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# **What's Behind the Non-Bank Mortgage Boom?**

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## **What's Behind the Non-Bank Mortgage Boom?**

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### **Abstract**

Mortgages constitute a large, complex, and controversial market in the United States, shaped largely by federal policymaking. Since 2010, the role of non-banks – a term commonly used to define firms unassociated with a depository institution – in the overall mortgage market has grown handily. In 2014, non-banks accounted for over 40 percent of total originations in terms of dollar volume versus 12 percent in 2010. Of the 40 largest servicers, 16 were non-banks, accounting for 20.5 percent of the total market and 28 percent of outstanding top-40 servicing balances, versus just 8 percent in 2010. We find that both regulatory factors and market factors are helping drive the non-bank boom, and identify key distinctions between pre-crisis non-banks and non-banks now. Today's non-banks are: 1) subject to much more regulation and supervision; 2) more active in mortgage servicing than ever before; and 3) using technology to transform the mortgage market. Without non-banks, today's sluggish mortgage market would be much less vibrant, and our analysis reveals positive impacts of non-banks on customers. However, non-banks' growing involvement in riskier non-prime FHA-insured originations is concerning. And while reducing the counterparty risk non-banks pose to Fannie Mae and Freddie Mac is a worthwhile policy goal, implementing bank-like standards for non-banks is not the best strategy to substantially mitigate risks in the housing system, and could stunt innovation. Instead, reforming the GSEs and FHA insurance is critical to reducing both counterparty and borrower default risk. Policymakers should act to do so, embrace non-banks, and address unintended regulatory impacts driving depository institutions out of the market.

**JEL Codes:** G21, G23, G28, G32

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## I. Introduction

In the United States, residential mortgages are among the most common and most important financial products. Worth \$9.8 trillion outstanding as of year-end 2014, residential mortgages constitute one of the largest financial markets in the U.S.<sup>1</sup> They are not just big in size; they are big in controversy. Mortgages were at the heart of the 2008-09 subprime crisis that led to the global financial meltdown and subsequent recession.

In the lead-up to that crisis, non-banks – a term we will use throughout this working paper for financial institutions that operate outside of, and are unaffiliated with, depository institutions – played a substantial role in the origination of subprime mortgages. We found that in 2006 – the height of the subprime boom – of the top 25 subprime lenders, representing 90.5 percent of the dollar volume of 2006 subprime originations, 15 were non-banks not affiliated with a depository institution, accounting for 42.5 percent of total subprime loans.<sup>2</sup> Yet in 2006, non-banks accounted for just 30 percent of originations, according to Goldman Sachs.<sup>3</sup> Of the 15 largest non-bank subprime originators, most expired during the crisis, including the two largest.<sup>4</sup>

By 2010, the subprime mortgage market had dissipated, and non-banks were responsible for just 12 percent of mortgage originations.<sup>5</sup> Since then, non-banks' market share in mortgage originations has skyrocketed, increasing to 42 percent in 2014.<sup>6</sup> Non-banks' share of the mortgage-servicing market, largely dominated by depository institutions and their subsidiaries through the mid- and late 2000s, surged amongst the top 40 servicers – which accounted for 73 percent of the overall 2014 servicing market – from 8 percent in 2010 to 28 percent in 2014.<sup>7</sup> Some policymakers have expressed a sense of growing alarm about non-banks' increased participation in the mortgage market;<sup>8</sup> memories of subprime non-bank lenders and their risky practices remain fresh. Regulators have moved to regulate non-banks using bank-like rules to reduce counterparty risk; for example, the Federal Housing Finance Administration (FHFA) – tasked with ensuring the safety and soundness of the housing government sponsored enterprises (GSEs) – recently proposed minimum capital standards for non-bank mortgage originators and servicers, and in May 2015, the GSEs adopted these proposed standards.<sup>9</sup>

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<sup>1</sup> Board of Governors of the Federal Reserve System, *Financial Accounts of the United States*, T.217 (Mar. 2015).

<sup>2</sup> Inside Mortgage Finance data (authors' calculations; ranks and percentages calculated in terms of dollar volume).

<sup>3</sup> See Ryan N. Nash & Eric Beardsley, *The Future of Finance: The rise of the new Shadow Bank*, Goldman Sachs Equity Research (Mar. 2015), 53 (citing Inside Mortgage Finance and Goldman Sachs Investment Research data; percentage calculated in terms of total dollar volume of 2006 originations).

<sup>4</sup> Inside Mortgage Finance data (authors' calculations; ranks and percentages calculated in terms of dollar volume).

<sup>5</sup> *Ibid.* (subprime market activity was “insufficient” to record from 2009 to 2012, according to Inside Mortgage Finance's Mortgage Market Statistical Annual, 2013); Nash & Beardsley, *supra* note 3, at 53 (citing Inside Mortgage Finance and Goldman Sachs Investment Research data; percentage calculated in terms of total dollar volume of 2010 originations).

<sup>6</sup> *Ibid.* (percentage calculated in terms of total dollar volume of 2014 originations).

<sup>7</sup> Inside Mortgage Finance data (authors' calculations; ranks and percentages calculated in terms of dollar volume).

<sup>8</sup> See, U.S. House Committee on Oversight & Government Reform, Office of Rep. Elijah E. Cummings, Ranking Member, *Cummings and Warren Request Investigation into Non-Bank Mortgage Servicing Industry* (Oct. 2014).

<sup>9</sup> See FHFA, *Proposed Minimum Financial Requirements for Enterprise Seller/Servicers* (Jan. 2015). See also Freddie Mac, *Bulletin to Freddie Mac Sellers and Servicers, Subject: Seller/Servicer Eligibility* (May 20, 2015); Fannie Mae, *Servicing Guide Announcement* (SVC-2015-08, May 20, 2015).

To better understand the causes and consequences of the non-bank surge, and how policymakers should react, we explored data from the American Enterprise Institute's (AEI) International Center on Housing Risk, the Consumer Financial Protection Bureau (CFPB), Goldman Sachs, Inside Mortgage Finance, and other sources. We also surveyed and synthesized current research on the U.S. mortgage market. We concluded that efforts to further tighten non-bank mortgage originator and servicer – firms that hold, oftentimes through purchasing from the originator, mortgage servicing rights (MSRs) (contractual agreements giving the holder the right to handle mortgage collection and accounting in exchange for a payment) – regulation fail to take into account critical issues and nuances, and do not address large, underlying sources of risks in the U.S. housing finance system.

Through our analysis, we found that the non-banks of today are very different from the non-banks of the subprime era. Prior to the crisis, fraudulent activities by both banks and non-banks were rife; non-banks were not heavily involved in mortgage servicing; technology was not vastly improving customer experience; Securities and Exchange Commission-regulated securities holding companies (SHCs) – that is, Wall Street investment banks – played a substantial role in the mortgage market; independent non-bank originators and servicers lacked a federal financial regulator; and some of these firms were deeply engaged in selling subprime mortgages, often in an imprudent fashion. Today, all non-bank mortgage originators and servicers are regulated by the CFPB and subject to strenuous examinations (and to heightened state regulation). Given that “deep” subprime originations have all but vanished,<sup>10</sup> non-banks largely do not engage in that business, and have lower risk profiles than before the crisis. Most importantly, technology and innovation play critical roles in attracting and holding consumer customers – and thus market success – for many non-banks. We discovered that non-banks play a unique role in the mortgage industry and that, without their growth over the last few years, purchase mortgage originations would have likely declined substantially in 2014.

Our analysis reveals the positive impact of non-banks on customer experience. However, our assessment of FICO score data provided to us by AEI's International Center on Housing Risk reveals that higher-risk Federal Housing Administration (FHA)-backed loans – backed 100 percent by government – have begun to account for a disproportionate share of non-bank originations. In the event of a housing market downturn, an excessive proliferation of risky FHA-insured loans to non-creditworthy borrowers could result in system-wide risk by bringing about higher rates of defaults that, in turn, could bring about counterparty risk. This concern should draw the focus of policymakers.

It is now seven years after the crisis and almost five after the regulatory overhaul – enough time to begin to judge the effects of the regulation that followed the financial crisis. Throughout our analysis, we attempt to answer some important questions: What kinds of institutions, banks or non-banks, are involved in the various parts of the mortgage industry? How has the structure of the industry changed? What regulatory factors are driving these changes? What effect have new entrants had? Are calls for heightened non-bank mortgage originator

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<sup>10</sup> See Yuliya Demyanyk and Daniel Kolliner, *FHA Lending Rebounds in Wake of Subprime Crisis*, Federal Reserve Bank of Cleveland (Apr. 2015).

regulations warranted? Will new non-bank servicer and seller requirements improve the long-term stability of the U.S. mortgage market? How should regulators balance safety and soundness concerns with the need for a regulatory climate that prizes and fosters innovation?

## II. A Brief History of the U.S. Mortgage Market

Before examining recent trends and attempting to examine these questions, an overview of how the U.S. mortgage market evolved and currently operates is necessary. It has been shaped by a history of heavy and ever-changing public sector involvement for nearly a century.

### a) From post-depression to pre-subprime

The roots of the current system go back to the Great Depression, which saw the destruction and reconstruction of a banking system that, at the time, provided mortgages for homeownership. In response, Congress passed the National Housing Act of 1934, which created the FHA to insure loans, and the Federal National Mortgage Association (Fannie Mae) (chartered in 1938) to purchase those loans, thus greatly enhancing liquidity in the mortgage market.<sup>11</sup> At first a down payment of 20 percent was required, but this was soon lowered.<sup>12</sup> During the mid-1900s, Fannie Mae borrowed to purchase mortgages adhering to this and other FHA standards.<sup>13</sup>

In response to the high budgetary costs of this system, President Johnson in 1968 recast Fannie Mae into a hybrid vehicle – a publicly traded, federally chartered GSE.<sup>14</sup> Consequently, federal guarantees of Fannie Mae loans could be taken off the budget.<sup>15</sup> The shadow of federal sponsorship entailed implicit government support, which would eventually help enable Fannie Mae to hold a very small amount of capital relative to its assets.<sup>16</sup> The Department of Housing and Urban Development (HUD) tasked the GSEs to not only engage in promoting low- and middle-income family homeownership, and also to obtain “reasonable economic return.”<sup>17</sup> Also in 1968, Ginnie Mae was created within HUD to guarantee payments on mortgage-backed securities (MBS) collateralized by mortgages guaranteed by the FHA and the Department of Veterans Affairs (VA); meanwhile, Fannie Mae would purchase government-insured mortgages in an effort to boost mortgage access.<sup>18</sup> In 1970, FHA’s mission altered to promote even greater home ownership for low-income families.<sup>19</sup>

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<sup>11</sup> See Thomas N. Herzog, *History of Mortgage Finance With an Emphasis on Mortgage Insurance* (2009), at 20 & 34.

<sup>12</sup> See *ibid.*, at 20-21; See also Financial Crisis Inquiry Commission, *Financial Crisis Inquiry Report*, 2011 [hereinafter “FCIC Report”], at 38.

<sup>13</sup> *Ibid.*; Herzog, *supra* note 11.

<sup>14</sup> FCIC Report, *supra* note 12.

<sup>15</sup> *Ibid.*

<sup>16</sup> See Lawrence J. White, *On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important, and How to Do It* (Presented at the Conference on “Fixing the Housing Finance System,” Wharton School, University of Pennsylvania, Apr. 2005), at 5-6 & 10-12.

<sup>17</sup> FCIC Report, *supra* note 12, at 40-41 (citing 12 U.S.C. 1723a[h]) (amended 1992)).

<sup>18</sup> See U.S. Government Accountability Office, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises’ Long-term Structures* (GAO-09-782, Sep. 2009), at 13; FCIC Report, *supra* note 12, at 38-39.

<sup>19</sup> See Mark Calabria, *Fixing Mortgage Finance: What to Do with the Federal Housing Administration?* (Cato Institute Briefing Papers, No. 123, Feb. 2012), at 3.

Also in 1970, Congress chartered a new GSE, Freddie Mac, to purchase mortgages from the S&Ls.<sup>20</sup> Notably, legislation also allowed Fannie Mae and Freddie Mac to buy mortgages that were not insured by the government, as long as they met conforming loan limits.<sup>21</sup> During the 1970s, FHA's share of the market shrunk from 24 percent to 6 percent as the inflation of the 1970s undermined the desirability of its insured fixed-rate mortgages.<sup>22</sup>

By the 1980s, both Fannie and Freddie were securitizing purchased mortgages to further bolster homeownership, freeing up lender money from both depository institutions and non-banks, which could then be put to work again.<sup>23</sup> These factors intensified the originate-and-distribute model, and have been attributed by some to the lack of risk monitoring by mortgage issuers that helped bring about the crisis.<sup>24</sup> Also by this time, the FHA's down payment floor had been lowered to 3 percent.<sup>25</sup>

In the late 1980s and early 1990s, the S&Ls failed in waves, leaving mortgage lending to growing regional banks, many of which were achieving scale as they grew through mergers and acquisitions, and to non-banks. This was a period that saw broad disintermediation of traditional banking services. Wall Street firms, from Merrill Lynch's cash-management account to Drexel Burnham Lambert's high-yield bonds to money market and mutual funds, took significant market share from traditional bank products.<sup>26</sup> This applied as well to mortgages. A number of non-bank mortgage originators emerged.

In 1992, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act (GSE Act), which changed the missions of Fannie and Freddie, placing less emphasis on profitability and more on homeownership for low- and middle-income families.<sup>27</sup> Loan targets were set for "very low-income" borrowers.<sup>28</sup> Between 1993 and 1995, the GSEs' goal was to ensure that 30 percent of mortgage originations went to low- and middle-income families; by 2001, the goal had grown to 50 percent, rising to 55 percent in 2007.<sup>29</sup> The GSE Act helped precipitate competition between Fannie, Freddie, FHA, and the private marketplace for

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<sup>20</sup> See FCIC Report, *supra* note 12, at 38-39.

<sup>21</sup> See *ibid.*, at 39.

<sup>22</sup> See Calabria, *supra* note 19, at 3.

<sup>23</sup> See FCIC Report, *supra* note 12, at 39 & 42-45. Freddie Mac began securitizing in 1971. See *ibid.*

<sup>24</sup> For an early history of the originate-and-distribute model, see Saul B. Klamane, *The Postwar Residential Mortgage Market* (Princeton University Press, 1961). Regarding the impact of the modern originate-and-distribute model, see Amiyatosh Purnanandam, "Originate-to-distribute model and the subprime mortgage crisis," *Review of Financial Studies* 24 (2011): 1881-1915; Benjamin J. Keys, Amit Seru & Vikrant Vig, "Lender screening and the role of securitization: evidence from prime and subprime mortgage markets," *Review of Financial Studies* 25 (2012): 2071-2108; John M. Griffin & Gonzalo Maturana, *Who Facilitated Misreporting in Securitized Loans?* (Working Paper, 2013) (citing the aforementioned studies, and listing more).

<sup>25</sup> See Calabria, *supra* note 19, at 3.

<sup>26</sup> See Jerry W. Markham, *A Financial History of the United States: From Christopher Columbus to the Robber Barons (1492-1900)*, at 135-136.

<sup>27</sup> See Edward Pinto, "Government Housing Policy: The Sine Qua Non of the Financial Crisis," *The American* (2011).

<sup>28</sup> See John C. Weicher, *The Affordable Housing Goals, Homeownership and Risk: Some Lessons from Past Efforts to Regulate the GSEs* (Presented at Conference on "The Past, Present, and Future of the Government-Sponsored Enterprises," Federal Reserve Bank of St. Louis, Nov. 2010), at 4.

<sup>29</sup> *Ibid.*, at 5.

low- and middle-income family market share, which resulted in much lower and even zero-down payments.<sup>30</sup> The FHA lost market share as the GSEs introduced these products.<sup>31</sup>

Conforming loans began to make up a smaller portion of large depository institutions' and large non-banks' mortgage originations throughout the mid-2000s.<sup>32</sup> But depository institutions – banks, credit unions, S&Ls – still made the vast majority of mortgage originations, and accounted for 84 percent of originations amongst the 40 largest originators in 2005.<sup>33</sup> However, during this time, non-banks also became active market participants.<sup>34</sup>

## **b) Non-banks and the subprime crisis**

In the years leading up to the crisis, housing prices rose dramatically, lending standards slipped, and both banks and non-banks, prudent and predatory lenders, found themselves sucked into the mortgage bubble. During this time, increasing home prices and loose credit, along with government-induced lower underwriting standards, fueled a massive surge in mortgage market participation. Originations increased 22 percent between 2004 and 2006<sup>35</sup> (there are two types of mortgage originations: purchase mortgages, which involve a long-term loan to buy a house and were dominant in the years leading up to the crisis; and refinancing, that is replacing the original mortgage with a loan with new terms). Non-conforming, private-label loans grew to account for more and more of the market; the GSEs' market share of mortgages declined from 57 percent in 2003 to 37 percent in 2006.<sup>36</sup>

Pre-crisis capital rules further incentivized increased exposure to mortgages of lower credit quality because of risk-weighting mechanisms that acted to further incentivize homeownership.<sup>37</sup> From 2005 to 2008, of the top 40 servicers – which accounted for 72.8 and 80.0 percent of the servicing market in 2005 and 2008, respectively – depository institutions' holdings of outstanding mortgage servicing obligations stayed relatively constant, between 85 and 89 percent.<sup>38</sup> Non-banks were relatively non-existent in the pre-crisis servicing market.

Yet according to Goldman Sachs research, non-banks made up 30 percent of originations in dollar volume during 2006, the height of the subprime boom.<sup>39</sup> That year, of the 25 largest subprime lenders, 15 were independent non-banks, accounting for 42.5 percent of all subprime mortgages originated in 2006 – a clearly disproportionate share.<sup>40</sup> However, it is also worth

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<sup>30</sup> See FCIC Report, *supra* note 12, at 454-456; Calabria, *supra* note 19, at 4.

<sup>31</sup> See *ibid.*

<sup>32</sup> Inside Mortgage Finance data.

<sup>33</sup> *Ibid.* (authors' calculations; ranks and percentages calculated in terms of dollar volume).

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.* (in terms of dollar volume).

<sup>36</sup> FCIC Report, *supra* note 12, at 105.

<sup>37</sup> See Prasad Krishnamurthy, "Rules, Standards, and Complexity in Capital Regulation," *Journal of Legal Studies* 43 (Jun. 2014): S273-S296.

<sup>38</sup> Inside Mortgage Finance data (authors' calculations; ranks and percentages calculated in terms of dollar volume).

<sup>39</sup> Nash & Beardsley, *supra* note 3, at 53 (citing Inside Mortgage Finance and Goldman Sachs Investment Research data).

<sup>40</sup> Inside Mortgage Finance data (authors' calculations; rank and percentages calculated in terms of dollar volume). The 25 largest subprime originators accounted for 90.5 percent of the market. *Ibid.*

noting that many subprime mortgages were issued by subsidiaries of large bank holding companies regulated by the Federal Reserve (Fed).<sup>41</sup> These firms enjoyed a loophole that, according to the Government Accountability Office, prevented the Fed from routinely examining these businesses, some of which engaged in subprime lending, for compliance with consumer finance laws.<sup>42</sup> Also, by 2007, affiliates and subsidiaries of major SEC-regulated SHCs, like Bear Stearns' EMC Mortgage Corp., accounted for many subprime originations.<sup>43</sup> More critically, the SHCs enabled non-banks to generate so many subprime loans by serving as the largest underwriters of subprime mortgages from 2005 to 2008.<sup>44</sup>

Some say that pre-crisis non-banks were – and today's non-banks are – “shadow banks.”<sup>45</sup> While the applicability of this term is hotly debated, and some say its insinuations are not appropriate,<sup>46</sup> non-banks were certainly not unregulated. A critical part of mortgage origination and servicing regulation entailed – and still does entail – examination and supervision for compliance with consumer finance laws, such as the Truth in Lending Act (TILA), the Fair Debt Collection Practices Act (FDCPA) and the Real Estate Settlement Procedures Act (RESPA). Non-banks, like their mortgage-originating bank counterparts, were held to these standards.<sup>47</sup> However, recent Urban Institute research accurately notes that pre-crisis state regulation of non-bank mortgage originators and servicers was quite scattered and uncoordinated.<sup>48</sup>

National banks, state-chartered banks and national thrifts, and the non-depository mortgage originating or servicing subsidiaries of these entities, were regulated and supervised by the Office of the Comptroller of the Currency (OCC), the Fed, the Federal Deposit Insurance Corporation (FDIC) or the Office of Thrift Supervision (OTS).<sup>49</sup> While historically many state regulations on mortgage servicing were tougher on mortgage servicers than were the federal rules, these more stringent regulations were preempted by federal regulators in the lead-up to the crisis, and were thus not applicable to federally regulated depository institutions and their subsidiaries.<sup>50</sup> The Fed regulated mortgage-banking non-depository subsidiaries of large bank holding companies, but as mentioned, academics note that a loophole existed regarding their regulatory authority over non-depository subsidiaries of these institutions.<sup>51</sup>

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<sup>41</sup> See David H. Downs & Lan Shi, “The Impact of Reversing Regulatory Arbitrage on Loan Originations: Evidence from Bank Holding Companies,” *Journal of Real Estate Finance and Economics* 50 (2015): 307-338.

<sup>42</sup> *Ibid.*, at 308 (citing U.S. General Accounting Office, *Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending* (GAO-04-280, Jan. 2004)).

<sup>43</sup> Inside Mortgage Finance data (authors' calculations).

<sup>44</sup> See Center for Public Integrity, *Who's Behind the Financial Meltdown* (2009), at 9.

<sup>45</sup> See, for example, Zoltan Pozsar, Tobias Adrian, Adam Ashcraft & Hayley Boesky, “Shadow Banking,” *FRBNY Economic Policy Review* (Dec. 2013).

<sup>46</sup> See, for example, Melanie L. Fein, *The Shadow Banking Charade* (Feb. 2013).

<sup>47</sup> See Eric S. Belsky & Nela Richardson, Understanding the Boom and Bust in Nonprime Mortgage Lending (Joint Center for Housing Studies Working Paper, Harvard University, Sep. 2010), at 128.

<sup>48</sup> Pamela Lee, “Nonbank Specialty Servicers: What's the Big Deal?” *Housing Finance Policy Center Commentary*, Urban Institute (Aug. 2014), at 3.

<sup>49</sup> Downs & Shi, *supra* note 41, at 309.

<sup>50</sup> See Kurt Eggert, Foreclosing on the Federal Power Grab: Dodd-Frank, Preemption, and the State Role in Mortgage Servicing Regulation, *Chapman Law Review* 15 (2011): 171-225.

<sup>51</sup> See Downs & Shi, *supra* note 41, at 309.



In 2007 and 2008, home prices declined and mortgage originations fell drastically, wreaking repercussions on the financial system, then the economy. Homeowners stopped paying, and the sharp decline in down payments that had occurred worsened the severity of the crisis, as borrowers who make low down payments are significantly more likely to default.<sup>52</sup> The Financial Crisis Inquiry Commission (FCIC) reported that in 2008 and 2009, median conforming loans experienced serious delinquency rates of 1 and 2.5 percent, respectively.<sup>53</sup> The FCIC also found that the median serious delinquency rate for FHA loans remained at roughly 6 percent; and for subprime loans, delinquencies soared from 29 to 39 percent.<sup>54</sup> However, these statistics do not reveal that FHA-insured originations to borrowers with FICO scores under 600 (referred to by Cleveland Fed researchers as “deep subprime”) and private originations to borrowers of this risk profile experienced similar default rates.<sup>55</sup> Similarly, FHA-insured originations and private originations to “subprime” borrowers (those with FICO scores between 601 and 660) also experienced similar crisis default rates.<sup>56</sup> Notably, between 2002 and 2007, the delinquency rate of FHA mortgages was higher than that of subprime.<sup>57</sup> And of all FHA-insured loans originated in 2007, 36 percent have experienced default.<sup>58</sup>

Overall, as mortgage delinquencies accelerated, many financial institutions were exposed to enormous leveraged losses, and as defaults continued, the MBS market imploded. A number of major depository institutions with mortgage businesses were close to failing when they were acquired, like Washington Mutual by JPMorgan Chase & Co. and Countrywide by Bank of America. Many firms engaged in the mortgage market failed outright. Because of the contagion caused by the meltdown, Bear Stearns was taken over by Chase, Lehman Brothers failed, and Bank of America bought Merrill Lynch. Many non-bank originators failed. The two GSEs, Fannie Mae and Freddie Mac, that securitized the most mortgages leading up to the crisis all but collapsed in September 2008 and were seized by the federal government; they are still overseen under a Treasury conservatorship by the FHFA (the primary federal regulator of Fannie and Freddie, established in 2008 to consolidate regulatory authority from HUD and the Office of Federal Housing Enterprise Oversight [OFHEO] over the GSEs).<sup>59</sup>

To access Federal Reserve emergency funding, the major SHCs – Goldman Sachs and Morgan Stanley – converted to bank holding companies in 2008, and thus the pre-crisis non-

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<sup>52</sup> See, for example, Brent Smith, “Mortgage Reform and the Countercyclical Role of the Federal Housing Administration's Mortgage Mutual Insurance Fund,” *FRB Richmond Economic Quarterly* 97 (First Quarter 2011): 95-110; Christopher J. Meyer et al., *The Rise in Mortgage Defaults* (Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2008-59, Nov. 2008).

<sup>53</sup> FCIC Report, *supra* note 12, at 218.

<sup>54</sup> *Ibid.*

<sup>55</sup> Demyanyk and Kolliner, *supra* note 10.

<sup>56</sup> *Ibid.*

<sup>57</sup> See Mark Calabria, Testimony before the Subcommittee on Insurance, Housing & Community Opportunity, House Committee on Financial Services, on “The Future Role of FHA, RHS, and GNMA in the Single- and Multi-family Mortgage Markets” (May 2011), at 4.

<sup>58</sup> Laurie Goodman et al., “VA Loans Outperform FHA Loans. Why? And What Can We Learn?” *Housing Finance Policy Center Commentary*, Urban Institute (Jul. 2014), at 9.

<sup>59</sup> FCIC Report, *supra* note 12, at 316-317.

bank regulatory structure ceased to exist.<sup>60</sup> In 2009, mortgage originations and outstanding mortgages being serviced plummeted further.<sup>61</sup> Subprime originations vanished, and the mortgage-origination industry consolidated rapidly.<sup>62</sup> That year, the Federal Reserve closed the loophole that had existed for bank holding companies' mortgage-originating subsidiaries.<sup>63</sup> Additionally, for mortgage servicers, the immediate post-crisis period resulted in tighter regulation in various states.<sup>64</sup>

By 2010, only a handful of the non-banks that had operated during the subprime crisis – notably, many that had minimized subprime exposure – remained in business.<sup>65</sup> The mortgage industry had shrunk significantly and was dominated by depository institutions and their subsidiaries.<sup>66</sup> Housing starts had plummeted to less than one-third of 2006 levels.<sup>67</sup> In July that year, regulations authorized by the Secure and Fair Enforcement (SAFE) Mortgage Licensing Act of 2008 were issued, establishing a nationwide mortgage licensing system (NMLS) and streamlining non-bank mortgage origination rules across the states.<sup>68</sup>

That same month, Congress's post-crisis reaction culminated in the Dodd-Frank Consumer Protection and Wall Street Reform Act (Dodd-Frank Act), which, while not addressing two of the institutions at the core of the crisis, Fannie Mae and Freddie Mac, granted authority to new and existing regulators to greatly augment non-bank and depository institution mortgage origination and servicing regulation. Yet the vast majority of Dodd-Frank's authorized rulemakings were not finalized until recent years, and as of early 2015, only 235 of the Act's 390 required rulemakings had been finalized.<sup>69</sup> The details of recently promulgated regulations authorized by Dodd-Frank and of other regulatory developments will be outlined in Section III. These details provide critical context to changes in industry composition described in Section IV.

### III. Recent Policy Developments

Dodd-Frank's most significant impact on mortgage origination and servicing is the creation of the CFPB, in which regulatory powers associated with existing consumer finance laws, such as TILA and RESPA, were consolidated.<sup>70</sup> Critically, Dodd-Frank authorized the CFPB to supervise, examine, and regulate all non-banks engaged in the mortgage market.<sup>71</sup> As

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<sup>60</sup> See Jon Hilsenrath, "Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis," *Wall Street Journal* (Sep. 22, 2008).

<sup>61</sup> Inside Mortgage Finance data.

<sup>62</sup> *Ibid.*

<sup>63</sup> Downs & Shi, *supra* note 41.

<sup>64</sup> Adam J. Levitin & Tara Twomey, "Mortgage Servicing," *Yale Journal on Regulation* 28 (2011):1-90, at 68-69.

<sup>65</sup> Inside Mortgage Finance data.

<sup>66</sup> *Ibid.*

<sup>67</sup> See *infra* Figure 2.

<sup>68</sup> See Federal Financial Institutions Examination Council, *Secure and Fair Enforcement for Mortgage Licensing Act (S.A.F.E. Act) FAQs*, <https://www.ffiec.gov/safeact.htm#saferec>.

<sup>69</sup> Davis Polk, *Dodd-Frank Progress Report*, 1<sup>st</sup> Quarter 2015.

<sup>70</sup> Sec. 1061, Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

<sup>71</sup> *Ibid.*, at Sec. 1024.

CFPB Deputy Director Steve Antonakes recently noted, the CFPB assesses consumer risks and supervises institutions at the “market level and then the institution level.”<sup>72</sup>

In January 2012, the CFPB announced a non-bank mortgage originator and servicer-supervision program,<sup>73</sup> and has since focused significant efforts on discovering how non-bank mortgage lenders pose a threat to consumers.<sup>74</sup> Upon the program’s announcement, CFPB officials noted that the agency’s examination of non-banks will be “the same as its approach to bank examination.”<sup>75</sup> CFPB audits to ensure consumer finance law compliance are seemingly conducted at random.<sup>76</sup> This has caused some to call the process uncompetitive because of the disproportionate cost of an examination to small non-bank lenders or servicers compared to larger non-bank lenders or servicers.<sup>77</sup>

Yet this new supervision arrangement hardly focuses just on pre-crisis consumer finance laws. Under Dodd-Frank’s authority, the CFPB implemented new restrictions on originator compensation in 2013 and 2014, tightened mortgage origination regulations for both depository institutions and non-banks by increasing lender disclosure requirements in 2014 and 2015, and required “full interior appraisal” for certain “higher-risk mortgage loans” in 2015.<sup>78</sup> Dodd-Frank notably granted the CFPB the power to write new mortgage-origination and servicing standards. All of these rules apply to depository institutions and non-banks.

In January 2013, the CFPB acted on this authority and finalized Qualified Mortgage (QM) rules, which augment mortgage-origination rules for depository institutions and non-banks. QM sets standards for what constitutes a “qualified mortgage” and establishes a regulatory framework in which those who lend outside those standards will be subject to penalties.<sup>79</sup> QM standards include restrictions on balloon terms and “no doc” lending, a requirement that loans not exceed 30 years and, most critically, an “ability to repay” provision.<sup>80</sup> This latter requires lenders to make a “good-faith” determination as to what constitutes a “reasonable” belief that a borrower can pay back a loan, opening up the door to regulatory discretion.<sup>81</sup> QM also requires extensive income documentation and calculation procedures, as well as fee disclosures.<sup>82</sup>

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<sup>72</sup> Steve Antonakes, Deputy Director, CFPB, *Prepared Remarks of CFPB Deputy Director Steven Antonakes to the Consumer Bankers Association* (Mar. 2015).

<sup>73</sup> See Peggy Twohig & Steve Antonakes, CFPB, *The CFPB launches its nonbank supervision program* (Jan. 2012).

<sup>74</sup> See, for example, CFPB, Press Release, *CFPB Supervision Report Highlights Risky Practices in Nonbank Markets* (May 2014).

<sup>75</sup> Twohig & Antonakes, *supra* note 73.

<sup>76</sup> Paulina McGrath, “Regulatory Relief Shouldn’t Leave Nonbank Mortgage Lenders Out in the Cold,” *American Banker* (Apr. 2015).

<sup>77</sup> *Ibid.*

<sup>78</sup> See CFPB, *CFPB Dodd-Frank Mortgage Rules Readiness Guide* (Version 3.0, Sep. 2014) (listing and summarizing recent CFPB mortgage origination and servicing rulemakings).

<sup>79</sup> Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6407-6620 (Jan. 30, 2013).

<sup>80</sup> See *ibid.* See also Mark Calabria, *Mortgage Reform under the Dodd-Frank Act* (Cato Institute Working Paper, Jan. 2014), at 9-11 (providing an overview of QM’s regulatory impact).

<sup>81</sup> Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), *supra* note 79, at 6611. See also Calabria, *supra* note 80, at 9-11.

<sup>82</sup> *Ibid.*, 6610-6611. See also Calabria, *supra* note 80, at 9-11.

Also in January 2014, an array of CFPB regulations amending RESPA and TILA went into effect. The final rules greatly augment the mortgage-servicing market and include a large array of new requirements, including more timely and detailed billing and payoff statements, early intervention with delinquent customers, stricter loss-mitigation procedures, and increased recordkeeping.<sup>83</sup> Dodd-Frank also required mortgage securitizers to maintain a risk position in securitized mortgages and finalized these rules in October 2014.<sup>84</sup> However, Fannie Mae and Freddie Mac are exempted from the rules as long as they remain in federal conservatorship.<sup>85</sup>

CFPB rulemakings and examinations – a product of Dodd-Frank – apply to both banks and non-banks. But Dodd-Frank, in conjunction with Basel III, particularly alters regulations for depository institutions engaged in the mortgage business through capital rule requirements.<sup>86</sup> In July 2013, the Federal Reserve finalized its Basel III rulemaking, which by altering new risk-weights for depository institutions significantly affects the mortgage-servicing industry.<sup>87</sup> Prior to the crisis, MSRs that could be included in regulatory capital (up to 50 percent of Tier 1 capital for banks) were assigned a 100 percent risk-weight; Basel III sets a 10 percent limit on the use of MSRs as common equity Tier 1 capital (a more restrictive category of capital than Tier 1), raises the risk-weight to 250 percent for MSRs included towards common equity Tier 1 capital, and sets a one-to-one dollar capital requirement for excluded MSRs.<sup>88</sup> As we will discuss in greater depth later in Section IV, this readjustment of capital rules has had a major impact on depository institutions' holding of MSRs.

The FSOC's 2014 Annual Report urged prudential state regulators to cooperate with the FHFA and CFPB to heighten regulatory restrictions on these non-bank entities that originate or service mortgages securitized by the two GSEs.<sup>89</sup> In January 2015, before state regulators had the chance to act, the FHFA proposed "minimum financial requirements" for non-banks engaged in residential-mortgage origination and servicing.<sup>90</sup> These requirements included:

- A minimum net worth requirement of "\$2.5 million plus 25 basis points of unpaid principal balance (UPB)" for all loans currently serviced;
- A minimum capital ratio of at least 6 percent (tangible net worth/total assets);
- A minimum liquidity requirement of 3.5 basis points for "total Agency loans,"

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<sup>83</sup> Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10901-11021 (Feb. 14, 2013).

<sup>84</sup> Sec. 941, Dodd-Frank Wall Street Reform and Consumer Protection Act (2010); Credit Risk Retention, 79 Fed. Reg. 77601-77766 (Dec. 2014).

<sup>85</sup> *Ibid.*

<sup>86</sup> Sec. 171, Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

<sup>87</sup> Regulatory Capital Rules, 78 Fed. Reg. 62017-62291 (Oct. 2013).

<sup>88</sup> See Jeff L. Plagge, Chairman, American Bankers Association, to Jacob J. "Jack" Lew, Chairperson, FSOC (May 12, 2014) (explaining this shift and the impact it has had); Laurie Goodman & Pamela Lee, "OASIS: A Securitization Born from MSR Transfers," Housing Finance Policy Center Commentary, Urban Institute (Mar. 2014).

<sup>89</sup> Financial Stability Oversight Council, *Annual Report* (2014), at 10.

<sup>90</sup> FHFA, *Proposed Minimum Financial Requirements for Enterprise Seller/Serviceers* (Jan. 2015).

- An additional liquidity ratio of 200 basis points for “total nonperforming agency servicing in excess of 6 percent of the total agency servicing UPB.”<sup>91</sup>

Then in March 2015, the Conference of State Bank Supervisors (CSBS) responded and proposed a number of regulatory standards aimed at improving safety and soundness at non-bank mortgage servicers.<sup>92</sup> These closely mirror those that were proposed by the FHFA for both servicers and originators, but only apply to servicers and exclude a minimum capital ratio requirement; also, under the CSBS’s proposal, the 3.5 basis point requirement would be applicable to all loans, not just Agency loans.<sup>93</sup> Additionally, the CSBS proposal includes data-management standards, heightened risk-management requirements, governance standards, stress testing and living will requirements, and several other new regulatory standards.<sup>94</sup>

In May 2015, Fannie Mae and Freddie Mac adopted the FHFA’s proposed standards for sellers and servicers.<sup>95</sup> Yet policymakers have still not fundamentally reformed Fannie Mae, Freddie Mac, or the FHA. Some estimates find that as much as 90 percent of the mortgage market is explicitly or implicitly government-insured, although private capital is creeping back into the market, and risk is increasingly borne by private sources.<sup>96</sup> Data from AEI’s International Center for Housing Risk reveals that 80 percent of purchase mortgage (explained in Section IV) originations and 85 percent of owner-occupied purchase loans are implicitly or explicitly government-insured.<sup>97</sup> Reliance upon these channels has been accompanied by lower down payment requirements and laxer insurance pricing: in December 2014, Fannie Mae introduced a 3 percent down payment mortgage, and in response the next month, FHA lowered its insurance premiums drastically.<sup>98</sup>

#### IV. Recent Industry Trends

To understand how the mortgage-origination and servicing markets have reacted to recent and past policy developments, and to assess the efficacy of regulatory frameworks, we analyzed data obtained from Inside Mortgage Finance, the U.S. Census, AEI’s International Center on Housing Risk, and the CFPB. We also assessed qualitative developments and the extent to which technological developments have augmented market structure. For the purpose of our analysis, mortgage originating and mortgage servicing subsidiaries of bank holding companies are

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<sup>91</sup> See *ibid.*

<sup>92</sup> Conference of State Bank Supervisors & American Association for Residential Mortgage Regulators, *Proposed Regulatory Prudential Standards for Non-Bank Mortgage Servicers* (Mar. 2015) [hereinafter “CSBS & AARMR Proposed Regulatory Standards for Non-Banks”].

<sup>93</sup> *Ibid.* See Jones Day, *State Regulators Propose New Prudential Standards for Non-bank Mortgage Servicers* (Apr. 2015) (presenting an in-depth overview of similarities and differences between these and FHFA’s proposed standards).

<sup>94</sup> See *ibid.*; CSBS & AARMR Proposed Regulatory Standards for Non-Banks, *supra* note 92.

<sup>95</sup> See *supra* note 9 and accompanying text.

<sup>96</sup> See Fannie Mae, “The Return of Private Capital,” *Fannie Mae Housing Insights* 4 (Oct. 2014), at 2 (citing internal estimates as well as Goldman Sachs, *The Mortgage Analyst* (May 22, 2014)).

<sup>97</sup> AEI’s International Center on Housing Risk, *Mortgage Risk Index – May 2015 release* (forthcoming, Jun. 2015).

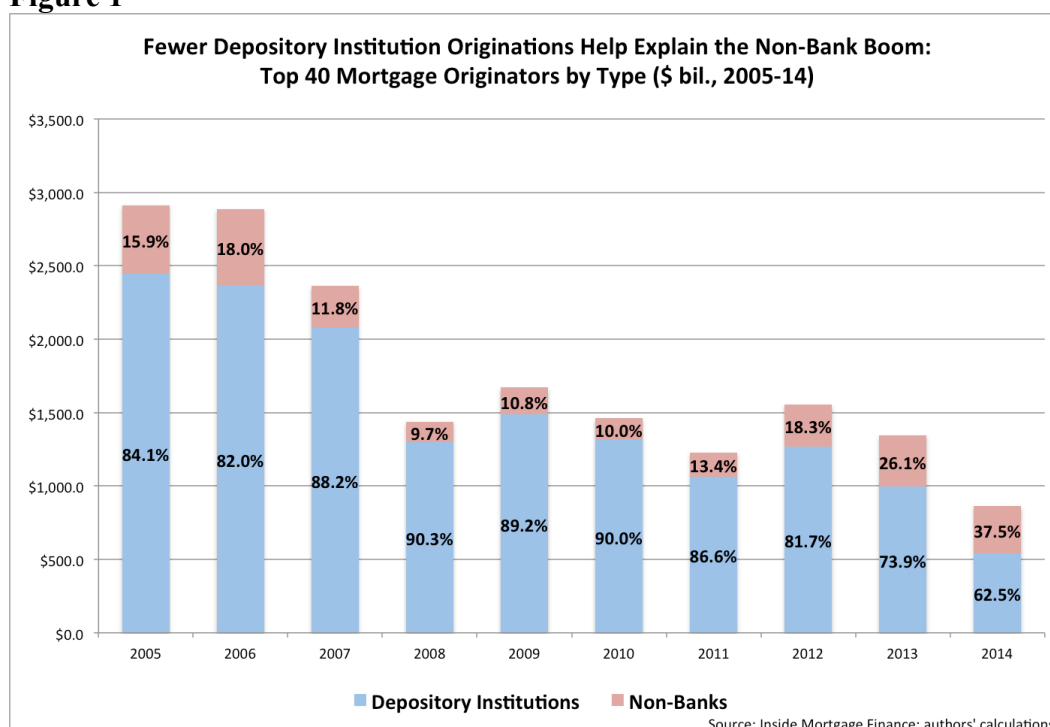
<sup>98</sup> See Fannie Mae, *Fannie Mae Announces 97 Percent LTV Option for First-Time Homebuyers*, Press Release (Dec. 8, 2014); FHA, *FHA to Reduce Annual Insurance Premiums*, Press Release (Jan. 8, 2015).

classified as depository institutions as they are overseen by depository institution-regulators: the FRS, OCC, FDIC, OTS (pre-Dodd-Frank), or the National Credit Union Administration.

### a) Mortgage origination trends

Figure 1 below reveals that a substantial scaling-back of depository institution participation in the origination market has accompanied a sizable increase in non-bank origination volume. Total mortgage originations declined to \$1.240 trillion in 2014, from \$3.120 trillion in 2005.<sup>99</sup> Amongst the top 40 originators, we find that non-banks accounted for 37.5 percent of originations in 2014, up from 15.9 percent in 2005.<sup>100</sup> Goldman Sachs research finds that overall, non-banks share of originations jumped from 12 to 42 percent during this time.<sup>101</sup>

**Figure 1**



Clearly, the decline in mortgage-origination volume (in terms of dollar amount) by depository institutions helps explain the rise in non-banks' market share cited by

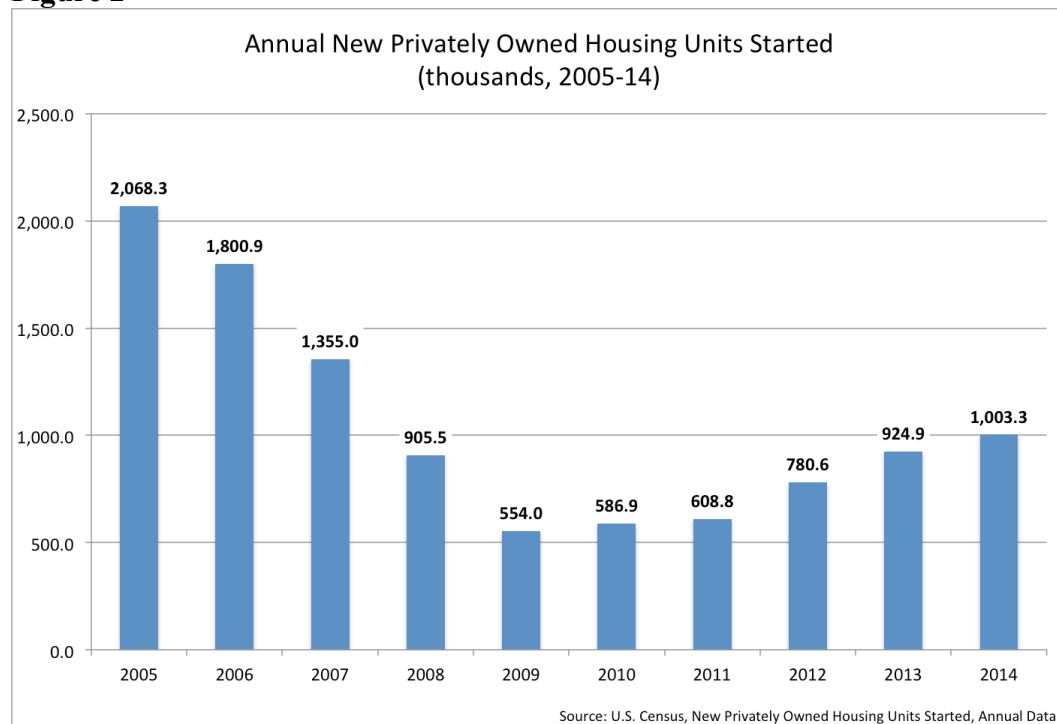
<sup>99</sup> Inside Mortgage Finance data.

<sup>100</sup> *Ibid.* (authors' calculations; ranks and percentages calculated in terms of dollar volume). Due to data limitations, we only could assess trends in origination patterns amongst the top 40 servicers between 2005 and 2014, but during this time, the top 40 originators accounted for 97 to 69 percent of the market in terms of dollar volume. *Ibid.* Some firms listed as top 40 originators in the mid-2000s are subsidiaries of the same holding company. *Ibid.* It is thus possible depository institutions' market share is marginally overstated between 2005 and 2007.

<sup>101</sup> Nash & Beardsley, *supra* note 3, at 53 (citing Inside Mortgage Finance and Goldman Sachs Investment Research data; percentages calculated in terms of total dollar volume of 2005 and 2014 originations, respectively).

policymakers.<sup>102</sup> This decline is driven in part by declining home starts, which have yet to fully rebound since the crisis, as Figure 2 below indicates.

**Figure 2**

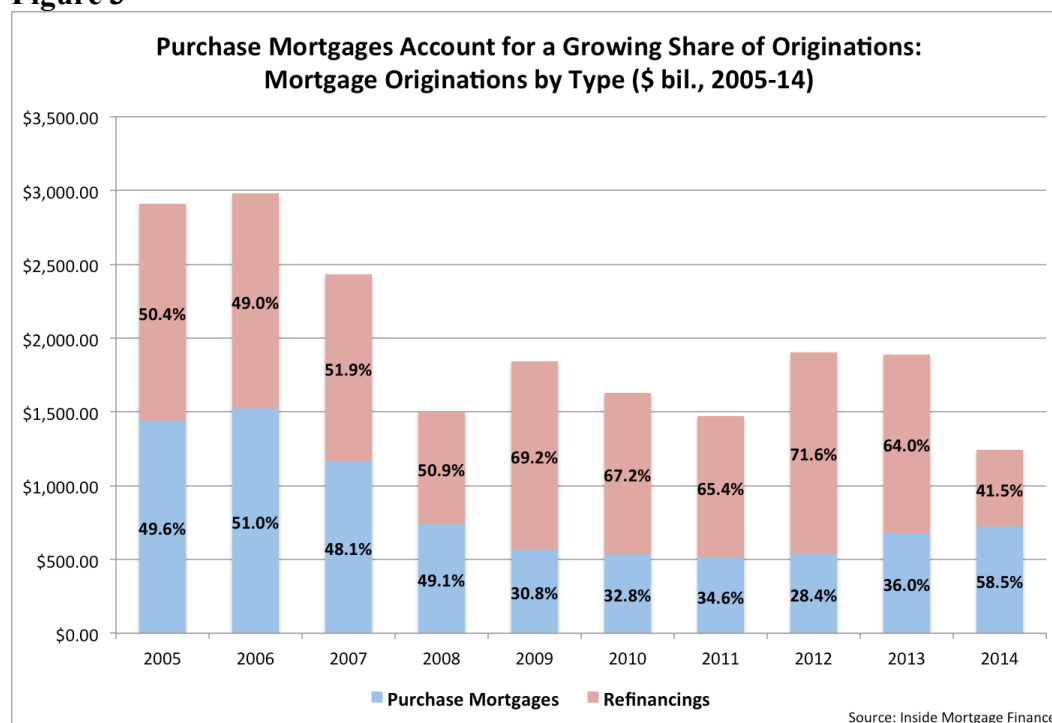


However, Figure 1 also includes mortgage refinancings, which boomed for several years as a result of very low interest rates and were at their height in 2012. That year, refinancings represented 71.6 percent of originations in terms of dollar volume, as Figure 3 below indicates.

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<sup>102</sup> U.S. House Committee on Oversight & Government Reform, Office of Rep. Elijah E. Cummings, Ranking Member, *supra* note 8.

**Figure 3**



As this boom ebbed in 2013 and 2014, the overall mortgage-origination market declined in volume.<sup>103</sup> During the boom, the FHFA’s Office of the Inspector General (FHFA OIG) noted that non-banks “[expanded] operations more aggressively than commercial banks in response to the recent boom in residential mortgage refinancing.”<sup>104</sup> However, as Figure 4 reveals, non-banks also greatly expanded their role in purchase mortgage originations in the last two years: by 2014, of the top 20 purchase mortgage originators in terms of dollar volume – whose loans made up 55 percent, or \$400.4 billion, of the total \$725 billion in 2014 purchase mortgage originations – 10 were non-banks, accounting for 28 percent, or \$111.1 billion, of 2014 purchase mortgages originated by the top 20 lenders.<sup>105</sup> The purchase mortgage origination market has also become much more fragmented in recent years: in 2010, the top 20 lenders accounted for 81 percent of the market.<sup>106</sup>

<sup>103</sup> Inside Mortgage Finance data.

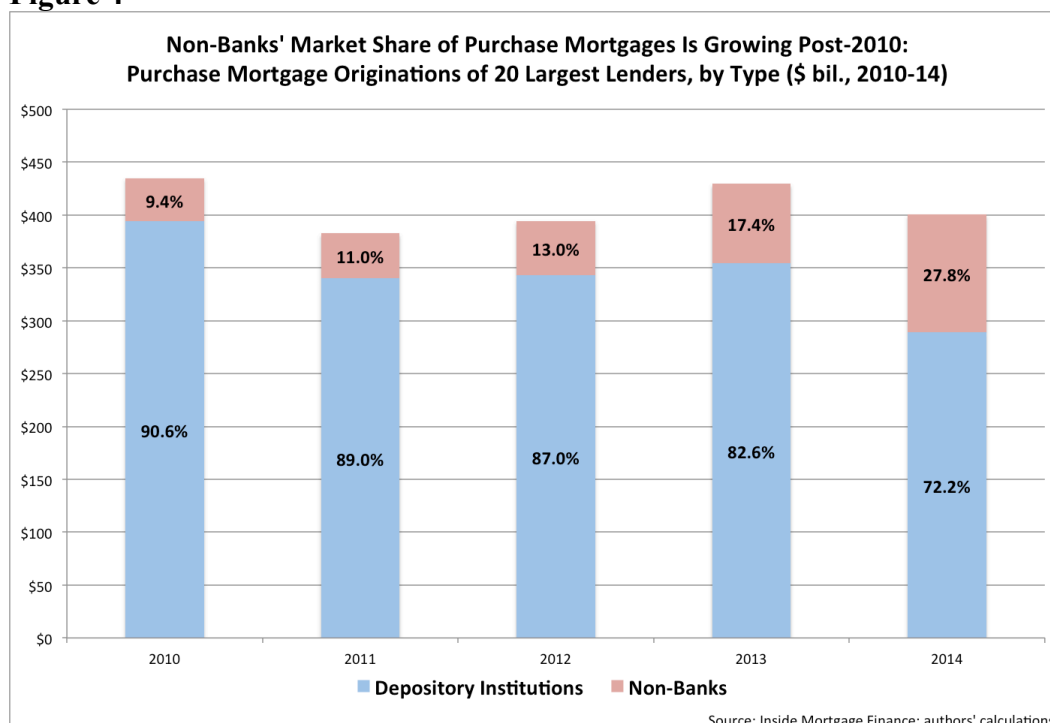
<sup>104</sup> Office of the Inspector General, FHFA, *Recent Trends in the Enterprises’ Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies* (EVL-2014-010, Jul. 2014), at 17.

<sup>105</sup> Inside Mortgage Finance data (authors’ calculations; rank and percentages calculated in terms of dollar volume; purchase mortgage dollar volume data by originator was only available for 2010 through 2014).

<sup>106</sup> *Ibid.* (authors’ calculations; rank and percentages calculated in terms of dollar volume).



**Figure 4**



The chart above makes it clear that without non-bank growth in mortgage origination, there would have likely been significantly less purchase mortgage lending in 2014. Data obtained from AEI's International Center for Housing Risk reveals that as a share of the total number of government-insured purchase mortgage originations, the picture is more drastic. Figure 5 reveals that while non-banks accounted for 26.3 percent of agency purchase mortgage loans originated in December 2012, by December 2014, that number had grown to 48.37 percent.<sup>107</sup>

**Figure 5**

<b>Market Share of the Number of Agency Purchase Mortgage Loans Originated by Lender Type (monthly data)</b>		
	<b>Non-Banks</b>	<b>Banks</b>
<b>December 2012</b>	26.63%	69.69%
<b>June 2013</b>	28.74%	67.88%
<b>December 2013</b>	37.47%	58.81%
<b>June 2014</b>	44.70%	51.82%
<b>December 2014</b>	48.37%	47.76%
Source: AEI's International Center on Housing Risk, <a href="http://www.housingrisk.org">www.housingrisk.org</a>		

<sup>107</sup> Figure produced using data provided by AEI's International Center on Housing Risk, [www.housingrisk.org](http://www.housingrisk.org)

If trends in Figures 1, 4, and 5 continue – depository institutions exit the purchase mortgage market while non-banks enter – it is quite possible that non-banks will soon account for a substantial majority of purchase mortgage originations. So what is driving this shift?

Banks may be at somewhat of a competitive disadvantage due to their historical reliance on correspondents. The CFPB explains that correspondents “are the primary interface with consumers, conducting all steps in the mortgage-origination process and funding their own loans,” that is, originating loans based on “underwriting standards set by other lenders or investors.”<sup>108</sup> These channels account for over 60 percent of bank mortgage originations versus about 35 percent for non-banks.<sup>109</sup> QM income documentation and fee-disclosure requirements have been particularly burdensome for correspondent mortgage origination, as Andrew Peters of First Guaranty Mortgage Corporation notes.<sup>110</sup> The level of documentation for most correspondents is a “better-safe-than-sorry environment,” meaning manual and technology costs are significant.<sup>111</sup> These costs are impactful on the market because, according to the National Association of Realtors, just 1.2 percent of Q1 2015 originations were non-QM.<sup>112</sup>

But a much more important factor driving down depository institutions’ mortgage market participation is that major banks have realized substantial decreases in mortgage market profitability.<sup>113</sup> In large part, massive fines and legal fees have driven banks away from mortgage origination.<sup>114</sup> As Bob Walters – the chief economist at Quicken Loans, a non-bank originator – recently told the *San Francisco Chronicle*, “Independent mortgage companies don’t have the same legacy exposure.”<sup>115</sup> Of particular concern to banks is “put-back risk” – the risk that regulators will ask banks to repurchase loans. Federal Reserve Board Chair Janet Yellen stated in June 2014 that banks are concerned about this risk, and Wells Fargo’s CEO told the *Financial Times* in August 2014: “If you guys want to stick with this programme of ‘putting back’ any time, any way, whatever, that’s fine, we’re just not going to make those loans and there’s going to be a whole bunch of Americans that are underserved in the mortgage market.”<sup>116</sup>

Regulatory fears are driving depository institutions to become more selective about customers. This trend is profiled by AEI’s International Center on Housing Risk, which, using government and private-firm data, documented that non-banks, especially large non-banks, are much more willing to lend to riskier borrowers compared to depository institutions.<sup>117</sup> The

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<sup>108</sup> CFPB, Examination Procedures, Mortgage Origination (Jan. 2014).

<sup>109</sup> Stephen Oliner, Edward Pinto & Brian Marein, AEI’s International Center on Housing Risk, *Study shows seismic shift in lending away from large banks to nonbanks continued in February* (Apr. 2015), [www.housingrisk.org](http://www.housingrisk.org).

<sup>110</sup> See Andrew Peters, “How New Regulations Are Reshaping Correspondent Lending,” *The Journal for Mortgage Banking Professionals* (Apr. 2014).

<sup>111</sup> See *ibid.*

<sup>112</sup> National Association of Realtors, Sixth Survey of Mortgage Originators (May 2015).

<sup>113</sup> See Rachel Norvell, “Big banks’ declining mortgage volumes signal shift in market,” *Mortgage Professional America* (Oct. 2014) (documenting recent quarterly and annual losses in mortgage profitability for JPMorgan, Wells Fargo, Citigroup, and Bank of America).

<sup>114</sup> See *ibid.*; Kathleen Pender, “Why big banks are losing out to nonbank lenders in mortgages,” *San Francisco Chronicle* (Feb. 27, 2015).

<sup>115</sup> *Ibid.*

<sup>116</sup> Camilla Hall, “Wells chief warns on mortgage lending,” *The Financial Times* (Aug. 26, 2014).

<sup>117</sup> Oliner et al, *supra* note 109.

Center use a risk index that estimates the percentage of loans that would be expected to default in a market-wide downturn that resembles that of 2007-2008.<sup>118</sup> AEI's Stephen Oliner, Edward Pinto, and Brian Marein found that the risk index for large non-banks' purchase mortgage originations is now on average about five percentage points greater than that of large banks; yet in 2012 purchase mortgage originations of large banks were of comparable riskiness to those of non-banks.<sup>119</sup> Similarly, recent Federal Reserve Bank of Boston research also documents a significant tightening in depository institutions' mortgage lending standards.<sup>120</sup>

So what is driving the discrepancy in risk? Conforming mortgage originations, which accounted for on average 65 percent of total closed originations in 2014,<sup>121</sup> appear to only be marginally driving the trend. Using data given to us by AEI's International Center on Housing Risk, we found that the FICO scores for conforming mortgages, while oftentimes lower at non-banks, are generally of comparable quality across banks and non-banks. Figures 6 and 7 reveal median FICO scores for the largest originators of conforming mortgages in Q4 2013 and Q4 2014.<sup>122</sup> Overall, the median FICO score of conforming mortgage borrowers was 761 at non-banks and 766 at banks in Q4 2013, versus 757 at non-banks and 764 at banks in Q4 2014.<sup>123</sup>

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<sup>118</sup> *Ibid.*, at 5. For more on the authors' methodology, see AEI's International Center on Housing Risk, National Mortgage Risk Index for Home Purchase Loans (Jan. 2015), [www.housingrisk.org](http://www.housingrisk.org).

<sup>119</sup> Oliner et al, *supra* note 109, at 3.

<sup>120</sup> Jordan Rappaport & Paul Willen, *Tight Credit Conditions Continue to Constrain the Housing Recovery*, (Current Policy Perspectives, Federal Reserve Bank of Boston, Jul. 2014).

<sup>121</sup> Ellie Mae, *Origination Insight Report* (Feb. 2015), at 3.

<sup>122</sup> Figures produced using data provided by AEI's International Center on Housing Risk, [www.housingrisk.org](http://www.housingrisk.org) (firms listed accounted for 65 and 64 percent of conforming purchase loans in Q4 2013 & Q4 2014, respectively).

<sup>123</sup> Data provided by AEI's International Center on Housing Risk, [www.housingrisk.org](http://www.housingrisk.org).

**Figure 6**

<b>Median FICO Score of Conforming Mortgage Borrowers by Large Conforming Mortgage Originators (over 2,000/quarter) (Q4 2013)</b>			
<b>Institution Type</b>	<b>Institution Name</b>	<b># of GSE Loans</b>	<b>Median FICO Score</b>
Bank	USAA	3429	775
Non-bank	Provident Funding Associates	2047	774
Bank	SunTrust	5921	773
Non-bank	Freedom Mortgage	2529	770
Non-bank	PHH Corporation	6410	769
Non-bank	Pulte Mortgage	2074	769
Bank	New York Community Bank	2186	769
Bank	Wells Fargo	80155	767
Bank	Citi	6754	767
Bank	JPMorgan	35203	767
Bank	BB&T	13084	766
Bank	US Bank	13992	766
Bank	FifthThird	5354	765
Non-bank	Guaranteed Rate, Inc.	4102	765
Bank	FHLB of Chicago	2426	764
Bank	PNC	3824	764
Bank	Flagstar	10448	763
Non-bank	Nationstar Mortgage	3671	763
Bank	BOKF	2334	762
Non-bank	Stearns Lending, Inc.	4187	762
Non-bank	Franklin American Mortgage Co.	10449	762
Non-bank	Caliber Home Loans, Inc.	3392	761
Non-bank	Quicken Loans	6285	760
Bank	Cole Taylor Bank	3218	760
Non-bank	United Shore Financial Services	4138	759
Non-bank	Green Tree Servicing, LLC	4739	759
Bank	Bank of America	4099	759
Non-bank	Academy Mortgage Corp.	2046	758
Bank	PrimeLending	3239	758
Non-bank	LOANDEPOT.com	2129	758
Non-bank	Stonegate Mortgage Corp.	4510	757
Non-bank	Prospect Mortgage	3188	756
Non-bank	PennyMac Loan Services	6434	755
Non-bank	Guild Mortgage Company	2341	754

Source: AEI's International Center on Housing Risk, [www.housingrisk.org](http://www.housingrisk.org)

**Figure 7**

<b>Median FICO Score of Conforming Mortgage Borrowers by Large Conforming Mortgage Originators (over 2,000/quarter) (Q4 2014)</b>			
<b>Institution Type</b>	<b>Institution Name</b>	<b># of GSE Loans</b>	<b>Median FICO Score</b>
Bank	Bank of America	6643	777
Non-bank	Pulte Mortgage	2125	770
Non-bank	Freedom Mortgage	3902	768
Non-bank	PHH Corporation	5155	768
Bank	JPMorgan	26361	767
Bank	BB&T	9562	766
Bank	SunTrust	7983	766
Bank	Citi	5728	765.5
Bank	Wells Fargo	54552	765
Bank	HomeStreet Bank	2037	765
Bank	FHLB of Chicago	2060	764
Bank	PNC	3280	764
Non-bank	Nationstar Mortgage	3508	762
Bank	FifthThird	3040	762
Non-bank	LOANDEPOT.com	2839	761
Bank	USAA	2163	761
Non-bank	Guaranteed Rate, Inc.	3252	760
Bank	US Bank	16928	760
Non-bank	United Shore Financial Services	4846	760
Non-bank	Fairway Independent Mortgage Corp.	2778	759
Bank	BOKF	3139	759
Non-bank	Stearns Lending, Inc.	7598	758
Non-bank	Universal American Mortgage Co.	3103	758
Non-bank	Franklin American Mortgage Co.	10592	758
Bank	Huntington	2091	757
Non-bank	Cornerstone Home Lending, Inc.	2502	757
Bank	Flagstar	10623	757
Non-bank	Quicken Loans	8757	756
Non-bank	Caliber Home Loans, Inc.	5613	756
Non-bank	Academy Mortgage Corp.	2475	756
Non-bank	Green Tree Servicing, LLC	6360	755
Non-bank	CMG Mortgage, Inc.	2326	755
Bank	MB Financial Bank	3020	755
Non-bank	Prospect Mortgage	2986	753
Bank	PrimeLending	3203	752
Non-bank	PennyMac Loan Services	9003	752
Non-bank	Homebridge Financial Services, Inc.	2592	750
Non-bank	Guild Mortgage Company	2296	749
Non-bank	Stonegate Mortgage Corp.	4139	749
Non-bank	Pacific Union Financial	2798	745
Non-bank	Plaza Home Mortgage	3077	741
Source: AEI's International Center on Housing Risk, <a href="http://www.housingrisk.org">www.housingrisk.org</a>			

Instead, the boom in non-banks' market share of FHA mortgage originations is a larger cause of the growing discrepancy between banks' and non-banks' risk profiles. Over 60 percent of FHA originations were by non-banks in early 2015 versus less than 30 percent in 2012.<sup>124</sup> Figures 8 and 9 reveal that FICO scores of many of larger non-banks' FHA-insured borrowers are significantly below that of large banks.<sup>125</sup>

<sup>124</sup> Oliner et al., *supra* note 109.

<sup>125</sup> Figures produced using data provided by AEI's International Center on Housing Risk, [www.housingrisk.org](http://www.housingrisk.org) (firms listed accounted for 76 and 70 percent of FHA-insured purchase loans in Q4 2013 & Q4 2014, respectively). Amongst the originators listed in Figure 7, in Q4 2014 the average conforming mortgage borrower FICO score was 748 at non-banks versus 755 at banks. *Ibid.*

**Figure 8**

Median FICO Score of FHA Mortgage Borrowers by Large FHA-Insured Mortgage Originators (over 1,500/quarter) (Q4 2013)			
Institution Type	Institution Name	# of FHA Loans	Median FICO Score
Non-bank	PennyMac Loan Services	9529	696
Bank	JPMorgan	13965	693
Bank	Bank of America	1975	690
Non-bank	Homebridge Financial Services, Inc.	1650	688
Bank	Flagstar	3758	688
Non-bank	Franklin American Mortgage Company	2166	687
Bank	Wells Fargo	44262	686
Non-bank	Stearns Lending, Inc.	1556	685
Bank	BB&T	3030	682
Bank	US Bank	10836	681
Bank	PrimeLending	1507	677
Non-bank	Prospect Mortgage	1670	676
Non-bank	Caliber Home Loans, Inc.	2133	676
Bank	M&T Bank	1756	676
Non-bank	Stonegate Mortgage Corp.	2699	675
Bank	FifthThird	1912	675
Non-bank	Quicken Loans	3045	675
Non-bank	Nationstar Mortgage	2169	672
Non-bank	Guild Mortgage Company	1764	666
Non-bank	Freedom Mortgage	3087	661
Non-bank	CMG Mortgage, Inc.	1696	658
Non-bank	Pacific Union Financial	3039	647
Non-bank	First Guaranty Mortgage Corp.	1576	640
Source: AEI's International Center on Housing Risk, <a href="http://www.housingrisk.org">www.housingrisk.org</a>			

**Figure 9**

Median FICO Score of FHA Mortgage Borrowers by Large FHA-Insured Mortgage Originators (over 1,500/quarter) (Q4 2014)			
Institution Type	Institution Name	# of FHA Loans	Median FICO Score
Bank	SunTrust	1659	696
Non-bank	PennyMac Loan Services	10006	695
Bank	Bank of America	1716	691
Bank	Wells Fargo	26089	687
Non-bank	Green Tree Servicing, LLC	2128	682
Bank	M&T Bank	1665	681
Bank	US Bank	12551	679
Non-bank	Homebridge Financial Services, Inc.	1716	679
Bank	Flagstar	4258	678
Non-bank	Stearns Lending, Inc.	3196	673
Non-bank	Quicken Loans	4339	671
Non-bank	Roundpoint Mortgage	2363	670
Non-bank	Pingora Loan Servicing	6985	669
Non-bank	Caliber Home Loans, Inc.	2978	668
Non-bank	Guild Mortgage Company	1821	665
Non-bank	Stonegate Mortgage Corp.	3304	665
Non-bank	Nationstar Mortgage	1681	665
Non-bank	Plaza Home Mortgage	2590	662
Non-bank	Freedom Mortgage	7434	662
Non-bank	Sun West Mortgage Comp.	1868	661
Non-bank	The Money Source, Inc.	3575	652
Non-bank	Pacific Union Financial	5487	647
Non-bank	First Guaranty Mortgage Corp.	2217	635
Source: AEI's International Center on Housing Risk, <a href="http://www.housingrisk.org">www.housingrisk.org</a>			

In Q4 2013 the median FICO score of FHA-insured borrowers was 675 at non-banks versus 685 at banks.<sup>126</sup> In Q4 2014, it was 667 at non-banks versus 682 at banks.<sup>127</sup> FHA-insured

<sup>126</sup> Data provided by AEI's International Center on Housing Risk, [www.housingrisk.org](http://www.housingrisk.org).

loans were on average 19 and 20 percent of monthly 2013 and 2014 closed originations, respectively,<sup>128</sup> and as a share of purchase mortgage origination volume, FHA-insured loans accounted for about 20 percent of the market as of April 2015.<sup>129</sup> While in fiscal year 2014 (ending mid-2014) the FHA reported over 45 percent of FHA mortgages originated were to borrowers with a credit score above 680,<sup>130</sup> data from AEI's International Center for Housing Risk reveals that by late 2014, at many non-banks this was likely not the case. Similarly, AEI's risk index, introduced above,<sup>131</sup> hit an all-time high for first-time homebuyers in mid-2015 of 15.28 percent in response to the recently lowered FHA premium, which has brought about a boost in higher-risk FHA-insured loan market share.<sup>132</sup>

Figure 9 reveals that over half of the loans originated by some non-banks are to borrowers with FICO scores below 660 – a benchmark used by some as to what constitutes subprime.<sup>133</sup> Notably, 2015 research from the Federal Reserve Bank of Cleveland found that 26 percent of FHA loans originated in 2014 were subprime, using a FICO score below 660 as the definition of subprime, and another 40 percent were near-prime, using a 661 to 700 definition.<sup>134</sup> The authors warn:

Although the standards for FHA originations have improved substantially in that originations to the deep subprime segment stopped and originations to near-prime and prime segments increased, the performance of the overall FHA mortgage market has not improved. The default rate of all FHA loans combined is still higher than it was before the onset of the subprime boom in 2003.<sup>135</sup>

Ginnie Mae policies are also actively expanding non-bank participation in the FHA-insured market: 68 of the 76 institutions that Ginnie Mae – which guarantees MBS backed by FHA-insured mortgages – admitted into its program in fiscal years 2011 and 2012 were non-banks.<sup>136</sup> If the riskiness of FHA-insured originations was to increase substantially in coming

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<sup>127</sup> *Ibid.* Amongst the large originators listed in Figure 9, in Q4 2014 the average FHA-insured mortgage borrower FICO score was 675 at non-banks versus 692 at banks. *Ibid.*

<sup>128</sup> Ellie Mae, *supra* note, 121. Others note that FHA-insured originations were about 11 percent of the market in 2014. Demyanyk and Kolliner, *supra* note 10.

<sup>129</sup> See AEI's International Center on Housing Risk, *supra* note 97 (finding that of the 80 percent of purchase mortgages that are explicitly or implicitly government insured, over 25 percent are FHA-insured).

<sup>130</sup> U.S. Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2014* (Nov. 2014).

<sup>131</sup> See *supra* notes 117-119 and accompanying text.

<sup>132</sup> AEI's International Center on Housing Risk, *supra* note 97.

<sup>133</sup> See Demyanyk and Kolliner, *supra* note 10. A 640 threshold is also used to commonly define subprime, but St. Louis Fed researchers note that a low LTV ratio could make even a below-640 score near-prime, not subprime. See Rajdeep Sengupta & William R. Emmons, "What Is Subprime Lending?" *Economic Synopses, The Federal Reserve Bank of St. Louis* 13 (2007).

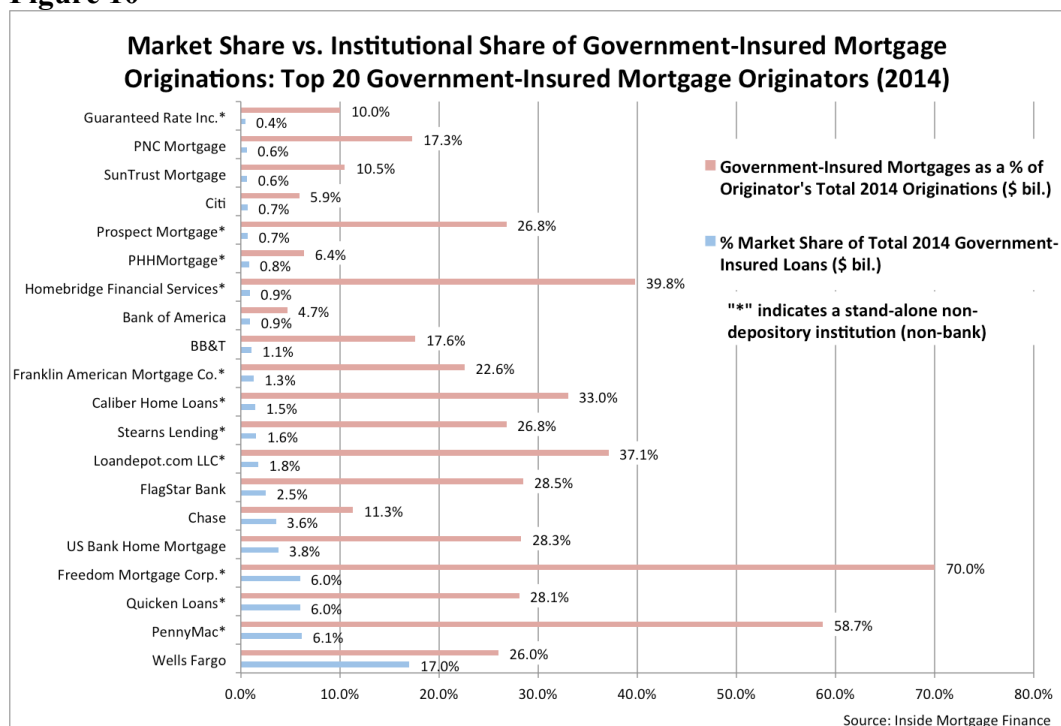
<sup>134</sup> Demyanyk and Kolliner, *supra* note 10.

<sup>135</sup> *Ibid.*

<sup>136</sup> Kathy Gibbons, Senior Policy Advisor, Ginnie Mae, *Ginnie Mae & Housing Finance Market Update*, presentation (Jan. 17, 2013).

quarters, then the high reliance on the government-insured market – most of which is FHA-insured<sup>137</sup> – exhibited by some non-banks, revealed by Figure 10, could be problematic.

**Figure 10**



However, it is critical to note that the risks of FHA-insured loans are different than those brought about by pre-crisis private subprime mortgage originations. Unlike private subprime mortgages issued before the crisis, FHA-insured mortgages are 100 percent insured by the government and issued with comparatively more straightforward terms.<sup>138</sup> These and other factors have caused some to note that classifying low-FICO score FHA-insured loans as “subprime” is inappropriate, and that “non-prime” is a better classification.<sup>139</sup> Also, only 10 percent of FHA-insured loans originated in fiscal year 2014 were to borrowers with FICO scores below 640, FHA does not insure borrowers with a score below 500, and for borrowers with a score between 500 and 580 FHA requires a 10 percent down payment.<sup>140</sup> Cost-structure and customer service improvements are partially contributing to this boom in market share (discussed in more depth below). Additionally, FHA mortgage delinquency rates are not extraordinarily high, and as mentioned the FHA has lent to many creditworthy borrowers in recent years.<sup>141</sup>

<sup>137</sup> AEI’s International Center on Housing Risk (as a percentage of monthly agency loans originated, other government-insured lending accounted for 15 to 18 percent of the market during 2014, while FHA-insured lending accounted for between 22 and 25 percent).

<sup>138</sup> See Laurie Goodman et al., *supra* note 58.

<sup>139</sup> See, for example, Darryl Getter, *The Federal Housing Administration (FHA) and Risky Lending*, (Congressional Research Service, Report for Congress, Dec. 2012), at 23.

<sup>140</sup> See Katie Jones, *FHA Single-Family Mortgage Insurance: Recent Policy Changes and Proposed Legislation*, (Congressional Research Service, Report for Congress, Jan. 2015), at 23.

<sup>141</sup> See *ibid.*, at 9 & 25; Demyanyk and Kolliner, *supra* note 10; U.S. Department of Housing and Urban Development, *supra* note 130.



Yet as mentioned the default rate of FHA-insured loans today is higher than before the crisis,<sup>142</sup> and their risk of default has increased since mid-2013; AEI's risk index for these loans recently reached over 23 percent.<sup>143</sup> Also, researchers at the New York Fed and NYU's Stern School of Business find methodological flaws in FHA's measure of delinquency.<sup>144</sup> Wharton School of Business Professor Jack Guttentag points out that because FHA mortgage insurance premiums are not linked to credit scores, many low-income borrowers are taking on loans with terms less favorable than they could otherwise obtain.<sup>145</sup> Of course, the 3.5 percent down payment requirement of FHA loans is making mortgages to some first-time borrowers.<sup>146</sup> But Federal Reserve research notes that low down payments significantly and harmfully contribute to the severity of housing market downturns.<sup>147</sup> Also, low down payments likely increase the risk of default; in fact, one older FHA study found that decreasing down payments from 10 to 3 percent increases the chance of default by 500 percent.<sup>148</sup> And as Guttentag notes, some originators of FHA-insured mortgages can and do originate without regard for credit scores, and as long as FHA-insurance can be secured, they execute the loan.<sup>149</sup> Overall, originations to riskier FHA-insured borrowers are contributing to non-banks growing market share.

Further driving non-bank participation in the FHA-insured mortgage market is regulatory activity, such as that mentioned above. JPMorgan CEO Jamie Dimon has cited the unpredictability with which the FHA litigates and fines as a reason to exit the FHA loan business.<sup>150</sup> *The Wall Street Journal* also reports that heightened legal actions against banks are driving the non-bank surge in the FHA market.<sup>151</sup> If government actions and market forces drive non-banks to engage in excessively risky FHA-insured originations, then in the event of a downturn, this could pose a risk both to neighborhoods highly reliant on FHA-insured mortgages and to a financially troubled FHA.<sup>152</sup> Concentrated defaults could also put the GSEs at risk if concentrated delinquencies precipitate a decline in surrounding home prices.

In short, banks are scaling back origination volume due to regulatory pressures and a loss in profitability. An increase in riskier FHA-insured originations by non-banks does pose a concern that explicit government insurance is enabling lending that could result in high defaults

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<sup>142</sup> Demyanyk and Kolliner, *supra* note 10.

<sup>143</sup> Data from AEI's International Center on Housing Risk.

<sup>144</sup> Andrew Caplin et al., *Is the FHA Creating Sustainable Homeownership?* (NBER Working Paper No. 18190, Jul. 2012).

<sup>145</sup> Jack Guttentag, "Subprime mortgage market still exists within the FHA," *The Washington Post* (Jul. 3, 2013).

<sup>146</sup> See Lisa Prevost, "F.H.A. Loans More Affordable," *The New York Times* (Jan. 9, 2015).

<sup>147</sup> See Meyer et al., *supra* note 52.

<sup>148</sup> See Calabria, *supra* note 19, at 9 (citing George M. Von Furstenberg, "Default Risk on FHA-Insured Home Mortgages as a Function of the Terms of Financing: A Quantitative Analysis," *Journal of Finance* 24 (1969): 459–77; Patric Hendershott and William Schultz, "Equity and Nonequity Determinants of FHA Single-Family Mortgage Foreclosures in the 1980s" *Journal of the American Real Estate and Urban Economics Association* 21 (1993)).

<sup>149</sup> Guttentag, *supra* note 145.

<sup>150</sup> See Saul Griffith, "Are Our Mortgage Markets Broken?" *ValueWalk* (Aug. 2014).

<sup>151</sup> Joe Light, "Federal Mortgage Agency Says More Needed to Police Nonbank Lenders," *The Wall Street Journal* (Apr. 28, 2015).

<sup>152</sup> See Edward Pinto, Statement before the Committee on Financial Services, U.S. House of Representatives, "Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market" (Feb. 2013).

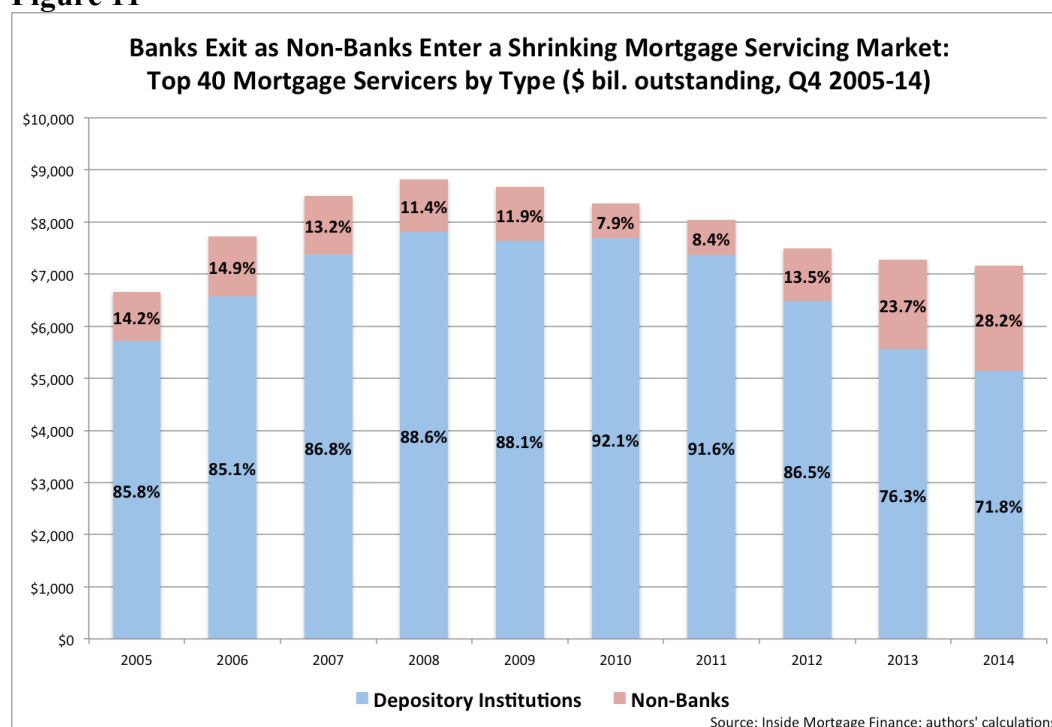
and lower property values in regions with heavy FHA mortgage concentration in the event of a market downturn.<sup>153</sup> Yet policymakers must be wary of a one-size-fits-all regulatory approach; clearly, the risk-exposure of non-bank lenders varies.

## b) Mortgage servicing trends

So what about mortgage servicing? As we explained above, some mortgage originators hold on to servicing rights, while others' MSR's are sold to depository institutions and non-banks. In recent years, pressures that exclusively affect depository institutions – including capital requirement adjustments and regulatory scrutiny – have driven them to sell MSR's to non-banks.

As opposed to mortgage-origination patterns, there was clearly no pre-crisis uptick in non-banks' participation in the mortgage-servicing market. Furthermore, outstanding servicing obligations have modestly declined since the mid-2000s; they have not plummeted like annual mortgage originations. Clearly, the upsurge in non-bank market share in mortgage servicing is a post-crisis, post-Dodd-Frank phenomenon not driven by a “shrinking pie.” As Figure 11 shows, in 2014, non-banks held 28.2 percent (\$2.02 trillion) of outstanding servicing obligations amongst the top 40 servicers (\$7.16 trillion); yet in 2010, non-banks held just 7.9 percent (\$657 billion) and in 2005 held only 14.2 percent (\$947 billion).<sup>154</sup>

**Figure 11**



<sup>153</sup> *Ibid.*

<sup>154</sup> Inside Mortgage Finance data (authors' calculations; ranks and percentages calculated in terms of dollar volume). Due to data limitations, we only could assess trends in servicing patterns amongst the top 40 servicers between 2005 and 2014, but during this time, the top 40 servicers accounted for 72 to 81 percent of the market in terms of dollar volume. *Ibid.*

What factors are driving the trend? For starters, depository institutions are aggressively selling MSR to non-banks in response to Basel III capital requirements.<sup>155</sup> For example, Citigroup sold 21 percent of its MSRs in 2013, worth \$63 billion at the time, and banks have been aggressively selling off MSRs as a result of recent capital rules.<sup>156</sup> The American Bankers Association notes that depository institutions will likely sell off an additional \$2 to \$3 billion in MSRs by 2017, and capital rules are a large reason this will occur.<sup>157</sup> Also, Goldman Sachs research notes that the fines and penalties incurred by depository institutions engaged in servicing are driving their exit, and today's non-banks – which were largely not active in pre-crisis origination and servicing – enjoy a regulatory advantage, driving their growth in market share.<sup>158</sup> Large banks have had to pay \$25 billion in fines as a result of mortgage-servicing misconduct,<sup>159</sup> further incentivizing banks to reduce their role in the servicing market.

Another factor is cost. In large part due to technological innovations – which will be discussed below – and also as a result of regulatory costs incurred by depository institutions, non-banks can service mortgages at significantly lower costs.<sup>160</sup> For large non-bank specialty servicers, the cost of servicing ranges from 17 basis points to 25 basis points, whereas for some large banks it is as high as 90 basis points.<sup>161</sup> Non-banks also do not have exposure to “legacy assets” – troubled mortgage obligations left over from before the crisis – which drive up costs.<sup>162</sup>

Yet there is reason to believe that the pendulum may be swinging. Regulators have begun to aggressively pursue non-bank mortgage servicers.<sup>163</sup> Also some non-banks have acquired MSRs too quickly, and Goldman Sachs research finds that in the servicing realm, non-banks' market share is projected to increase at a slower pace.<sup>164</sup> Also, it is not just regulatory forces driving banks to sell MSRs. Fannie Mae has actively facilitated this process. The Urban Institute reports that the GSE recently purchased 384,000 loans from Bank of America in order to distribute them to “specialty servicers.”<sup>165</sup> Yet the emergence of specialty servicers has primarily been market-driven, and reflects the technical expertise and innovation of many non-banks.

### **c) Innovation in the mortgage market**

Churn in the mortgage market has been extraordinary. We found that only 11 of the top 40 mortgage originators that existed in 2006 exist amongst the top 40 today, and of those 11, just two (Quicken Loans and PHH) are non-banks.<sup>166</sup> In 2014, the third largest originator was

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<sup>155</sup> See Plagge, *supra* note 88.

<sup>156</sup> Heather Perlberg & Dakin Campbell, “Citigroup Selling Servicing Rights as Banks Shrink Role,” *Bloomberg* (Oct. 25, 2013).

<sup>157</sup> See Plagge, *supra* note 88.

<sup>158</sup> Nash & Beardsley, *supra* note 3, at 53.

<sup>159</sup> *Ibid.*

<sup>160</sup> *Ibid.*, at 55.

<sup>161</sup> *Ibid.*

<sup>162</sup> *Ibid.*, at 56.

<sup>163</sup> See, for example, Ben Lane, “Ocwen’s bad day just got worse,” *Housing Wire* (May 20, 2014).

<sup>164</sup> Nash & Beardsley, *supra* note 3, at 54.

<sup>165</sup> See Lee, *supra* note 48, at 2.

<sup>166</sup> Inside Mortgage Finance data (ranks calculated in terms of dollar volume).

Quicken Loans,<sup>167</sup> which is a non-bank that lacks the traditional bank branching network where many mortgages are sold. Instead, Quicken sells mortgages online, undercutting the banks with its lower costs and a business model through which it is better suited to engage regulators; it represents one of many so-called “disrupters” in the industry.<sup>168</sup> In the origination market, behind Quicken come a number of non-banks.<sup>169</sup> One is PHH – the sixth largest originator in terms of dollar volume– whose CEO recently noted that the firm is “a technology company that originates mortgages” and that “technology allows [PHH] to keep productivity and efficiency high and keep costs down.”<sup>170</sup> In fact, technology drives all aspects of PHH’s business: from origination to processing to underwriting.<sup>171</sup>

How are non-banks so effective at using technology to improve their origination process? Many are taking a familiar incremental approach: using their digital tools to eliminate middlemen and automate the process in discrete and logical steps, integrating larger and larger segments. Heightened integration, greater efficiencies, lower costs, and improved ease of use for customers can and does bolster growth. These online and app-based service providers are following a path that tech companies have pursued for decades: rethink inefficient, paper-based systems with lots of intermediaries – appraisers, brokers, bankers, lawyers, each taking a fee – through digital means. They want to reach customers where they live: on desktops, tablets or smartphones; through video, text or chat; through extensive automation. And as opposed to depository institutions that must work to change existing mortgage origination and servicing processes, non-banks are oftentimes starting from scratch.

Notably, all three 2014 finalists of the 2014 Mortgage Technology Awards Online Originator Award were non-banks.<sup>172</sup> PennyMac was acclaimed for its phone call-matching service, which bolstered compliance.<sup>173</sup> United Wholesale Mortgage used technology to improve relationships between the firm and brokers.<sup>174</sup> And Waterstone Mortgage was applauded for rolling out a mobile app that provides direct access to origination systems.<sup>175</sup> Larry Summers, Harvard University economics professor and former U.S. Treasury Secretary, recently noted that “technology-based businesses have the opportunity to transform finance over the next generation.”<sup>176</sup>

Innovation has also driven non-banks’ growth in servicing. Quicken Loans is the 10th largest servicer,<sup>177</sup> and its CEO notes that technology has enabled it to be a leader in mortgage-

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<sup>167</sup> *Ibid.*

<sup>168</sup> See Nash & Beardsley, *supra* note 3, at 57-58.

<sup>169</sup> Inside Mortgage Finance data (PHH [6<sup>th</sup>]; Penny Mac [8<sup>th</sup>]; Freedom Mortgage Corp. [10<sup>th</sup>]). See also Figures 6, 7, 8 & 9.

<sup>170</sup> Inside Mortgage Finance data; BMC Software, *Customer Success Story: PHH Mortgage Services* (2009).

<sup>171</sup> *Ibid.*

<sup>172</sup> Mortgage Technology, “2014 Mortgage Technology Awards: Online Originator Award,” video, *National Mortgage News* (Dec. 29, 2014).

<sup>173</sup> *Ibid.*

<sup>174</sup> *Ibid.*

<sup>175</sup> *Ibid.*

<sup>176</sup> See Chris Matthews, “Larry Summers' full-throated endorsement of online lending,” *Fortune* (Apr. 15, 2015).

<sup>177</sup> Inside Mortgage Finance data.

servicing customer service.<sup>178</sup> Most notably, Quicken has leveraged technology to predict the risk of default and determine loss reduction strategies.<sup>179</sup> Technological innovation has also enabled other servicers – such as Walter Investment Management (ninth largest) and Nationstar (fifth largest) – to become more competitive by improving customer experience and channel efficiency; non-banks have lowered delinquency rates by leveraging technology to improve borrower education, streamline processes, and determine loan modification processes that effectively work.<sup>180</sup> State regulators note that non-banks’ “advanced servicing technology systems” can improve “loss mitigation alternatives to troubled borrowers.”<sup>181</sup>

Ocwen Financial, the fourth largest servicer,<sup>182</sup> has applied technology to service loans that other firms would not handle. Ocwen was able to grow its servicing market share through a “superior level of technology,” according to Morningstar.<sup>183</sup> It was able to perform rapid loan modification due to proprietary technology and has designed software that transformed how a servicer interacts with an at-risk borrower.<sup>184</sup> Ocwen was recently acclaimed for its servicing practices by a New York City housing organization regarding its willingness and ability to modify loan terms for delinquent borrowers so they would be able to keep their homes.<sup>185</sup>

Most critically, non-bank participants in the mortgage market are on the cusp of future, greater innovations that demand a careful regulatory hand. For example, SoFi is a venture-backed peer-to-peer lender marketplace aiming to disrupt a paperwork-heavy origination process by targeting young professionals not able to make a large down payment by taking into consideration employment history, school attended and projected income growth to offer individually tailored loan terms via mobile platforms.<sup>186</sup> Privlo lends to customers with unconventional credit profiles by leveraging analytics to predict future income streams and even probabilities of growth.<sup>187</sup> Even some familiar non-bank names have edged into the business: warehouse club Costco started marketing mortgages online in 2012 with a group of bank and

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<sup>178</sup> Quicken Loans, “Quicken Loans Earns Top Spot for Unprecedented 5th Consecutive Year in J.D. Power Study for Customer Satisfaction Among U.S. Mortgage Originators,” *Quicken Loans Press Room* (Nov. 13, 2014).

<sup>179</sup> Mortgage Technology, “2013 Top Tech-Savvy Lenders and Servicers List Revealed,” *National Mortgage News* (Aug. 22, 2013).

<sup>180</sup> See David Vita, in MortgageOrb, “LenderLive’s David Vida on the New World of Servicing” (Oct. 4, 2011); Marilyn Alva, “Banks to Specialty Mortgage Servicers: Take My Loans,” *Investor’s Business Daily* (Jan. 25, 2013); Nash & Beardsley, *supra* note 3; Lee, *supra* note 48. Ranks are calculated in terms of dollar volume. See Inside Mortgage Finance data.

<sup>181</sup> CSBS & AARMR Proposed Regulatory Standards for Non-Banks, *supra* note 92.

<sup>182</sup> Inside Mortgage Finance data (in terms of dollar volume).

<sup>183</sup> Morningstar, *Operational Risk Assessments News Bulletin: Ocwen Loan Servicing, LLC, Morningstar Assigns ‘MOR RSI’ Non-Prime and Special Servicer Rankings to Ocwen Loan Servicing, LLC* (2012).

<sup>184</sup> *Ibid.*

<sup>185</sup> Neighborhood Housing Services of New York City, Inc., Press Release, *Neighborhood Housing Services of New York City Teams Up with Ocwen Financial Corporation to Offer Aid to Struggling Homeowners* (Mar. 6, 2015).

<sup>186</sup> See Ben McLannahan, “SoFi hopes to shake up mortgages online,” *Financial Times* (Mar. 11, 2015); Kayla Tausche, “Would you bypass a bank for your next mortgage?” *CNBC* (Oct. 7, 2014); Colin Robertson, “Peer-to-Peer Lender SoFi Now Offering Mortgages to Smart People,” *The Truth About Mortgage* (Oct. 9, 2014).

<sup>187</sup> See Amina Elahi, “Privlo, ‘cool math’ and mortgage eligibility for founders, others,” *Blue Sky Originals, The Chicago Tribune* (Apr. 30, 2015).

non-bank lenders<sup>188</sup> and the U.S.'s largest retailer, Wal-Mart, has been considering mortgages.<sup>189</sup> Figure 12 below profiles innovation in mortgage origination and servicing.

**Figure 12**



Certainly, innovation brings about risks. Pre-crisis originators like Countrywide and Indy Mac were once viewed as innovators as well, as were the securitizers on Wall Street. Yet so far, in a post-crisis period rich in experimentation, non-banks are having a positive effect – they are bringing about market fragmentation and improved customer experience. More critically, the mortgage industry is particularly vulnerable to change. There has always been an asymmetry of knowledge between consumers and mortgage providers, and existing processes are notoriously complex, cumbersome, and opaque – from finding rates to filing documents to closing.

#### **d) Customer experience in the mortgage market**

Innovation by non-bank mortgage originators and servicers appears to likely be improving customer experience, just as it is bolstering market share. Quicken Loans, the third largest originator, has won the JD Power Award for excellence in mortgage origination for the past five years.<sup>190</sup> During the financial crisis, the Treasury Department found the three worst

<sup>188</sup> See Colin Robertson, “Costco Mortgage Review: What Don’t They Do?” *The Truth About Mortgage* (Apr. 26, 2012).

<sup>189</sup> See Beth McKenna, “Would You Apply for a Mortgage Loan from Walmart?” *GoBankingRates* (Jan. 23, 2013); Al Lewis, “Wal-Mart mortgages could fuel the next bubble,” *MarketWatch* (Dec. 5, 2012).

<sup>190</sup> Quicken Loans, *supra* note 178.

servicers to be depository institutions, not non-banks.<sup>191</sup> Urban Institute research recently noted, “It does not appear that non-bank specialty servicers perform worse as a group than bank servicers; in fact, they may actually provide better service to delinquent borrowers given the difficult loans they tend to service.”<sup>192</sup>

Our analysis of CFPB data mirrored the findings of the Urban Institute. In 2014, we found that there were about 38,700 servicing-related complaints.<sup>193</sup> Interestingly, one non-bank servicer – Ocwen – accounted for just 4 percent of 2014 market share in dollar volume but 15 percent of these complaints, and another – Nationstar – accounted for 10 percent of servicing-related complaints but just 4 percent of market share.<sup>194</sup> If you subtract Ocwen and Nationstar servicing-related complaints (5,724 and 3,756, respectively) and market share from total 2014 non-bank servicing-related complaints and market share, the customer service performance of non-banks and depository institutions appear to be roughly equivalent, as Figure 13 reveals.

**Figure 13**

<b>2014 Mortgage Servicing Market Share vs. Servicing-Related Complaint Share by Institution Type for 40 Largest Mortgage Servicers</b>			
	Institution Type (number of institutions)	% of Total 2014 Complaints	% of Total 2014 Servicing Obligations Outstanding
<b>Including Ocwen &amp; Nationstar</b>	Non-banks (16)	36.0%	20.5%
	Depository Institutions (24)	49.3%	52.3%
<b>Excluding Ocwen &amp; Nationstar</b>	Non-banks (14)	11.5%	12.6%
	Depository Institutions (24)	49.3%	52.3%
<b>Source:</b> Inside Mortgage Finance; CFPB, Consumer Complaint Database (accessed Mar. 2015); authors' calculations			
<b>Data note:</b> Servicing complaints defined as mortgage-related debt collection complaints, or as "loan servicing, payments, escrow account" or "loan modification, collection, foreclosure"-related mortgage product complaints			

Yet complaint data does not fully attest to non-banks' customer service performance. While it is certainly impressive that Quicken Loans was responsible just 0.2 percent of servicing-related complaints, yet held 1.6 percent of the servicing balances outstanding, and that PHH, the third largest non-bank servicer, was responsible for just 0.8 percent of complaints but 2.3 percent of the market,<sup>195</sup> the high number of complaints received by Ocwen and Nationstar are not

<sup>191</sup> U.S. Department of the Treasury, Making Home Affordable, Program Performance Report Through 2011 (cited in Eggert, *supra* note 50, at 182).

<sup>192</sup> Lee, *supra* note 48, at 11.

<sup>193</sup> CFPB, *Consumer Complaint Database* (accessed Mar. 2015). We define servicing-related complaints using the following CFPB Consumer Complaint Database classifications: mortgage-related debt collection complaints, "loan servicing, payments, escrow account"-related mortgage product complaints, and "loan modification, collection, foreclosure"-related mortgage product complaints. *See ibid.* We omit "credit decision / underwriting" and "settlement process and costs"-related complaints (933 and 1,535, respectively, in 2014) from our analysis of both servicing and origination complaints because of the difficulty in determining whether such complaints are related to servicing as opposed to origination. We define 2014 complaints as those received by the CFPB in 2014.

<sup>194</sup> Inside Mortgage Finance data; CFPB, *Consumer Complaint Database* (accessed Mar. 2015) (authors' calculations; ranks and percentages calculated in terms of dollar volume).

<sup>195</sup> *Ibid.*; Inside Mortgage Finance data (authors' calculations; ranks and percentages calculated in terms of dollar volume).



necessarily reflective of poor service. The two largest non-bank specialty servicers –Ocwen and Nationstar – service a disproportionate share of distressed loans when compared to banks.<sup>196</sup>

Also, in 2012 and 2013 Ocwen and Nationstar had the third and second lowest rates of foreclosure and modification complaints as a percentage of delinquent loans, respectively.<sup>197</sup> Thus the amount of complaints received by Ocwen and Nationstar are arguably impressively low. As mentioned, Ocwen has been acclaimed for its willingness and ability to favorably modify loans for delinquent borrowers,<sup>198</sup> and Christopher Whalen of Kroll Bond Rating Agency notes that there is also reason to believe that recent regulatory actions against Ocwen were in part motivated by political optics.<sup>199</sup> Furthermore, regulators are more than well-equipped to aggressively pursue firms they perceive to be bad actors – the CFPB and state regulators aggressively engaged Ocwen for a number of violations.<sup>200</sup>

Our analysis of CFPB data also appears to have revealed that larger non-bank originators also serve customers well. Figure 14 shows that for the top 40 mortgage originators, non-banks' share of mortgage origination-related customer complaints – 2,690 in total during 2014 – is significantly less than their share of the overall market.<sup>201</sup>

**Figure 14**

<b>2014 Mortgage Origination Market Share vs. Origination-Related Complaint Share by Institution Type for 40 Largest Mortgage Originators</b>		
<b>Institution Type (number of institutions)</b>	<b>% of Total 2014 Complaints</b>	<b>% of Total 2014 Origination Dollar Volume</b>
<b>Non-banks (20)</b>	<b>14.3%</b>	<b>26.2%</b>
<b>Depository Insitutions (20)</b>	<b>52.2%</b>	<b>43.6%</b>
<b>Source:</b> Inside Mortgage Finance; CFPB, Consumer Complaint Database (accessed Mar. 2015); authors' calculations		
<b>Data note:</b> Origination-related complaints defined as "application, originator, mortgage broker"-related mortgage product complaints		

However, it is worth noting that this analysis is much more limited in its validity than our analysis of servicing data – many 2014 origination-related complaints could be in regards to originations from prior years, and this skews complaints towards depository institutions, as non-banks played a comparatively much less significant role in mortgage originations in previous

<sup>196</sup> Lee, *supra* note 48, at 11.

<sup>197</sup> *Ibid.*, at 6 (citing Barker, Kevin, Isaac Boltansky & Steven Seperson, "Mortgage Finance: Are the Special Servicers Bad Actors?" *Compass Point Research & Trading Report* (Mar. 2014)).

<sup>198</sup> See *supra* note 185 and accompanying text.

<sup>199</sup> See Trey Garrison, "What the Ocwen agreement means for Ocwen and beyond: Q&A with KBRA's Christopher Whalen," *HousingWire* (Dec. 22, 2014).

<sup>200</sup> See CFPB, Press Release, *CFPB, State Authorities Order Ocwen to Provide \$2 Billion in Relief to Homeowners for Servicing Wrongs* (Dec. 19, 2013); Alan Zibel, "Ocwen's Regulatory Troubles: A Timeline," *The Wall Street Journal* (Dec. 22, 2014).

<sup>201</sup> We define origination-related complaints using the CFPB Consumer Complaint Database classification of "application, originator, mortgage broker" for mortgage product complaints. See CFPB, *Consumer Complaint Database* (accessed Mar. 2015). For market share data, see Inside Mortgage Finance data (authors' calculations; ranks and market share calculated in terms of dollar volume).



years. Also, overall, there are simply much fewer origination-related complaints. Finally, regarding our analyses of origination and servicing related complaints, it is possible that there are factors that heighten the propensity of depository institutions' customers to complain.

## **V. Policy Recommendations**

Policymakers are right to see the dramatic rise in non-banks' share of the mortgage-origination and servicing market as potential cause for concern. However, as our analysis in Sections III and IV reveals, macroeconomic and regulatory environments have changed drastically since the financial crisis. Consequently, regulatory objectives should not just be driven by fear of pre-crisis regulatory mishaps. Instead, regulators should take into account lessons learned, strive not to overreact, and focus on establishing a regulatory environment that appropriately balances innovation, systemic stability and consumer protection, while keeping the regulatory playing field even. Most critically, they should address sources of risk, not symptoms. These goals necessitate establishing a delicate balance between priorities. Below, we outline a general framework and highlight some solutions that regulators should adapt when addressing the opportunities and risks brought about by non-bank mortgage originators and servicers.

### **a) Realistically assess non-bank risk and solutions**

FHFA's regulatory mission – and its mission as conservator – is to protect Fannie Mae and Freddie Mac. And in its recent proposed standards for servicers and originators, adopted in late May 2015 by the GSEs, the FHFA responded to a clear policy problem: non-bank originators and servicers may pose a counterparty risk to the GSEs in a market downturn. FHFA's OIG correctly observed in early 2015 that “some of the new sellers, particularly non-bank mortgage companies, may lack the capacity to honor their representation and warranty commitments to the Enterprises.”<sup>202</sup> And as Henry Cisneros and Mel Martinez of the Bipartisan Policy Center recently noted, Fannie and Freddie themselves lack the “financial cushion” to protect themselves against future losses.<sup>203</sup>

However, risks concerning the liquidity and capital levels of non-banks are likely unaddressed by new standards. In assessing FHFA's proposed rule, Fitch stated that it “does not view the capital and liquidity requirements as materially reducing the risk of default for mortgage servicers under stress.”<sup>204</sup> Fitch also notes non-banks' business is “mostly monoline, cyclical, short-term wholesale funded, thinly profitable and subject to operational and regulatory risks.”<sup>205</sup> Yet valid concerns exist regarding the appropriateness and impacts on competitiveness of bank-like regulation for non-banks. Non-banks have no FDIC insurance or Fed access, and do not have the same access to short-term debt markets that large depository institutions utilize to capitalize on asset-liability mismatches.<sup>206</sup> Bill Cosgrove of the Mortgage Bankers Association

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<sup>202</sup> Office of the Inspector General, FHFA, *supra* note 104, at 32.

<sup>203</sup> Henry Cisneros & Mel Martinez, Bipartisan Policy Center, *Years After Crisis, Housing Finance System Still in Need of Reform* (Apr. 2015).

<sup>204</sup> Fitch, *FHFA's Proposed Capital Rules Not a Panacea* (Feb. 3, 2015).

<sup>205</sup> *Ibid.*

<sup>206</sup> Christopher Whalen & Marjan Riggi, Capital Requirements for Non-Bank Mortgage Companies, *Kroll Bond Rating Agency* (May 2014).

notes that non-banks largely access liquidity through warehouse lenders and repo financing.<sup>207</sup> He also explains that while non-banks dedicate all capital to the mortgage business and mostly finance through personal capital and lines of credit, depository institutions have varying demands for capital, and a wide array of assets.<sup>208</sup>

The risk non-banks pose as counterparties is further mitigated by the fact that they do not appear to hold mortgages on their balance sheet. As of 2014, the GSEs as well as GSE- and Agency-backed pools hold 61 percent of originated home mortgages, while banks and credit unions hold 28 percent.<sup>209</sup> Non-banks also generally hold significantly higher levels of tangible capital than depository institutions.<sup>210</sup> Certainly, the GSEs' recently implemented capital and liquidity standards will curb some of the counterparty risk associated with non-bank mortgage servicers, but in its proposal for heightened servicer and seller standards, the FHFA did not provide a clear justification for benefits associated with capital and liquidity requirements for non-banks.

More significantly, it appears that large non-banks are already in compliance with new standards.<sup>211</sup> Yet large non-banks have significantly riskier borrower profiles than small non-banks according to data from AEI's International Center on Housing Risk,<sup>212</sup> while some small non-banks will clearly have a more difficult time complying with these standards. Also, it will likely be difficult for some smaller players to enter the market. Pamela Lee of the Urban Institute notes, "regulators should consider the development of regulations that improve the safety and soundness of this channel, rather than those that eventually close it down."<sup>213</sup> Yet new standards will narrow origination channels. Thus the benefits of non-bank seller and servicer capital rules and minimum size requirements – while risk-mitigating for Fannie Mae and Freddie Mac – appear likely to also bring about some unintended consequences.

In short, it appears most clear is that these rules would likely not make a major difference in the event of a large-scale downturn. Also, FHFA's OIG recently noted, the "recent shift in direct mortgage sales by smaller and non-bank mortgage company lenders reduces [Fannie Mae's and Freddie Mac's] concentration risks."<sup>214</sup> So if new servicer and seller standards result in industry consolidation, they could actually increase risk. Policymakers must exhibit caution when encouraging bank-like regulation for non-banks, and appropriately assess the impacts on competition and consumer experience of such rules.

## **b) Implement reforms to mitigate counterparty and default risk**

While new seller and servicer standards may marginally improve safety and soundness, truly addressing the risks associated with riskier non-bank originations and the risk of non-banks

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<sup>207</sup> Bill Cosgrove, "The importance of nonbanks in the mortgage market," *HousingWire* (Apr. 29, 2015).

<sup>208</sup> *Ibid.*

<sup>209</sup> Board of Governors of the Federal Reserve System, *supra* note 1, at L.218.

<sup>210</sup> *Ibid.*

<sup>211</sup> Brena Swanson, "Nationstar, Walter ready for new FHFA nonbank requirements," *HousingWire* (Feb. 2, 2015).

<sup>212</sup> See Oliner et al, *supra* note 109.

<sup>213</sup> Lee, *supra* note 48, at 11.

<sup>214</sup> Office of the Inspector General, FHFA, *supra* note 104, at 32.

as counterparties entails reforming the GSEs and improving FHA insurance procedures. While politically difficult, doing so would not just address concerns regarding safety and soundness, but also enable non-banks to continue innovating and competing.

A full discussion of the trade-offs between systemic risk and homeownership associated with reforming the GSEs and FHA is outside this paper's scope. However, recent legislation<sup>215</sup> would have certainly been a step toward a more sustainable balance in which non-banks can innovate, and regulators can worry less that their failures will leave GSEs in a precarious financial position. More diversified risk channels in which there is a larger incentive for private risk monitoring would certainly mitigate the risk of individual originators and servicers.<sup>216</sup>

Of course, conforming mortgages originated by non-banks are largely going to credit-worthy borrowers, as Figures 6 and 7 and the accompanying text indicate. Instead, as we established, the risk profile of non-banks is largely being lowered by the high exposure of some non-banks to FHA-insured loans. Some non-banks may be taking advantage of FHA guarantees to proliferate loans that borrowers will not be able to repay.<sup>217</sup> And while many FHA loans are going to credit-worthy borrowers, that an increasing portion of FHA loans could be going to riskier borrowers for whom this debt may not be appropriate<sup>218</sup> is concerning. As discussed, low down payments – like those stemming from GSE and FHA policies – make it more likely that the borrower will default,<sup>219</sup> as do large and unpredictable income swings.<sup>220</sup> Worse, the geographic concentration of FHA-insured loans could likely intensify housing price declines in the event of a downturn,<sup>221</sup> thus potentially fostering even more counterparty risk not just to FHA, but also to the GSEs, which could in turn precipitate system-wide risk. Also, Edward Pinto of AEI has expressed concern that FHA pressure is driving a rebirth in subprime markets.<sup>222</sup>

In order to prevent government-insured loans from becoming excessively risky, policymakers should act now to ensure FHA pricing for insurance premiums better account for the true risk of default.<sup>223</sup> Right now, the insurance premiums associated with a high-risk loan do not differ from those of a low-risk loan – FHA insurance premiums do not reflect credit risk.<sup>224</sup> Importantly, because premiums do not reflect the propensity of a borrower to default to income

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<sup>215</sup> H.R. 2767, Protecting American Taxpayers and Homeowners Act of 2013; S.1217, Housing Finance Reform and Taxpayer Protection Act of 2014.

<sup>216</sup> For legislation that would more effectively achieve these desirable ends, *see ibid.* For an overview of how winding down Fannie Mae and Freddie Mac could mitigate systemic risk, *see White, supra* note 17.

<sup>217</sup> *See Guttentag, supra* note 145.

<sup>218</sup> *See ibid.*; Figures 8 & 9 and accompanying text.

<sup>219</sup> *See supra* note 98 & 146-149 and accompanying text.

<sup>220</sup> *See* Darryl E. Getter, "Contributing to the Delinquency of Borrowers," *The Journal of Consumer Affairs* (Summer 2003): 86-100.

<sup>221</sup> *See* Charles A. Capone, Jr. & Albert Metz, *Mortgage Default and Default Resolutions: Their Impact on Communities* (presented at the Federal Reserve Bank of Chicago, Conference on Sustainable Community Development, Washington, DC, March 27, 2003), at 3-4; Pinto, *supra* note 145, at 27.

<sup>222</sup> Edward Pinto, "Wells Fargo and subprime loans," *American Enterprise Institute* (Feb. 14, 2014).

<sup>223</sup> *See* Pinto, *supra* note 152, at 17-18 & 41; Calabria, *supra* note 57.

<sup>224</sup> *See* Jones, *supra* note 140, at 22.

shocks,<sup>225</sup> they do not assess for one of the most significant sources of default that could bring about the end of a non-bank originator or servicer – large and unpredicted household income swings.<sup>226</sup>

To ensure non-banks do not originate risky mortgages for which customers are not eligible, residual income should be incorporated into FHA decision-making as to whether to insure a mortgage, as it is for mortgages insured by the Department of Veterans Affairs (VA).<sup>227</sup> As scholars at the Urban Institute explain, this entails the FHA assessing “the borrower’s ability to pay for food, clothing, transportation, medical expenses, and other day-to-day living expenses after paying for the expenses related to the home.”<sup>228</sup> By “protect[ing] borrowers from entering into mortgage transactions that have a high likelihood of failure,”<sup>229</sup> a residual income test would likely reduce the propensity of some non-banks to lend to severely subprime borrowers. Edward Pinto of AEI has noted that ensuring FHA only insures loans with a projected termination claim rate of less than 10 percent would also mitigate risk, and facilitate the FHA making a “reasonable and good faith determination” that borrowers “have a reasonable ability to repay.”<sup>230</sup> Policymakers should also consider this reform option.

Additionally, as with VA-insured loans, which have significantly lower rates of default,<sup>231</sup> risk-sharing standards with issuers and borrowers should be implemented.<sup>232</sup> Another way to prevent unscrupulous FHA-insured mortgage lending would be to require originators to “take back” any FHA-insured loan that defaults within six months of origination, as Mark Calabria of the Cato Institute has suggested.<sup>233</sup> This would likely also reduce the risk position of some non-banks heavily engaged in FHA lending. Regardless, the status quo sets up an undesirable incentive system in which non-banks can issue mortgages that threaten to undermine mortgage market sustainability because insurance premiums fail to adequately price risk.

### **c) And avoid unintended consequences**

Regulators have adopted a patchwork quilt of regulations aimed at mitigating various manifestations of risk within the mortgage market. A streamlined, balanced, and predictable regulatory environment is essential to ensuring that non-banks capture market share as a result of consumer-friendliness, innovation, and cost-cutting – not regulatory arbitrage. Unsurprisingly, recent Goldman Sachs market research lists regulatory factors as a lead competitive advantage for non-bank mortgage originators and servicers.<sup>234</sup>

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<sup>225</sup> See Stuart Quinn, *FHA Premium Pricing: How Consumers are Winning*, CoreLogic (Jan. 30, 2015) (providing an overview of existing premium rules).

<sup>226</sup> See Getter, *supra* note 220.

<sup>227</sup> For a discussion of this proposal, see Goodman et al., *supra* note 58, at 10-11.

<sup>228</sup> *Ibid.*, at 3.

<sup>229</sup> *Ibid.*, at 11.

<sup>230</sup> See Edward Pinto, *supra* note 152, at 40 (citing Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (July 15, 2010), Section 1411). See also *supra* notes 74-75 and accompanying text.

<sup>231</sup> See Goodman et al., *supra* note 58.

<sup>232</sup> See Edward Pinto, *FHA Watch*, Vol. 2, No. 6 (Jun. 2013), 8.

<sup>233</sup> See Calabria, *supra* note 57, at 7.

<sup>234</sup> Nash & Beardsley, *supra* note 3, at 50.

Mitigating unintended consequences starts with rethinking capital rules, which as we documented above, are driving non-bank's surge in market share. The FHFA OIG recently found that capital rules are a factor in driving depository institutions to participate less actively in the mortgage-servicing market.<sup>235</sup> Academics, industry, and regulators all agree that Basel III capital requirements have driven depository institutions away from mortgage origination, servicing and securitization, and shifted it to non-depository institutions.<sup>236</sup> Thus policymakers should reconsider the efficacy of existing risk-weights. Yet improperly constructed risk-weights could bring about different and potentially more damaging regulatory arbitrage, which is why a robust analysis of the costs and benefits of capital rules and alternatives is so critical.<sup>237</sup>

Similarly, uncoordinated regulatory objectives – the status quo – heighten unintended consequences. For example, while Basel III discourages depository institutions from holding high levels of MSRs, New York regulators recently prevented the sale of MSRs held by Wells Fargo to Ocwen.<sup>238</sup> Similar regulatory confusion prompted one commentator to recently note, "[a]t a point when you don't know what exactly your regulator is going to do, it raises more concern when the regulator appears to take a very aggressive stance – all but threatening enforcement actions and fines and penalties" – as a result, banks exit the market.<sup>239</sup> Unpredictable regulatory changes across the states and between federal and state regulators have certainly led to unnecessary regulatory costs,<sup>240</sup> while advantaging the smaller non-banks that FHFA fears are unsuitable counterparties.<sup>241</sup>

Put-back rules are also resulting in unintended consequences. Existing rules – while well intended to ensure originators do not lend to un-creditworthy borrowers – may be discouraging origination without mitigating risk.<sup>242</sup> As Pamela Patenaude, formerly of the Bipartisan Policy Center, notes, "Most underwriting errors will be detected soon after origination," and thus the "current three-year put-back window is too long and should be reduced."<sup>243</sup> Similarly, CFPB's QM rule has disrupted mortgage origination in unintended ways, and may be contributing to the non-bank surge.<sup>244</sup>

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<sup>235</sup> FHFA, *supra* note 9, at 16.

<sup>236</sup> See, for example, Tobias Adrian & Adam B. Ashcraft, "Shadow Banking Regulation," *Annual Review of Financial Economics* 4 (2012): 99-140; New York State Department of Financial Services, *Excerpts From Superintendent Lawsky's Remarks on Non-Bank Mortgage Servicing in New York City* (Feb. 12, 2014); Nash & Beardsley, *supra* note 3, at 54; Plagge, *supra* note 88.

<sup>237</sup> See Krishnamurthy, *supra* note 37.

<sup>238</sup> See Plagge, *supra* note 88.

<sup>239</sup> Victoria Finkle, "Are Regulators Driving Banks Out of Mortgage Servicing?" *Mortgage Servicing News* (Mar. 3, 2014).

<sup>240</sup> Neal Doherty & Maria Moskver, "The Consequences of the Cost of Compliance," *Legal League Quarterly* (Q2 2014).

<sup>241</sup> Office of the Inspector General, FHFA, *supra* note 104, at 3.

<sup>242</sup> See Pamela Patenaude, "Here's a solid 3-point plan for put-back reform," *HousingWire* (May 8, 2014).

<sup>243</sup> *Ibid.*

<sup>244</sup> See National Association of Realtors, *supra* note 113; Calabria, *supra* note 80; Faith Schwartz, *Loan servicing: The Rise of the Non-Bank Servicer* (Insights Blog, CoreLogic, Mar. 2015); *supra* notes 108-112 and accompanying text.

To reduce regulatory arbitrage, reduce unintended consequences, and improve regulatory coordination, bipartisan legislation to bring about robust cost-benefit analysis and the non-binding review of federal financial rulemakings by the Office of Information and Regulatory Affairs (OIRA) – policies that we have endorsed for similar reasons in previous research – should be passed.<sup>245</sup> OIRA review would be particularly helpful in the context of improving the coordination of non-bank mortgage originator and servicer regulation at the state and federal levels; former OIRA administrator and Harvard Law School professor Cass Sunstein notes that OIRA review of executive agency regulations fosters the participation of state governments in the federal rulemaking process.<sup>246</sup>

Critically, this legislation – entailing OIRA review and heightened cost-benefit analysis – would mitigate unintended consequences – such as those brought about by capital rules and put-back rules – by enabling federal financial regulators to better understand costs or benefits of their proposed regulatory actions.<sup>247</sup> FHFA’s proposed standards for non-banks were accompanied by inadequate explanation and justification for costs or benefits, or policy alternatives. Similarly, as University of California at Berkeley Professor Prasad Krishnamurthy notes, the trade-offs between homeownership and system-wide stability brought about by capital rule risk-weights would be made more apparent and be better considered through cost-benefit analysis,<sup>248</sup> which OIRA engages in. OIRA review would mitigate agency “tunnel vision”<sup>249</sup> – FHFA would be better equipped to weigh the costs to innovation and mortgage access that their proposals bring about, and banking regulators would better understand the implications to Fannie Mae and Freddie Mac caused by creating a competitive advantage for non-banks via capital rules.

## VI. Conclusion

Non-bank mortgage originators and servicers play a critical role in U.S. mortgage markets. Policymakers are right to be concerned about growing risk in U.S. mortgage origination and servicing markets, and to pay close scrutiny to the increased market share of non-bank mortgage originators and servicers. However, as our research suggests, the market-wide trends of and system-wide risks posed by today’s non-banks are different than those of pre-crisis subprime-originating non-banks. The increase in non-bank market share is more attributable to both the reduced presence of depository institutions in origination and servicing spheres and to an increase in non-bank origination and servicing volume. Regulatory arbitrage and differing cost structures, as well as innovation, are key factors in this trend. Some non-banks appear to be engaging borrowers of troublingly low creditworthiness as a result of FHA policies, driving an increase in their risk profile relative to depository institutions.

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<sup>245</sup> Marshall Lux & Robert Greene, *The State and Fate of Community Banking* (Harvard Kennedy School, M-RCBG Associate Working Paper Series, No. 37, Feb. 2015).

<sup>246</sup> Cass Sunstein, *The Office of Information and Regulatory Affairs: Myths and Realities* (Harvard Public Law Working Paper No. 13-07, 2012), 21 & 33-34.

<sup>247</sup> See Lux & Greene, *supra* note 245, at 27-28 for a discussion of these benefits.

<sup>248</sup> Krishnamurthy, *supra* note 37.

<sup>249</sup> For a discussion of agency “tunnel vision,” see Omri Ben-Shahar & Carl E. Schneider, *The Futility of Cost Benefit Analysis in Financial Disclosure Regulation* (Coase-Sandor Inst. for L. & Econ. Working Paper No. 680, 2014), at 15-16.

Certainly non-banks, just like depository institutions that originate or service mortgages, pose a counterparty risk to the GSEs. However, bank-like standards for non-banks, when the riskiest non-banks appear to be the largest and best capitalized, will only marginally mitigate this risk. Truly improving both the vitality and stability of the U.S. mortgage market necessitates the more politically difficult task of reforming risk channels – that means reforming the GSEs and, more important in the context of non-banks, reforming FHA insurance guidelines, which appear to be enabling some non-banks to engage in lending to subprime borrowers while the government bears the risk. Regulatory coordination is also critical to mitigating unintended competitive advantages to non-banks brought about by the existing regulatory environment, such as capital rules creating a competitive advantage for non-banks. OIRA review and cost-benefit analysis of federal financial rulemakings could help ensure that the sometimes-conflicting objectives of FHFA, CFPB, banking regulators, and state regulators are better balanced in such a way that does not bring about regulatory arbitrage or unintended outcomes.

**Note:** On June 8, 2015, this working paper was updated to include a slightly edited Section II, part a), in response to helpful feedback we received regarding the early history of the FHA and the GSEs. Also, two edits were made within the accompanying text of footnotes 209 and 222.