GSE Activity Report

Wednesday, February 4, 2015

Non-Banks Need Not Apply

Summary

We have reviewed FHFA's proposed seller-servicer eligibility standards. Like the draft PMIERS, they're tough. Like the MIs, non-banks are saying they can comply with them. Maybe, but only at considerable cost to their current business model.

Impact

In these standards, FHFA has wisely ducked angering community banks, let alone its big bank seller-servicers, stipulating from the start that regulated banks are in the clear as long as they comply with applicable prudential standards. Non-banks have no prudential regulator – the CFPB looks at them only from a consumer-protection perspective and state regulation is spotty at best. As a result, FHFA lowers both the capital and liquidity booms.

Specifically, non-depository servicers must meet a minimum net-worth standard that keeps out the very small fry as well as a capital standard-equivalent to 6%. This is laid out essentially as a leverage standard, with non-banks required to hold total equity less receivables due from related entities less goodwill and other intangibles less pledged assets equal to the 6% standard that roughly approximates to the higher leverage – capital requirements for the largest banks.

FHFA has also demanded liquidity standards in which non-banks have to hold eligible assets (defined more broadly than for banks) equal to set percentages of their total (not just GSE) servicing books. For them, as for banks, liquidity standards mean that non-banks must fund up-front claims like servicer advances, securing high-quality – and high-cost – funding at the start of a servicing agreement, not only upon likely draws (when of course funding may be hard to find, especially under stress scenarios).

Outlook

Before this standard came out, non-bank servicers have walked on the sunny side of the street, holding only whatever capital and liquidity counterparties demanded – read not much. To be sure, Fannie and Ginnie have recently increased their eligibility standards, changing the rules of the road but not to the extent FHFA now lays out.

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Nor, of course, to expanding the standards to cover Freddie Mac.

The more solvent and liquid servicers may well be able to meet FHFA's requirements, especially given the warm-up of the Fannie/Ginnie rules. Over time, though, it remains to be seen if they can grow and raise sufficient capital and liquidity to support their agency obligations. Some may, but the pressure on non-bank servicers by state and federal consumer-protection regulators and enforcement agencies complicate the capital and liquidity equation. Banks may want to lend a hand, but only if they don't instead want to claw back the mortgage-servicing business lost in large swaths to non-banks since the Basel III MSR rules were first announced. Our bet: banks will look anew at this business, at the very least cherry-picking the non-banks and, over time, retaking at least a significant part of the market share they've lost since 2010.

FHFA's outline is laid out as FAQs on which industry comment is sought through the first quarter pending action before July that would then take effect sometime before year-end. We would expect both Republicans and Democrats on the Hill to support FHFA's tough stand – several have called on it to do so and others are pushing legislation to get community banks back in the game. FHFA may well ease a few provisions in the new standards, but we doubt it will significantly alter them and, then, expose itself to political risk even as GSE counterparty risk would then go uncorrected from a regulatory point of view.

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