Loss Mitigation Toolkit Improvements for Borrowers Exiting COVID-19 Forbearance

Karan Kaul, Laurie Goodman, and Michael Neal

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Nearly a year and a half since the start of the pandemic, the US economy is on the mend. The vaccine rollout is progressing, allowing businesses to reopen and rehire workers who lost their jobs last year. Consequently, many borrowers are exiting their COVID-19 forbearance plans, which have proven to be an effective addition to the loss mitigation toolkit. Seventy to 80 percent of exiting borrowers are opting for payment deferrals (where missed payments are added to the end of the loan), and the rest are exiting forbearances with a need for loan modifications. This necessitates a closer look at the loss mitigation toolkit to maximize the number of loans that can be cured.

In this brief, we identify a few improvements to the loss mitigation toolkit that have received little focus. These improvements aim (1) to maximize the number of delinquencies that can be cured by offering more sustainable payments and (2) to move forward with property disposition most efficiently when all home retention options have been exhausted.

The rationale for these improvements is straightforward. Even as the economy improves, it will look different from the prepandemic world. Some borrowers will not get their old jobs back, and others will experience permanent pay reductions, thus requiring a deeper mortgage payment reduction than is possible today. In addition, many improvements made to the toolkit post-2009 were tailored for negative-equity situations. Most borrowers in need of assistance today have positive equity, a key distinction from the last crisis. This requires the toolkit to be tweaked to achieve better outcomes.

A More Flexible FHA Partial Claim Program

The Federal Housing Administration (FHA) COVID-19 Standalone Partial Claim, for borrowers who can resume their pre-COVID-19 payments, uses a second lien/partial claim to move arrearages (i.e., forborne principal, interest, taxes, and insurance payments, or PITI) to the end of the life of the loan. For borrowers who cannot afford their pre-COVID-19 payments, the FHA offers modification options. These include an owner-occupant loan modification, which can be offered with or without a second lien/partial claim. When combined with the second lien/partial claim, the forborne PITI is payable at the end of the life of loan. Without the second lien, the forborne amount is capitalized into the loan balance. That loan balance, with or without the arrearages included, is then modified. The interest rate is reduced to the market rate (no greater than the Primary Mortgage Market Survey rate plus 25 basis points), and the term is extended to 30 years to achieve payment reduction.

If the borrower still cannot afford the resulting payment, the FHA offers a Home Affordable Modification Program (HAMP) modification with a second lien/partial claim, which provides deeper payment relief with some documentation of income. Under the FHA HAMP modification, the target is a PITI payment of 31 percent of borrower income, with at least a 20 percent reduction in the monthly payment. FHA HAMP can use a partial claim up to 30 percent of the unpaid principal balance. The first step is to forbear the unpaid principal balance by up to the full 30 percent partial claim limit and re-amortize the remaining balance over 30 years at the market interest rate (no greater than the Primary Mortgage Market Survey rate plus 25 basis points). The forborne principal is put into a non-interest-bearing second lien that is due at loan payoff. The borrower receives a lower monthly payment that is more sustainable.

To further improve assistance options for borrowers, on June 25, the FHA published Mortgagee Letter 2021-15,[1] which outlines a requirement to review all eligible borrowers for a new COVID-19 Advance Loan Modification (ALM) upon exit from forbearance. The ALM must achieve a minimum 25 percent payment reduction by capitalizing arrearages, reducing the rate to the Primary Mortgage Market Survey rate, and extending the term to 30 years. The servicer does not need to contact the borrower before reviewing for COVID-19 ALM or sending out the modification documents.[2]

The FHA's second lien/partial claim program has been in place for years, but the US Department of Veterans Affairs recently issued a final rule that would allow the agency to provide a second lien/partial claim to veterans exiting forbearance.[3] This option was not available before, which left only traditional loan modifications available to provide payment relief to veterans.

The change we propose below (table 1) would front-load the benefit of a second lien/partial claim to provide a deeper temporary payment reduction than is possible today, even under FHA HAMP. A portion of the partial claim amount would be used to reduce the monthly payment, dollar for dollar; the payment would increase after a few years when the borrower has regained their financial footing.

TABLE 1

Illustrative Example Showing Current and Proposed Borrower Solutions

Description	Amount
Borrower situation	
Original principal balance	$300,000
Original principal and interest payment (at 3.5 percent interest rate)	$1,347
Monthly taxes and insurance	$450
Original principal, interest, taxes, and insurance	$1,797
Unpaid principal balance at time of first default	$290,000
Number of months of missed payments	14
Total arrearage amount	$25,160
Current partial claim with loan modification	
Partial claim funds (8.7 percent) applied to arrearages	$25,160
Interest-bearing unpaid principal balance	$290,000
New principal, interest, taxes, and insurance (at 3.25 percent interest rate, 30-year extension)	$1,712
Payment reduction	-4.7%
Proposed partial claim with loan modification	
Partial claim funds available (8.7 percent)	$25,160
Partial claim funds used to cover arrearages	$15,000
Remaining arrearages capitalized into loan balance	$10,160
New interest-bearing unpaid principal balance ($290,000 plus $10,160)	$300,160
New principal, interest, taxes, and insurance (at 3.25 percent interest rate)	$1,756
Total partial claim amount available to offset principal, interest, taxes, and insurance in years 1 to 5	$10,160
Monthly payment offset ($10,161 / 60)	$169
New principal and interest in years 1 to 5 (after partial claim offset)	$1,587
Payment reduction	-11.7%
Principal, interest, taxes, and insurance after year 5	$1,756

Source: Urban Institute calculations.

Consider a borrower with an original loan balance of $300,000. At a 3.5 percent original interest rate on a 30-year mortgage, the original monthly principal and interest payment would be $1,347. An assumed $450 per month in taxes and insurance escrows yields an original (i.e., pre-COVID-19) PITI payment of $1,797. Assume this borrower took forbearance for 14 months and had an outstanding unpaid principal balance of $290,000 at the start of forbearance. With $25,160 in total arrearages, this borrower would need 8.7 percent in partial claim assistance to cover arrearages, which would be put in a second lien. Under a combination of a partial claim with an FHA loan modification, at a 3.25 percent modified interest rate and interest-bearing unpaid principal balance of $290,000, the new PITI would be $1,712, a mere 4.7 percent reduction compared with the prepandemic PITI of $1,797.

The proposed front-loading of the same partial claim amount would allow this borrower to get a deeper payment reduction. If we applied $15,000 instead of the full $25,160 in partial claim assistance to cover arrearages, the new interest-bearing unpaid principal balance would be slightly higher at $300,160, and the new PITI payment at a 3.25 percent modified interest rate would be $1,756. The leftover $10,160 in partial claim amount (i.e., $25,160 minus $15,000) could be used to reduce monthly payments dollar for dollar temporarily. In this example, we used five years, yielding a monthly payment reduction of $169. During these five years, the borrower would pay $1,587 per month (i.e., $1,756 minus $169) in PITI, or an 11.7 percent reduction (compared with the 4.7 percent reduction the borrower would receive under today's partial claim system).

The monthly payment would rise to $1,756 after five years. This proposal assumes that borrowers who have not fully regained financial stability at the end of forbearance would have done so after five years. The front-loading of partial claim funds would in effect give borrowers most adversely affected by COVID-19's economic impacts additional time to get back on track. This would be most useful for borrowers who cannot afford their payments even after receiving the full 30 percent in partial claim assistance under FHA HAMP.

This change has several advantages. First, it would present no additional costs to the FHA because we are neither increasing the partial claim amount nor extending the timing of when the second lien is repaid. Second, the change would give borrowers more time to regain financial stability and improve the sustainability of the modification.

This change could be implemented in two different places in the waterfall. It could be offered to borrowers who cannot afford monthly payments under the combined owner-occupant loan modification with partial claim. Today, such borrowers are instead reviewed for combined FHA HAMP with partial claim. This option could also be employed when the combined HAMP with partial claim does not produce the required 20 percent payment reduction or a PITI that is 31 percent of borrower income. The proposed solution would be a big improvement because under the current waterfall, such borrowers are evaluated for home disposition options.

Servicer-borrower communication will be key to the program's success, as borrowers used to making a lower payment may find it difficult to accept a payment increase. A periodic notification reminding the borrower that their payment will increase in the future may help them better prepare. It is also possible to structure the program such that the monthly payment increases gradually, as was the case for HAMP interest-rate-step-up modifications coming out of the Great Recession.

Another way of increasing payment relief would be to allow the mortgage term to be extended to 40 years. This is something the government-sponsored enterprises (GSEs) offer, as they can hold modified whole loans in their retained portfolios. The FHA faces two hurdles to this: it does not have a portfolio to hold whole loans, and it relies on servicers to modify delinquent loans, which are then securitized again and sold to Ginnie Mae mortgage-backed securities (MBS) investors at the prevailing secondary price. The secondary market for 40-year MBS is small and less liquid. Ginnie Mae recently announced a new pool type to support securitization of modified 40-year loans,[4] but MBS pricing for loans with 40-year terms is less competitive relative to pricing for 30-year terms. Moreover, in a rising-rate environment, market participants are less likely to take on long-duration risk, making the market rate on a 40-year mortgage even less economical. Although the development of a 40-year secondary market is desirable, it is not something that can be expanded in time for the current crisis. In addition, developing this market will likely require a certain degree of government subsidy for investor, servicer, and borrower economics to work.

Facilitate Efficient Borrower Move-Out When Home Retention Fails

When borrowers have exhausted the home retention toolkit and cannot remain in the home, it is important to sell the home as quickly and as efficiently as possible, consistent with maximizing its value. This prevents distressed properties from falling into disrepair and bringing down neighborhood home values (Gordon et al. 2021). It also maximizes recoveries for the entity on the hook for credit losses, typically the GSEs, the FHA, or the VA. In the last crisis, with widespread negative equity, these entities had a strong incentive to maximize recoveries to cut losses. Because most struggling borrowers today owe less than the home is worth, the likelihood of losses is remote, which could decrease the incentive to facilitate speedy resolution. All else equal, a distressed property that sits in limbo will eventually sell at a deeper discount, which will come largely out of borrower's equity even as the agencies make a full recovery.

Borrowers who have exhausted all loss mitigation strategies should be promptly evaluated for preforeclosure sales and other disposition options. In today's tight market, the loss mitigation toolkit should encourage struggling borrowers to sell their homes in the open market to maximize equity value upon exit. Servicers could ask whether the borrower can handle this by themselves or whether they need to be referred to a housing counselor that can facilitate a smooth exit while maximizing recovery for the borrower. If the borrower selects the counselor option, the costs of this counseling should be borne by the insurer or guarantor on the mortgage (the FHA, the VA, or the GSEs).

A quicker move-out could be encouraged by offering reasonable relocation allowances for borrowers who lose their home, with both positive and negative equity. Currently, Fannie Mae, Freddie Mac, and the FHA offer up to $3,000 in relocation allowance to borrowers who complete a short sale or a deed in lieu of foreclosure. This amount has not been increased even as house prices and rents have increased substantially and does not apply to borrowers who do a market sale. The $3,000 is also much less than the $10,000 in relocation assistance borrowers received under the Home Affordable Foreclosure Alternative Program for a successful short sale or deed in lieu. The Home Affordable Foreclosure Alternative Program was offered during the Great Recession as part of the Making Home Affordable program. It offered incentives to borrowers and servicers who used a short sale or a deed in lieu to avoid foreclosure. We recommend increasing the borrower relocation assistance amount to facilitate voluntary move-out, whether or not the borrower has equity.

Conclusion

The housing market faces two major structural challenges. Credit availability is tighter today compared with historical standards, making it difficult for younger, low- and moderate-income households and racial and ethnic minorities to become homeowners. At the same time, a shrinking supply of homes for sale amid strong demand has pushed prices to unaffordable levels. While efforts to ease these barriers will take time, we must, in the immediate term, preserve the limited gains in homeownership made in the past seven years. Although forbearance was instrumental in giving struggling borrowers a financial lifeline, minimizing the number of borrowers that eventually lose their homes should be the goal.

Today's loss mitigation toolkit is better than the one we had going into the 2008 crisis. The prompt establishment for forbearance and foreclosure moratoriums since the start of the pandemic has kept the housing market strong and allowed homeowners to stabilize their finances. At the same time, key differences between the pandemic and the 2008 bubble necessitate certain tweaks to the toolkit. And the time to act is now, as borrowers are exiting forbearance and working on loan workout options with their servicers.

Notes

1. Lopa P. Kolluri, principal deputy acting secretary, Office of Housing, Federal Housing Administration, mortgagee letter 2021-15 to all FHA-approved mortgagees and others, June 25, 2021, https://www.hud.gov/sites/dfiles/OCHCO/documents/2021-15hsgml.pdf.
2. In addition, the Consumer Financial Protection Bureau finalized its 2021 Mortgage Servicing COVID-19 Rule that permits servicers to offer streamlined loan modification options based an incomplete borrower application. See "Protections for Borrowers Affected by the COVID-19 Emergency under the Real Estate Settlement Procedures Act (RESPA), Regulation X," Consumer Financial Protection Bureau, June 28, 2021, https://www.consumerfinance.gov/rules-policy/final-rules/protections-for-borrowers-affected-by-covid-19-under-respa/.
3. "AR05-Final Rule-Loan Guaranty: COVID-19 Veterans Assistance Partial Claim Payment Program," Regulations.gov, May 28, 2021, https://www.regulations.gov/document/VA-2020-VBA-0026-0022.
4. Ginnie Mae, "Ginnie Mae to Enable Securitization of Mortgage Modifications with Terms Up to 40 Years," press release, June 25, 2021, https://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=209.

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About the Authors

Karan Kaul is a senior research associate in the Housing Finance Policy Center at the Urban Institute. He publishes innovative, data-driven research on complex, high-impact policy issues to improve the US mortgage finance system. A strategic thinker and thought leader with nearly 10 years of experience in mortgage capital markets, Kaul has published nearly 100 research articles on such topics as mortgage servicing reforms, efficient access to credit, benefits of alternative credit data and scoring models, and single-family rentals. He has advocated for efficient industry practices, regulation, and legislation to make the mortgage market work better for all Americans. Kaul is the lead researcher on the Mortgage Servicing Collaborative and regularly speaks at housing conferences. Before joining Urban, he spent five years at Freddie Mac as a senior strategist analyzing the business impact of postcrisis regulatory reforms. He holds a bachelor's degree in electrical engineering and a master's degree in business administration from the University of Maryland, College Park.

Laurie Goodman is vice president for housing finance policy and the founder of the Housing Finance Policy Center at the Urban Institute. The center provides policymakers with data-driven analyses of housing finance policy issues they can depend on for relevance, accuracy, and independence. Before joining Urban, Goodman spent 30 years as an analyst and research department manager at several Wall Street firms. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial, Arch Capital Group Ltd., Home Point Capital Inc., and DBRS Inc. and is a consultant to the Amherst Group. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

Michael Neal is a senior research associate in the Housing Finance Policy Center. Previously, he worked at Fannie Mae, where he was a director of economics in the Economic and Strategic Research division. Before his service at Fannie Mae, Neal was the assistant vice president at the National Association of Home Builder's Economic and Housing Policy department. As a housing economist, Neal has an in-depth knowledge of housing market trends and has provided expert analysis and commentary on housing to media outlets around the country. Previously, Neal worked at Congress's Joint Economic Committee, the Federal Reserve System, the Congressional Budget Office, and Goldman Sachs. Neal has a bachelor's degree in economics from Morehouse College and a master's degree in public administration from the University of Pennsylvania.

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500 L'Enfant Plaza SW
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