Update: Forbearance and the Mortgage Market

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Recap

In April, we published an update designed to help securitized investors navigate the wave of forbearance in the mortgage market.

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. The COVID-19 forbearance guidance that was previously announced by HUD and the FHFA was codified in the CARES Act.

Since the time of our initial blog, the amount of loans in forbearance has grown—unsurprising given labor market conditions. The Mortgage Bankers Association's latest Forbearance and Call Volume Survey showed mortgage loans in forbearance increased to 8.36% as of May 17, up from 5.95% as of April 12. So far, new delinquencies have not translated one for one from forbearance. We are seeing measurable portions of borrowers who have requested forbearance continue to make payments. However, we remain in an early stage, so we are not advising interpreting this as an all clear sign that delinquencies in non-agency RMBS transactions are to be less than expected.

In addition to the growing amount of loans in forbearance, there have been several updates as it relates to the specifics of forbearance and the broader mortgage market in general. Below, we summarize what has changed since we published our last blog.

What's Changed?

Prepayment Speeds Could Accelerate

One drawback to forbearance is that borrowers in forbearance are not able to refinance at rates that are hovering near all-time lows and, until recently, could not for some time after taking forbearance. As part of the recent announcement from the FHFA, borrowers are eligible to refinance or buy a new home three months after their forbearance ends as long as they have made three consecutive payments since utilizing forbearance. As a result, this should make it easier for borrowers who have used forbearance to refinance. This could lead to an acceleration in prepayments towards the end of this year and into next year as more borrowers who were unable to refinance look to refinance.

While the acceleration of prepayments introduces a potential risk to parts of the agency mortgage-backed securities market, this development is generally positive for securitized credit markets. Prepayments are used to pay down tranches in these securitizations, de-leveraging them and leaving remaining investors in a shorter, more credit worthy position. This dynamic tends to influence favorable rating agency actions and, ultimately, tighter credit spreads. In some cases, often in Credit Risk Transfer (CRT), these paydowns from prepayments are shared directly in repayment of tranches that are priced at a discount to par. These paydown returns also contribute positively to the bond's total return profile.

FHFA Announces Payment Deferral as New Repayment Option

Over the short-term, one concern related to forbearance was its potential to disrupt repayment timeframes for mortgage-backed securities (MBS). The concern was that when loans entered forbearance, delinquency triggers within MBS structures could potentially get hit, which would cause cashflows to be re-directed within a securitized bond's capital structure.

In our initial blog we alluded to the Payment Deferral Plan option as a potential remedy for the concerns related to forbearance requests impacting delinquency triggers. However, at the time of our initial blog post, the Payment Deferral Plan was more limited in its scope, only applying to borrowers who took forbearance for up to 2 months. On May 13, Fannie Mae and Freddie Mac broadened the eligibility criteria to allow this Deferral Plan to be utilized for borrowers who took forbearance for up to 12 months, the current maximum amount afforded to them. As it stands now, the Payment Deferral Plan allows borrows who enter forbearance the ability to repay their missed payments at the time the home is sold, refinanced, or at the maturity of the loan. Under this approach, forborne loans will avoid the delinquency triggers within MBS structures, the most painless option for borrowers and one that will likely mitigate at least some portion of default risk.

Overall, this is a positive development for the CRT market (GSE borrowers are the underlying source of repayment referenced for CRT deals).

The Government Continues to Do "Whatever it Takes" to Support Markets

In our initial post, we also highlighted that the Fed and the Treasury have demonstrated that they are willing do "whatever it takes" to restore order to the capital markets and we had no reason to believe their approach to the mortgage market would be any different.

This belief was reinforced after the FHFA extended the previously announced ability for GSEs to purchase single-family mortgages in forbearance. The GSEs are now able to buy forborne loans, with note dates on or before June 30, 2020, as long as they are delivered to the (GSEs) Enterprises by August 31, 2020 and where only one mortgage payment has been missed. The previous policy was set to expire on May 31, 2020. This extension will continue to provide liquidity to mortgage markets and allow originators to keep lending, which of course, is another positive development for securitized markets.

Overall, recent developments are positive for securitized markets. As new developments emerge, we will continue to provide updates to share our perspective.

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