COVID-19 Forbearance Programs

A LIFELINE FOR BORROWERS... AND AN OPPORTUNITY FOR AGENCY MBS INVESTORS?

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Agency MBS investors have benefited from a variety of U.S. government programs designed to support mortgage borrowers and ensure the smooth functioning of the U.S. housing market, a key sector of the U.S. economy.

Perhaps most significant, the Federal Reserve's Quantitative Easing program developed in response to the 2008-2009 Global Financial Crisis has been relaunched, and the Fed has indicated it may purchase Agency MBS in unlimited amounts. Through May 27, 2020, the Federal Reserve balance sheet reflects Agency MBS holdings total $1.8 trillion, a $417 billion increase year-to-date.[1] This unwavering support of the Agency MBS market should provide comfort to investors that the U.S. government remains committed to the housing sector.

In addition to supporting the secondary market for Agency MBS, the U.S. government has initiated programs through the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act")[2] to provide financial support to individual mortgage borrowers experiencing financial distress due to COVID-19. For borrowers with "federally-backed mortgage loans," the U.S. government, through its agencies responsible for government-assisted lending and securitization programs, is providing payment relief in the form of forbearance.

This paper will provide a high-level overview of the COVID-19 forbearance programs and describe how these programs may affect borrower and servicer behavior and, as a result, Agency MBS cashflows. UIA-IM investment professionals seek to identify Agency MBS that offer attractive returns on a risk-adjusted basis. The firm is closely monitoring the growing popularity of the forbearance programs, and initial analysis indicates these programs may provide attractive relative value to investors in select high-coupon MBS.

GNMA MBS Mortgage Forbearance Programs

On March 27, 2020, President Trump signed the CARES Act into law. This law provides payment relief to single-family homeowners with government-insured mortgages who are experiencing financial difficulty as a result of the COVID-19 pandemic. All government agencies responsible for overseeing the issuance of government-guaranteed mortgages, including the Federal Housing Administration ("FHA"), the Department of Veterans Affairs ("VA"), and the Rural Housing Service ("RHS"), have established similar programs to implement the CARES directive to provide mortgage payment relief. Under these programs, mortgage servicers are directed to provide deferred or reduced mortgage payment options (i.e., "forbearance") for up to six months, followed by an additional six months if requested by the borrower. The programs require that mortgage servicers advance funds to investors on behalf of homeowners, and defer the repayment of those advances until the end of the forbearance period. The details of the repayment programs post-forbearance vary by agency. Under the FHA's COVID-19 National Emergency Partial Claim program,[3] for example, the sum of deferred payments is an interest-free subordinate mortgage that remains outstanding until a repayment plan is implemented, and the beginning of the repayment program may be extended until after the first mortgage is retired. FHA servicers are reimbursed for forbearance advances. The VA does not have a Partial Claim program, which places an additional burden of funding the forbearance on servicers, and this may affect VA forbearance volume and post-forbearance treatment of individual mortgages.

Fannie Mae and Freddie Mac Mortgage Forbearance Programs

On May 13, 2020, the Federal Housing Finance Agency ("FHFA"), the primary regulator for Fannie Mae and Freddie Mac (the Government-Sponsored Enterprises or "GSEs"), announced a new payment deferral program for GSE borrowers who enter into a forbearance plan as a result of adverse financial developments related to COVID-19.[4] At the end of the forbearance period, borrowers unable to make a lump sum payment to reinstate their loans, and those who cannot afford an additional payment plan to repay all missed payments, may be given an option to defer the missed payments until the loan is paid-off when: 1) the property is sold, 2) the loan is refinanced, 3) the loan matures, or 4) the loan is retired by the borrower through curtailments. Similar to the GNMA-related programs described above, borrowers will be permitted to defer up to 12 months of missed mortgage payments to the end of the mortgage term. Servicers of Fannie Mae and Freddie Mac mortgages may be reimbursed for deferral advances exceeding four months of payments.[5] All agency forbearance programs provide for an extended repayment plan, and none require a balloon payment of the deferred amount at the end of the forbearance period.

Agency MBS Prepayment, Default, and Buyout Implications

Agency MBS cashflows may be affected by borrower and servicer responses to the forbearance programs as described below:

Prepayments: Borrowers with suspended or reduced mortgage payments under a forbearance program may not be eligible to refinance or buy a new home if they are not current on their existing GSE-backed mortgage. In a statement issued on May 19, 2020, the FHFA announced it will limit mortgage refinancing to borrowers who are continuing to make monthly payments on a mortgage technically in forbearance, or who have reinstated their mortgage (ended forbearance) and made three consecutive payments under their repayment plan, or payment deferral option or loan modification.[6] UIA-IM believes this restricted access to refinancing opportunities in the current low rate environment will slow prepayments on high-coupon MBS.

Refinancing demand may also be affected by forbearance, as borrowers may not see a compelling reason to refinance even if the rate incentive is substantial. Lowering future mortgage payments through refinancing on a mortgage that is not requiring any current payments (although for a limited period) may not be viewed as a high priority by borrowers.

Due to FHFA current policy restricting or prohibiting access to refinancing and potentially lower demand for refinancing of loans in forbearance, UIA-IM expects refi prepayment speeds for higher-coupon MBS pools with high forbearance rates will slow over the coming year.

Defaults: At the end of the forbearance period, borrowers will be required to resume regular payments, and select a repayment plan for the deferred amount. The normal default rate, and prepayments related to defaults, may decline during the forbearance period as borrowers experiencing financial distress take advantage of forbearance programs. There may be, however, a "catch-up" increase in defaults at the end of the forbearance period as some borrowers will not be able to resume even their normal payment schedule. The volume of default-related prepayments will depend on the speed and strength of the U.S. economic recovery, which may vary significantly by geographic region. Understanding the proportion of loans that will default or cure will be a key to forecasting MBS cashflows at the end of the forbearance period.

Buyouts: Servicers may buy-out individual mortgages from an MBS pool at par, and this payment passes through to the MBS investor as a principal prepayment. Buyouts are conducted for seriously delinquent mortgages that are moving down the path to default, or mortgages that require loan term modification to help rehabilitate the borrower. The COVID-19 deferral programs, however, may mitigate the risk of buyouts related to loan modification, as borrowers able to resume normal mortgage payments may simply agree to a repayment plan that leaves the current mortgage undisturbed and adds the deferral payments to the end of the current mortgage. As a result, buyout-related prepayments may be lower than some market participants anticipate at the end of the forbearance period.

Potential Relative Value Opportunity

UIA-IM monitors prepayment activity of individual MBS pools, and the firm's analysis indicates that there are a number of factors influencing the level and variability of prepayments, including loan type, loan size, loan age, geography, servicer, etc. This analysis will now include an evaluation of pool-by-pool rates of forbearance. Fannie Mae and Freddie Mac will begin releasing pool level forbearance data in June 2020.

UIA-IM believes that prepayment speeds on higher-coupon Agency MBS backed by loans in forbearance will be generally lower than most model forecasts for three reasons: 1) Refinancing activity is dampened, 2) Default activity is slowed during the forbearance period, and 3) Payment deferral programs reduce the need for loan modifications. Slower prepayments than forecast are beneficial to high-coupon Agency MBS investors, but the magnitude of this effect will depend on the adoption of forbearance programs and, of course, on the strength and speed of the U.S. recovery. The popularity of mortgage forbearance is still to be determined, but UIA-IM believes higher forbearance rates may indicate a greater relative value opportunity.

This is a rapidly evolving situation, with little historical data to help forecast the effect of these programs on the mortgage sector. New government programs are being proposed through legislation and existing programs modified to provide borrower relief and address possible inequalities in implementation. UIA-IM is closely monitoring these developments, and at this time, the firm views forbearance as adding another factor that may help explain future differences in prepayment activity. UIA-IM focuses on adding value through bottom-up security selection, and including forbearance effects in the firm's prepayment analysis should help identify attractive investment opportunities in the high-coupon Agency MBS sector.

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6. "FHFA Announces Refinance and Hope Purchase Eligibility for Borrowers in Forbearance," Federal Housing Finance Agency. (https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Refinance-and-Home-Purchase-Eligibility-for-Borrowers-in-Forbearance.aspx)

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