Forbearance and the Mortgage Market: What Investors Need to Know

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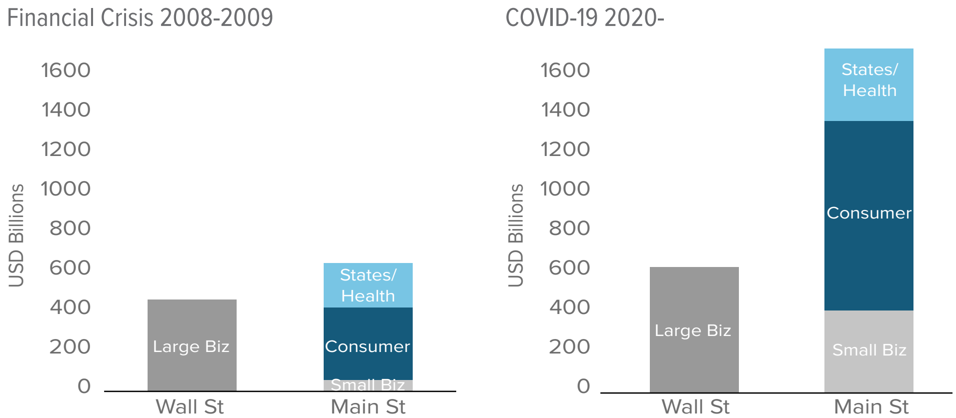
As U.S. businesses temporarily close in response to the COVID-19 pandemic, government agencies have implemented numerous measures to support consumers who have lost their source of income. To date, the scope and scale of the government's response has been enormous and in the mortgage market, forbearance is one of the government's key tools to help consumers through this extremely difficult time.

The U.S. government's response to COVID-19 has been heavily skewed towards consumers



Source: CARES Act, Los Angeles Times, and Voya Investment Management. Financial Crisis Categories: Large Biz as defined by Federal Government commitments under the Troubled Asset Relief Program (TARP), Small Biz as defined by small business loans, Consumer as defined by relief for families, States/Health as defined by Healthcare payments, Education and Infrastructure. Covid-19 Fiscal Categories: Large Biz as defined by Corporate Loans + Airline & Cargo Loans/Grants, Small Biz as defined by small business loans, Consumer as defined by household payments, Unemployment Insurance and Tax deferrals and deadline extensions, States/Health includes aid to states, Hospitals & Veterans Care.
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What is Forbearance?

While the scale of the government's response to this crisis is unprecedented, forbearance is not a new concept and is arguably mainstream given our country's unfortunate recent run of natural disasters. When mortgage borrowers are unable to make their required loan payment, lenders will sometimes arrange a special agreement designed to help avoid a foreclosure—this special agreement is referred to as forbearance. Forbearance is typically granted when a borrower's inability to repay their loan is deemed temporary. As alluded to above, government agencies have used forbearance as a tool to help consumers and communities recover from natural disasters like hurricanes, fires and earthquakes.

How Does the Current Forbearance Plan Work?

The COVID-19 forbearance guidance that was previously announced by HUD and the FHFA was codified in the CARES Act. Current plans allow for an initial six-month forbearance period, which means borrowers will be able to delay or reduce their mortgage payment for six months. Guidance in the CARES act also stipulates the potential to extend forbearance for an additional six months, totaling relief of up to one year.

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After the forbearance period, borrowers need to resume making full mortgage payments, and get current on the payments they missed or reduced during the forbearance period. While terms vary across loans, borrowers usually have the option to pay the amount in a lump sum, add an extra amount to their regular monthly payments until the entire forborne amount is repaid, or complete a loan modification in which the lender adds the unpaid amounts to the balance of the loan.

Forbearance has the positive impact of keeping potential borrower defaults lower than would be the case if servicers had to force a borrower down the traditional prescribed path. Well worn in the aftermath of the credit crisis, the progression pushing borrowers through mounting delinquencies to foreclosure, Real Estate Owned (so called REOs) to the ultimate sale of the foreclosed property is a painstaking process that leaves few winners.

Why is This Time Different?

From an implementation perspective, for this version of the forbearance program, **there is no paperwork required**. Only verbal contact and attestation of the borrower's COVID-induced hardship is necessary—greasing the skids, so to speak, for these borrowers.

The length of the forbearance period (i.e. initially 6 months with the potential for 1 year) is also notable, as borrowers should have ample time to recover as businesses reopen and incomes normalize (forbearance periods during recent hurricanes were understandably shorter). Given the unknown duration of the current economic shutdown, this potentially longer period afforded to borrowers, while appropriate, does increase the potential scale of the relief with time.

Furthermore, following the forbearance period, options for the borrower to repay forborne amounts are greater. The sequentially prescribed path starts with a full and immediate repayment of these amounts (however difficult it may sound) in addition to intuitive monthly repayment plans, but also includes a new "Payment Deferral" option for GSE borrowers (underlying source of repayment referenced for credit risk transfer or "CRT" deals). This interesting new option is for borrowers who miss up to 2 payments, and allows them to defer these owed amounts in a non-interest bearing manner to the end payment due date of the loan. This new "Payment Deferral" feature is least burdensome for the borrower and lines up with a relatively short disruption period that everyone is cheering for.

But perhaps the most striking difference is the sheer number of potential loans that may go into forbearance. Natural disasters are local events. Some natural disasters, like hurricanes, affect large regions but pale in comparison to the broad-based disruption that the COVID-19 pandemic is causing across the entire country. We have all seen the charts showing the dramatic spike in unemployment claims. More than 20 million people have lost their jobs and while not all are mortgage holders, there is no denying that the impact to the mortgage market will be significant.

While the government's response has been appropriately swift and sized to date, there are justifiable concerns about how the mortgage market will absorb the potential increase in forbearance claims. 100% of loans in the agency mortgage market will be eligible for the COVID-19 forbearance plan and, while not explicitly covered in the federal forbearance guidance, non-agency servicers generally follow the lead of their agency counterparts, meaning most, if not all, of the non-agency mortgage market is in play as well. With all that said, what have we seen so far in terms of "take-up" of forbearance? The latest Mortgage Bankers Association's Forbearance and Call Volume Survey covered 38.3 million loans (~77% of the first mortgage servicing market) and showed the number of loans in forbearance grew from 0.25% on March 2 to 5.95% through April 12.

Do the Service Providers Have Enough Liquidity to Pay Investors during the Forbearance Period?

Mortgage servicers are responsible for advancing payments to investors during the forbearance period and are obligated by law to advance interest payments as long as the loan is "recoverable".

> "Forbearance will not cause interest payments to stop among RMBS as mortgage servicers are legally on the hook to deliver these payments."

Note: a loan is deemed "recoverable" by evaluating a number of factors, including how much equity the borrower has in the home. Heading into this market shock, borrower equity rose to an all-time high in the first half of 2019 and has more than doubled since the housing recovery started (Source: CoreLogic). This backdrop means it is likely that more loans in the mortgage universe will be deemed "recoverable". Accordingly, forbearance will not cause interest payments to stop, as we expect the majority of loans will be deemed recoverable and mortgage servicers are legally on the hook to deliver interest payments. The next questions is: As the amount of loans in forbearance swells, will the servicers have enough capital to make good on that legal obligation?

As we have already witnessed, past due amounts will rise as borrowers utilize the forbearance program. As this happens, servicers will be required to advance delinquent payments across the RMBS universe, and do so in increasingly material amounts.

As a rough estimate, forbearance requests of ~5% require advance amounts totaling close to $2 billion of scheduled principal and interest to MBS each month across the mortgage landscape. While this will be manageable for better-capitalized servicers (i.e. banks), almost half of the post 2008 crisis mortgage market is now made up of non-bank servicers such as Mr. Cooper and Cenlar.

"The Fed and the Treasury have demonstrated that they are willing do 'whatever it takes' to restore order to the capital markets and we have no reason to believe their approach to providing liquidity to non-bank mortgage servicers will be any different."

The government is aware of the potential strain on servicers and have already addressed this issue for Ginnie Mae through the adjustment of its Pass Through Assistance Program (PTAP). FHFA Director, Mark Calabria, has acknowledged the concern but has thus far indicated Fannie and Freddie do not need a liquidity facility, highlighting the FHFA contingency plan to transfer servicing rights to those servicers on stronger capital footing.

Though Calabria has deemphasized the need for government help, the government stands at the ready to step in and provide assistance to support the market. Treasury Secretary Steve Mnuchin has been looking for ways to address the strain as evidenced by the task force he assembled to explore options. So far, the Fed and the Treasury have demonstrated that they are willing do "whatever it takes" to restore order to the capital markets and we expect them to deliver on their promises and avoid disrupting a core part of the American dream.

In What Other Ways Does Forbearance Affect Mortgage-Backed Securities?

When held to maturity, holders of non-agency mortgage-backed bonds typically face two major risks:

1. **Prepayment risk:** Will I receive my principal and interest payments on time?
2. **Credit risk:** Will I fully recoup my investment, i.e. the initial amount of my security and interest payments promised?

Overall, from a long-term perspective, the forbearance program is a positive for non-agency mortgage-backed securities and CRT because it helps borrowers avoid defaults, which in turn helps lower the risk of investors not recouping their initial principal investment. In the short term however, forbearance can have negative implications for MBS repayment timeframes. Delinquency triggers within MBS structures will potentially get hit, which would cause cashflows to be re-directed within a securitized bond's capital structure. This is designed to protect senior debt holders until forborne amounts are repaid or structures de-leverage allowing triggers to come back into compliance.

However, the recently announced Payment Deferral Plan (alluded to earlier and likely to be offered to GSE borrowers), as we interpret it, should help avoid these delinquency triggers. Under the Payment Deferral Plan, impacted borrowers will be able to be returned to current more quickly, by rolling past due principal amounts into the balance of the mortgage loan. The plan is intended to cover the truly short-term expected impacts, so, at this stage is only being offered to borrowers from July to December of this year.

Also recall that the risk of principal loss only applies to non-agency MBS and credit risk transfer (CRT) securities. In agency mortgage-backed securities (securities issued by government-sponsored enterprises Ginnie Mae, Freddie Mac or Fannie Mae), the U.S. government has removed the risk associated with line item number 2, i.e. the question of whether or not an investor will recoup their principal investment. Agency mortgage-backed securities have the assurance that investors' principal return is backed by the full faith and credit of the U.S. government. For investors in agency mortgage-backed securities, it is not a question of if they receive payments but WHEN – including repayment of all principal and interest.

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