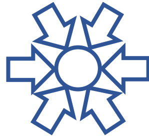

# GSE Activity Report

**Tuesday, May 9, 2023**

# Nervous About Nonbanks

## Summary

As our in-depth report earlier today details, the Fed's latest financial-stability report pulls a lot of punches because, as always, it's afraid to frighten the children with frank discussion of what might actually threaten financial stability in the near term. That said, the Fed is clearly worried about nonbank mortgage companies, laying some pipe to support systemic designation if FSOC winds its way there as augured at its last meeting. And, when the Fed next designs its stress tests, housing finance will surely get still more conservative treatment along with exposures to nonbank mortgage firms.

## Impact

Concerns about nonbank mortgage companies come in concert with broader housing-market jitters. Although house prices remain high, the Fed worries about continuing, acute valuation risk as high rates and dubious growth kick in. Price-to-rent ratios have abated, but the median ratio is above its pre-GFC peak. More worrisome still, the Fed believes that housing-market fundamentals are eroding as evidenced by foreclosures and distress sales. Although better underwriting and less household leverage are comforting, the report notes that half of new purchase loans in 2022 had high LTVs often accompanied by low credit scores, adding an additional element of market vulnerability worrisomely showing itself in a rise in early delinquencies.

All of these conclusions feed the Fed's willies about nonbank mortgage companies due to bank exposures to the sector via large funding commitments. Nonbank mortgage companies are observed to have declining profitability at a time of rising delinquencies and, even though the Fed takes some systemic comfort in the factors noted above, it sees the sector as subject to distress followed by funding shortages even though nonbank mortgage companies have generally drawn only 50% of committed lines and delinquencies in this sector are lower than those across all NBFIs.

## Outlook

Will the Fed do anything about any of these housing risks? When it surfaces from all the failures and turns to the promised rewrite of stress-test scenarios, severely-adverse ones for residential mortgages and nonbank mortgage-company exposures will surely be still more conservative. This will exacerbate bank aversion to most forms of mortgage lending and additional credit or liquidity lines, but it will take at least a year for any of these test scenarios to change and much between now and then could well alter the course of housing finance.

When it comes to nonbank-mortgage designation, that's over to the FSOC. As previously noted, we expect this will prove an area of systemic identification once the Council finalizes its analytical methodology, a finding that will then result in direct barriers to bank inter-connectivity given the absence of primary federal regulators that could do what FSOC thinks needs to be done to nonbanks beyond what FHFA and Ginnie Mae have attempted so far.

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