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INSIGHT

Mortgage Servicing Rights and Selected Market Developments

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After a single-family mortgage has been originated, a *mortgage servicer* receives a fee to perform various administrative tasks—collecting and remitting the principal and interest payments to the mortgage lender; managing the borrower's escrow account; processing the loan title once paid in full; and administering loss mitigation (e.g., forbearance plans) or foreclosure resolution on behalf of the lender if the borrower falls behind or fails to make full payment. Just as a mortgage is an asset for a lender, the right to earn income for servicing a mortgage is an asset for the mortgage servicer. A *mortgage servicing right* (MSR) generates a servicing fee averaging 25 basis points (0.25% or $250 per $100,000 of an outstanding mortgage balance) per month. This Insight describes the MSR market and pre- and post-COVID-19 (Coronavirus Disease 2019) market developments.

MSRs' Financial Risks

MSRs can be traded in a separate market from the original underlying mortgage. MSR values are calculated as the discounted sum of projected future cash flows, which are based upon the expected cash flows generated from the underlying mortgage asset. The risks to a MSR's cash flows are also linked to the risks of the underlying mortgage.

- *Prepayment risk* is the risk that a borrower repays the mortgage ahead of schedule, causing the asset to generate a lower return than expected. If falling interest rates increase a mortgage's prepayment risk, then a linked MSR value also declines in anticipation of future cash payments being terminated.
- *Credit (default) risk* is the risk that a borrower fails to repay the mortgage principal and interest obligations. A default reduces the cash flows and value of a mortgage asset and its linked MSR. Furthermore, the costs to service a defaulted mortgage increase substantially.

For a portfolio of mortgages, prospective servicing firms may bid on MSRs via an auction process. After settling on the price, a servicer may borrow via a servicer advance loan to purchase MSRs, with the expected cash flows as loan collateral. If a rise in one or both of the aforementioned financial risks causes a MSR's cash flow and value to decline, then the servicer would likely receive a *margin call*, requiring either more collateral to be pledged or the servicer advance to be repaid. Consequently, macroeconomic events, such as a sudden change in interest rates or a rise in the unemployment rate, may result in a large volume of unexpected mortgage prepayments or defaults, translating into material financial losses for servicers experiencing numerous margin calls. Hence, the MSR market is vulnerable to *systemic risk*, or sudden shifts in performance expectations and liquidity disruptions that may trigger widespread collapses in market values.

Market Developments After the 2008 Financial Crisis

Following the 2008 financial crisis, notable developments have occurred in the MSR market. First, revisions to banks' capital requirements reduced the amount of MSRs that banks were willing to hold. For example, in 2013, nonbanks purchased more than $500 million of MSRs from banks in bulk sales. As of April 2020, nonbank mortgage servicers hold the MSRs for approximately 50% of the federally insured mortgage market, which includes the entities Fannie Mae and Freddie Mac—also referred to as the government-sponsored enterprises (GSEs)—and Ginnie Mae, the federal agency that facilitates the creation of mortgage-backed securities (MBS) linked to mortgages guaranteed by various federal agencies. In 2016, Ginnie Mae, established a facility to securitize servicer advances, thus expanding access to financing for many of its servicers. Although greater funding access reduces liquidity pressures, servicers would still be susceptible to margin calls if their MSRs' values decline.

Second, servicing rules and requirements were revisited in 2014 to address issues that emerged when the industry attempted to process surging mortgage delinquencies during the 2007-2009 recession. Specifically, the Consumer Financial Protection Bureau (CFPB) and other federal regulators addressed delays in loss mitigation applications and resolutions due to information about troubled borrowers' circumstances being lost during transfers of MSRs to *specialty servicers* that focus on servicing delinquent and defaulted loans. Servicing troubled mortgages is labor intensive, and compliance with the updated servicing rules requires greater interaction with borrowers to ensure that information is not lost. Greater reliance on manual labor, however, arguably runs counter to financial industry trends to automate mortgage servicing functions to streamline costs and increase efficiency. Furthermore, if a delinquency or default occurs on a securitized mortgage, which is held in a trust with other mortgages and funded with MBS issuances, a servicer is still required to forward timely payments to MBS investors until the troubled mortgage has been repurchased out of the trust. For Ginnie Mae MBS, the servicer must purchase the mortgage out of the trust.

Recent Developments Related to COVID-19

In response to the COVID-19 pandemic, the Federal Reserve lowered interest rates, among other actions. Lower rates potentially increases prepayment risk for existing mortgages. In addition, the rise in unemployment filings would indicate impending increases in mortgage delinquencies and defaults. For all federally insured loans, the CARES Act (P.L. 116-136) requires a moratorium on foreclosures; borrowers may request from their servicers 180 days forbearance relief for no additional fees and, if necessary, an additional 180-day period. Furthermore, servicers are normally expected to continue forwarding payments to investors holding federally guaranteed MBS as well as tax and insurance premiums, which also intensifies liquidity pressures. Given rising prepayment and delinquency risks, MSR values have declined and triggered margin calls for servicers.

The Federal Housing Financing Agency (FHFA), the primary regulator for the GSEs, and Ginnie Mae have announced various programs that would support liquidity for mortgage servicers. On April 7, 2020, Ginnie Mae announced a private market servicer liquidity facility for its servicers borrowing to finance their MSRs. On April 21, 2020, FHFA announced that servicers for GSE mortgages will have no further obligation to advance scheduled payments after having advanced four months of missed payments. On

April 15, 2020, the FHFA and CFPB also announced a joint initiative to share information about mortgage servicing activities to monitor the effectiveness of providing borrowers with assistance.

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