lender protections and are very closely scrutinized. If nonbanks fail to meet their contractual obligations, banks can cancel their credit lines and seize the collateral. The risk of forced redemptions of mortgage loans in a dispute is borne not by the banks, but by the nonbank originators.

Risk for the taxpayer

In the event of massive bankruptcy of nonbanks, the financing of the real estate market would be greatly disrupted, especially for low income households. Ginnie Mae operates on the assumption that loan servicers have adequate resources to absorb a substantial share of credit losses before the government steps in. Yet, this does not seem to be the case. In addition to the losses that the government is on the line for under implicit or explicit state guarantees, it could be called on to intervene more broadly to backstop the nonbanking system and prevent dislocation in the real estate market—at a potentially very high cost to the taxpayer.

The risks to financial stability are starting to dawn on regulators

Last December 3rd saw the Financial Stability Oversight Council highlight the potential risk that nonbanks could pose for financial stability for the first time. Its report recommends continued extensive coordination between federal and state agencies to gather and share data on the sector to identify the risks and tighten supervision.

Conclusion

Today nonbank lenders are key players in the US mortgage finance market. They account for a large proportion of loans to the most vulnerable households. Regulation is lighter compared to banks and they have fewer resources to weather a storm in the market, a marked slowdown, a recession or a sharp hike in interest rates. One of the main vulnerabilities arises from their heavy reliance on short-term funding, especially on the servicing side of the business for loans securitized and guaranteed by Ginnie Mae. If default rates or interest rates rise significantly, the risk is that many nonbanks would find themselves exposed as banks withdraw their lines of credit, just when they most need the liquidity. Considering the dominance of nonbanks in the mortgage loan market, large-scale nonbank failures represent a risk for financial stability. The authorities are beginning to take notice of the risks and are calling on federal and state regulators to step up cooperation to gather and share more data on the sector to give a clearer picture of the risks and to enhance supervision. There is still much to do.

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