GSE Activity Report

Thursday, June 8, 2023

Under Their Thumb and What a Big Thumb It Is

Summary

As we will detail in a forthcoming in-depth report, the banking agencies' new "guidance" on third-party vendors essentially brings all nonbank counterparties with whom banking organizations deal under the agencies' enforcement thumb. As a result, nonbank mortgage companies, MIs, credit enhancers, and tech providers and even the GSEs – Home Loan Banks included – will be forced at the least to answer a lot of questions from the banking entities with whom they do pretty much any kind of business. And, if the agencies don't like the answers, they now assert that they will issue enforcement orders not just against banks, but also nonbank entities to ensure they comply with the full panoply of safety-and-soundness standards referenced in the guidance along with ensuring appropriate consumer protection.

Impact

It took the banking agencies two years to finalize guidance proposed in 2021. At the time, we said the proposal would redefine an array of interconnections across the banking system. With the final, still more stringent standards, this is still more true.

What matters most to each nonbank counterparty will depend on what it does for how many banks. Low-priority services for smaller banks will pass muster with little to no revision. However, anything that puts a bank at risk or that the banking agencies think puts it at risk will at the least need to answer to banks and even examiners as to the quality of internal controls, the protections to the bank in contractual relationships, risks even when there isn't a contract, how consumer protections are assured, the degree to which financial condition guarantees ability to honor commitments or maintain liquidity, and on and on and on.

Although third-party vendor coverage has long been focused on tech services – and these new standards are very attuned to this sector – the new approach essentially forces banks to reckon with every interconnection node outside the agencies' regulatory perimeter and sometimes even within it when it comes to affiliates and subsidiaries. As we noted, FSOC's new methodology to detect systemic risk is laser-focused on interconnections between banks and nonbanks. Declaring these off-limits or subjecting them to express conditions may come via FSOC, but the banking agencies have put a heavy foot down on all of these that they can find. This may prove just a compliance nightmare for banks and counterparties, but the banking agencies will make more of it where they or FSOC see worrisome linkages, perhaps putting nonbank mortgage originators and servicers forward in the firing line given the unfavorable attention FSOC gave them when issuing the systemic construct.

Outlook

These standards are effective immediately. As noted, they are guidance, with the agencies going out of their way in the final standards to reinforce this status by expressly declaring most of the very extensive details stipulated in the standards as only of "illustrative" use. Banks may thus alter the way they comply with this guidance, but comply they must and, for large counterparties or targeted interconnections, in a hurry.

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