Shadow Bank Distress and Household Debt Relief: Evidence from [the] CARES Act

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Summary

- Background: The CARES Act allowed all GSE/FHA/VA mortgages forbearance starting 2020q2.
- Causal question: Were shadow banks less likely to offer mortgage forbearance than banks? If so, why?
- Strategy: Use GSE loan-level data and shadow debt call report data to ask whether shadow banks with weaker balance sheets less likely to forbear.

- Findings: Yup, mortgages serviced by shadow banks were less likely to be in forbearance in 2020q2-3. Esp. true for shadow banks w/ lower equity ratios.

Two very policy-relevant motivations

1. What kept Covid relief packages from being more effective?

   - Worry that aid was significantly undistributed because of bureaucracy
   - Similar set of ?s valuable to ask after every rescue package.
     e.g., was HAMP effective? why not? servicers! (Agarwal et al., 2017)
   - CARES Act allowed postponing payments on gov’t mortgages until Sep 2021
   - What sand was in the gears of mortgage forbearance?
     See Zhao et al. 2020, Kim et al. 2021, An et al. 2021, Cherry et al. 2021

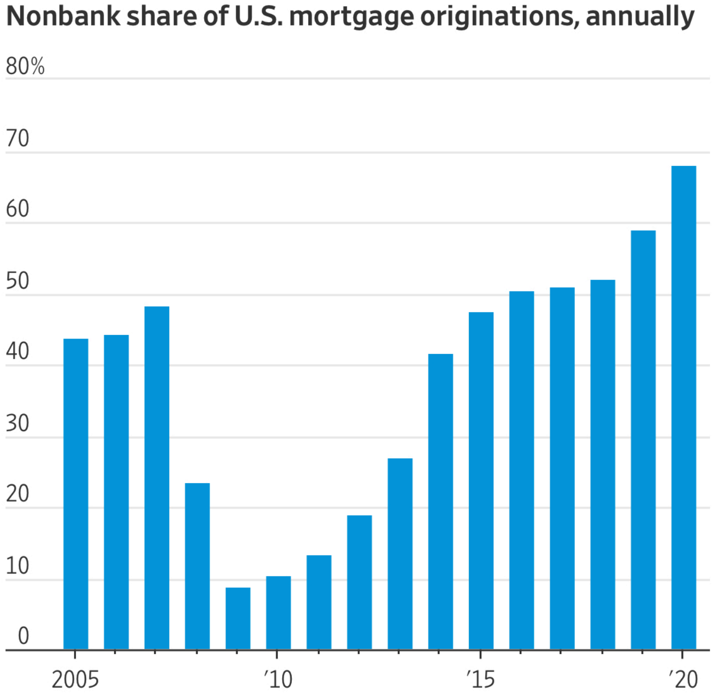
   - <u>This paper</u>: payment advances put strain on servicer finances, particularly worrisome for lightly regulated non-bank servicers

Two very policy-relevant motivations

2. So non-banks originate most mortgages today. Who cares?

- When non-banks crossed 50%, lots of headlines, but what's the big deal? 2/3 of mortgages today.
- Kim et al. (2018): If my servicer goes under, nbd unless a) I need a modification and b) servicers are *all* in distress. Systemic, unregulated risk for stress scenarios. Need for costly bailouts.

- <u>This paper</u>: evidence that non-banks finances makes them have a harder time dealing with mortgage market distress



Source: Inside Mortgage Finance

Laudable data lift

- Shadow banks don’t report to FFIEC/NCUA
  + most are private companies
  ⇒ call reports + financials not public
- FOIA Shadow Bank call reports from *state* regulators (Jiang, 2019)
- Similar data used by Kim et al. (2021): any firm with NMLS ID
- Combine with GSE and Ginnie Mae loan performance data including identities of large servicers and forbearance flags

Identification worries *support* findings

- How do we know whose fault bank vs. non-bank forbearance rates are?
- After all, can’t see borrowers’ distress and demand for forbearance.
- And non-banks service riskier mortgages (**2-3 years** younger)
- More recent mortgage cohorts more sensitive to stress (Palmer, 2015)

- But if anything, predicts **higher** missed payments + forbearance demand
  - For example, non-bank forbearance rate for GSE (FHA) was 5.5% (8.5%)
- Instead find the opposite during 2020q2-3: lower forbearance

Useful to see longer pre-trends

THE WALL STREET JOURNAL.

MARKETS

Retreat of Smaller Lenders Adds to Pressure on Housing

- "Some lenders are selling their mortgage-servicing rights to raise money, though that means giving up a steady income stream."
- The problem?

By Christina Rexrode Follow

Updated Nov. 22, 2018 5:44 pm ET

→... would be useful to see years of pre-trends instead of 3 months

More details on forbearance patterns?

1. By October 2020, non-banks' forbearance rate is *higher* than banks
    - Mortgagor stress is ongoing, but: a) other policy supports coming online, b) refinances booming, c) debt markets open.
        - Which of these matter the most?
    - And why higher? Now because of differing loan composition?
        - Does controlling for loan age or (loan age)*post explain pattern?

1. For banks, it seems that higher equity to assets predicts *lower* forbearance rates. Why? Is there a better measure of bank servicers' financial capacity?

3. How important is non-bank reliance on short-term debt? It's very high… Is there cross-sectional variation in short-term debt/assets for non-banks?

Policy question: how much equity is enough?

- Table 2 suggests that average shadow bank with average equity ratio had *higher* forbearance than banks.
- Problems isolated to minority of shadow banks with very low equity ratios?
- Useful to quantify what equity ratio would have been needed for non-banks to have had the same forbearance provision as banks in 2020q2.

Worthwhile adjacent question on FHLB

- FHLB “stepped up to keep liquidity in the market.” (footnote 5)
- Details on this seem juicy.
- Dayin Zhang (JMP 2020) shows FHLB credit can have big effects on primary mortgage market.
- What liquidity did FLHB banks inject? Causal evidence this made a difference?
  - Dayin’s JMP identifies cross-sectional variation in FHLB access…
- Any evidence of moral hazard because of reliance on FHLB support?

Conclusion

- It was a striking fact when lightly regulated non-banks started originating more mortgages than banks. Does this seemingly unrelated fact interact with CARES Act effectiveness?
- Yes, shadow banks forbear less during 2020q2, especially if lower equity ratios.
- Many interesting forbearance patterns to explore: other time periods, banks, figure out best balance sheet characteristic to target.