GSE Activity Report

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That Was Close!

Summary

A new Fed paper analyzes the striking differences between mortgage-market liquidity – or the dramatic lack thereof – in the great financial crisis of 2008 and the pandemic crisis of March, 2020. Providing often unique insights into market strain over the last two weeks of that month, the paper concludes that market resilience in this last near systemic cataclysm was due to better underwriting ahead of the 2020 collapse and – more significantly – far larger and faster federal interventions that quickly stabilized the agency market.

There was significant stress in mortgage banks exposed to TBA-hedge margin calls and among mREITs, with these strains only made manageable thanks to the Fed's overall market support and the small size of the non-agency market in 2020 versus 2008. The paper draws no conclusions about the next stress scenario, but its clear inference is that bailout is going to be the necessary order of the day absent more liquidity resilience at nonbank companies and mREITs.

Analysis

This paper focuses on nonbank mortgage companies and MBS given that the market now heavily depends on them, and because banks have backstop liquidity via both the Federal Home Loan Banks and Federal Reserve. It details stresses in the mortgage market in mid-March of 2020 and, while these are familiar in broad terms, its assessment of mortgage-market specific strains is nonetheless striking, with Fed interventions for mortgages "called gargantuan" – the Fed in fact bought more than 100% of agency issuance at the height of the crisis, almost triple what the Fed did when it belatedly began its asset purchases in the great financial crisis. As with commercial paper and CLOs, once the Fed started to purchase some obligations, markets stabilized for all like-kind issuances, with even the PLS market stabilized ahead of a full recovery in terms of spreads by September of 2020.

The paper also documents fiscal-policy actions to stabilize mortgage borrowers via the CARES Act and forbearance. Federal backstops and protections for mortgages were quickly taken up in the private market, preventing both foreclosures and the stress these created in the great financial crisis, following which there were 7.8 million foreclosures. Better underwritten mortgages and better servicing also reduced the payment shock compared to what borrowers experienced the last time around.

Although there was and is a good deal of concern about nonbank mortgage companies, this paper calls them "wildly profitable" throughout 2020 and 2021. This is largely due to sharp interest rate drops and resulting refi activity. At the outset of the crisis, mortgage banks experienced warehouse funding shortfalls, but these were quickly addressed for loans with a guaranteed secondary market by banks able to remain liquid due to better preparation ahead of the crisis and all the Fed's interventions during its course. That said, servicing advances remained problematic, and borrowers were more likely to receive forbearance if their servicer was large or a bank.

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But for all the relative stability in the mortgage market, liquidity stresses above and beyond those due to servicer advances were evident due to TBA-hedge margin calls. TBA prices were extraordinarily volatile during the last two weeks of 2020, falling fast ahead of Fed intervention and then recovering just as steeply. This led to margin calls estimated to be at least $5 billion, ending working capital and threatening viability at even well-capitalized mortgage companies. However, broker-dealers chose not to enforce margins "ruthlessly," preserving the most vulnerable companies until market conditions afforded TBA-pricing relief. The paper notes that mREITs were largely unable to handle margin calls in 2020, accelerating market stress that put originators very much in harm's way. Unlimited Fed purchases of agency MBS also saved most mREITs, but those specializing in non-agency paper or with a hybrid model came close to collapse.

Based on this analysis, the paper concludes that the 2020 crisis was marked by continued illiquidity that failed to have 2008's catastrophic impact largely because the Fed came in bigger and faster, quickly followed by a raft of fiscal-policy and regulatory buffers and market interventions along with a sharp spike in house prices that would not have occurred but for continued market liquidity thanks to all these government actions. Because the non-agency market was so stricken, the paper concludes that it is a guide to what might have happened in 2020 but for the Fed, FHFA, FHA, and Congress, but stress in this sector had no systemic impact because it accounted for 5% of the market in 2020 versus its 55% share in the last go-round.

Outlook

This analysis leads the Fed paper to point to the need for fast work on better liquidity standards for nonbank companies and mREITs along with a better understanding of how the overall mortgage system can be stable under stress without massive federal intervention. That would indeed be useful.

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