Forbearance in the CARES Act: A Review of Issues, Impact, and Mitigation Strategies

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Executive Summary

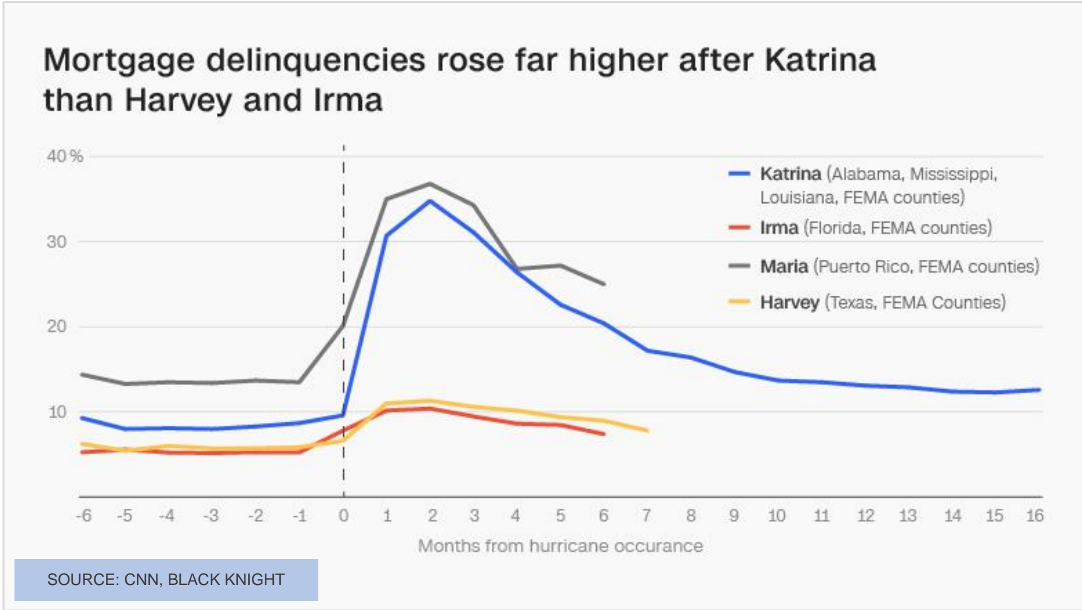
- On March 27, 2020, Congress passed the Coronavirus Aid, Relief, and Economic Security Act. The CARES Act includes significant sections designed to keep homeowners and renters in their homes.
- The CARES Act creates significant changes to current forbearance processes for government-backed loans (approximately $6.9 Trillion in asset value).
- The simplified forbearance process is very generous to borrowers and restricts certain types of Servicer diligence, which may result in very high usage of the forbearance option by borrowers.
- Depending on take-up rate and forbearance duration assumptions, the total value for government backed loans of deferred P&I could exceed $107 Billion, and the total value of deferred Taxes, Insurance, and HOA fees could exceed $48 Billion. Current legislation does not yet relieve Servicers of the requirement to advance these funds.
- There are no updated guidelines for bringing borrowers current after a forbearance period mandated by the CARES Act ends, leaving multiple options on the table.
- A wave of loan modifications is almost certain to result at the end of the covered period, and FHA is likely to offer further guidance to avoid a wave of defaults from harming borrowers, the property market, and its insured portfolio.
- Although Servicers cannot gather documentation for forbearance approval, they may be able to gather documentation after the forbearance is initiated in order to prepare for efficient resolution (including possible modification) after the forbearance period ends.
- Servicers will need to carefully evaluate how they wish to manage non-government backed loans.
- It is likely that properties with forbearance on the loan will require ongoing drive-by property inspections to ensure the property remains occupied, thus adding further cost for Servicers.
- Creating a unified process with proper automation and automated documentation is critical to scaling the operational management of the CARES Act forbearance process, meeting regulatory requirements without challenges, and preparing for the upcoming modification wave at the end of the forbearance period.

Brief Background

Prior to the CARES Act, the Servicer guidance from the GSEs for the Coronavirus crisis had been to use existing programs that were in place for natural disasters. These programs have historically been intended to apply to areas that are limited in geographical scope and duration. For example, Fannie Mae and Freddie Mac have maintained a streamlined forbearance process since 2018, when they rolled out the final Form 710 Mortgage Assistance Application.

This program generally requires a Servicer to achieve QRPC (quality right party contact), but permits temporary action (up to 90 days) without QRPC so long as attempts to obtain QRPC are ongoing. The program allows forbearance to extend to up to 12 months at the discretion of the Servicer, with further forbearance requiring Fannie Mae approval. Form 710 requires a borrower to submit a range of information, including documentation, to prove hardship. Moreover, the borrower continues to accrue interest on all components of the loan during the forbearance period.

Even prior to the updated Form 710, the existing forbearance options had proven highly successful at mitigating the housing impact following major catastrophic events. For example, the local delinquency rate in affected areas for hurricanes Irma (2017) and Harvey (2017) peaked at about 10%, compared to a roughly 35% peak in delinquency rates for hurricane Katrina (2005) which peaked at 36%.[1] These experiences, combined with the learnings from the 2008 housing crisis, have convinced policymakers, investors and Servicers of the efficacy of strong forbearance programs.



[1] https://money.cnn.com/2018/04/22/news/economy/hurricane-foreclosures-houston/index.html

The CARES Act and What It Contains

Prior to the CARES Act[2], historical programs were intended to manage localized challenges primarily related to natural disasters. The scale and scope of the Coronavirus response far exceeds prior disaster responses.

Section 4022 of the CARES Act covers all residential mortgages issued, insured, or guaranteed by the federal government or agency (Fannie Mae, Freddie Mac, VA, USDA, Ginnie Mae, or other FHA). It mandates that Servicers must grant forbearance to any borrower "experiencing a financial hardship due, directly *or indirectly*, to the Covid-19 emergency" (emphasis added). This represents a significant relaxation from prior standards used to assess financial hardship.

Section 4022 further mandates that "the Servicer shall with *no additional documentation* required other than the *borrower's attestation* to a financial hardship caused by the COVID-19 emergency and with no fees, penalties, *or interest* (beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the terms of the mortgage contract) charged to the borrower in connection with the forbearance, provide the forbearance for up to 180 days" (emphasis added). These directives also indicate significant changes from prior rules.

Essentially, a Servicer is required to grant up to 6 months forbearance to any borrower upon request, provided that the borrower attest to direct or indirect hardship due to the Covid-19 emergency. This standard is flexible enough that a large portion of the US population could qualify, even those who are not suffering a loss of employment or large reduction in income.

A CARES Act forbearance also differs from other forbearance rules in banning the application of interest being applied on the amount in forbearance. This is further clarified in language regarding applying interest "as if the borrower made all contractual payments on time". Thus, the amount in forbearance cannot simply be immediately recapitalized. Instead, the amount might be held in abeyance until the end of the covered period, at which point it might be recapitalized.

The specificity and generosity implied in Section 4022 is further emphasized by alternate language used in Section 4023, which addresses multifamily properties with federally backed loans. Multifamily borrowers must be current as of February 1, 2020 to apply under the program, and Servicers are specifically directed to document the hardship. Servicers are further directed to grant 30 days of forbearance, with up to 2 extensions of 30 days each, and borrowers availing themselves of the program face further restrictions relating to their management of tenants (no evictions, eviction proceedings, late payment fees, or penalties associated with non-payment of rent). The directives regarding no

[2] https://www.govtrack.us/congress/bills/116/hr748/text

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documentation under Section 4022 should thus be considered in the context of the Section 4023 language.

Given the language in the CARES Act and the sense of Congress expressed elsewhere in the Act, Servicers should engage borrowers with some degree of caution. For example, Servicers should avoid even the appearance of requiring documentation to approve a forbearance request on federally backed loans. A request for documentation, even if it occurs outside of the forbearance application process, could be interpreted in the future by regulators as implying a requirement for documentation that might deter borrowers from using the CARES Act program. Although there are likely to be very valid reasons for following up with documentation requests (for example, preparing for post-forbearance delinquency resolution or loss mitigation), any communication requesting documents should very clearly explain that the request is not associated with forbearance and has no impact on any forbearance review.

Servicers also should explain to borrowers the financial impact of forbearance under the CARES Act, and ensure that they communicate the impact in simple and accurate language. For example, Servicers should ensure borrowers understand how interest will be applied through the period of forbearance. The language of the Act, “as if the borrower made all contractual payments on time”, may not be intuitive to many or most borrowers.

Finally, Servicers need to consider their process for handling non-government backed loans in the context of their process for handling loans covered under the CARES Act. While many investors and Servicers have grown used to localized, short term disruptions and determined that following GSE standards is suitable for non-government backed loans, this determination may change when considering the financial impact of the program outlined in the CARES Act, as well as the duration and scope. It is likely, for example, that the dismissal of the documentation requirements in the CARES Act will increase the risk of fraud, and almost certain that it will result in many applications where minimal hardship has occurred and borrowers might not ordinarily qualify for forbearance. The duration, scope, and limitation on fees and interest may create further financial challenges for Servicers. The cost for applying CARES Act standards to non-government backed loans could thus be quite high. Servicers must weigh the operational costs of creating different processes with different standards, and any operational risks of mistakes (and accompanying penalties) from inadvertently applying the wrong process to government backed loans. Stronger and more flexible technologies may offer Servicers more flexibility in making this tradeoff.

Estimating Impact: Assessing the Magnitude of the Forbearance Wave

Tremendous uncertainty exists in terms of the likely burden on Servicers resulting from the CARES Act, particularly as consumer media and financial advisors begin to publicize the details of the Act. We therefore take a top down approach to framing the estimates. The projections herein do not account for loans that are not covered under the CARES Act (approx. $4.2 trillion in assets), many of which are held in portfolios across thousands of large and small institutions, and for which there is currently no unified policy response.

In Jan 2020, total Agency Mortgage Backed Securities (MBS) summed to $6.9 trillion. Portfolio loans totaled to $3.2 trillion, and PLS and 2nd liens each totaled about half a trillion.[3] (Urban Institute). This suggests about 35 million agency loans, along with the smaller government programs. Program take-up will depend both on the impact of the recession, the media response to the CARES act, and how borrowers react to the extremely generous terms and absence of required documentation.

One approach to estimating the impact might examine response to past disasters. Fortunately, recent research provides us with benchmarks that we might use. For example, Fannie Mae has published findings on the usage of forbearance programs in hurricane affected areas along with ultimate outcomes of those programs.[4] In the sample pool observed, 8% of the loans were in the affected regions, and only 4.4% of those loans became more than 60 days delinquent, reflecting the limited geographical scope of damage even within affected areas. Among those which became delinquent, however, over half of the loans entered some sort of modification. The data below indicate that loans in forbearance required modification more often than loans never in forbearance, but we should not read causality into this data due to adverse selection - loans requiring forbearance were more likely to be impaired to begin with.

[3] https://www.urban.org/sites/default/files/publication/101766/february20chartbook202020.pdf
[4] https://www.fanniemae.com/portal/funding-the-market/credit-risk/news/hurricane-affected-regions-performance-update-090619.html

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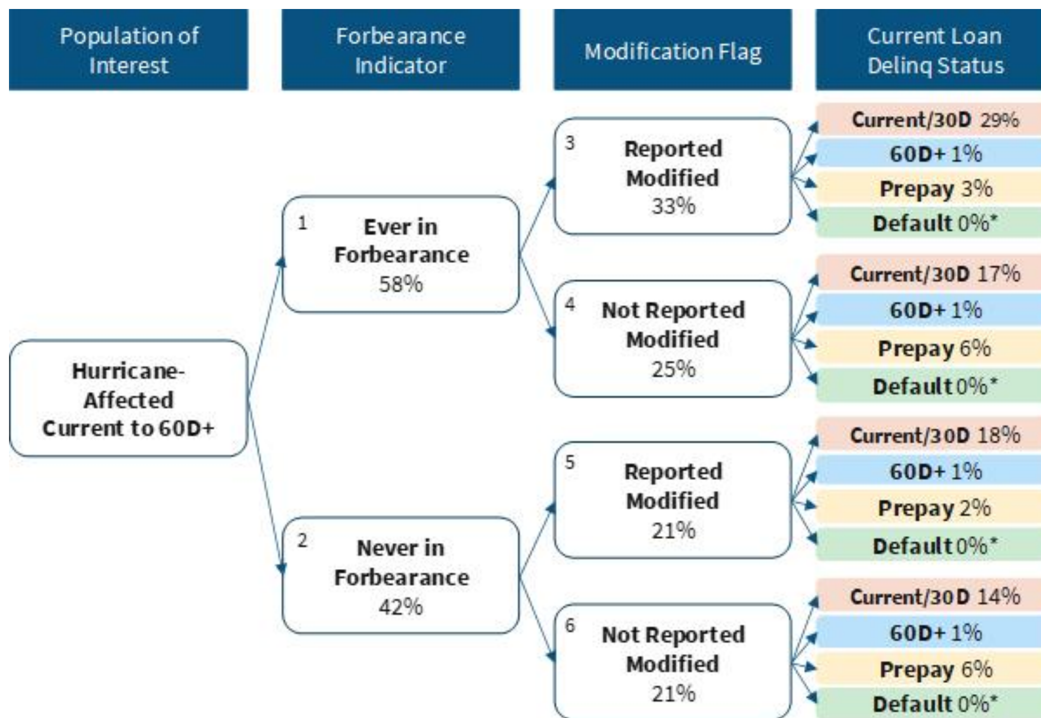
Fannie Mae: Hurricane Affected Region Performance



We believe that this data suggests a reasonable lower bound for take-up rate of the CARES Act program. Thus, we might expect a minimum of 5% of borrowers with government backed loans to request a forbearance (1.5 million), and half of them (about 875,000) to require eventual modification.

Several other factors argue for a higher program usage rate, however. First, the CARES Act program is substantially more generous than the standard disaster relief programs, as noted above. Second, hurricanes represented a natural disaster which often increases the demand for local labor, whereas the current COVID-19 crisis is creating massive unemployment. According to the Federal Reserve of St. Louis, the most severe situation could result in an unemployment rate of 32%, with 47 million unemployed.[5] Recently released estimates from Goldman Sachs are more sanguine, projecting unemployment topping out at 15% with a 34% drop in 2nd quarter GDP.[6] A 15% unemployment rate represents an increase of 11% out of a labor force of 165 million, or just over 18 million people. Many of these will be renters (36%)[7], many owners will not have a mortgage (37%)[8], and only 70% of owners will have government backed loans. Assuming statistical independence, this still leaves a potential needy population of nearly 5.2 million homeowners. To the degree that independence does not hold (e.g. FHA

[5] https://www.forbes.com/sites/sarahhansen/2020/03/30/coronavirus-could-lead-to-47-million-lost-jobs-says-st-louis-fed/#75ee051a66fa
[6] https://www.cnbc.com/2020/03/31/coronavirus-update-goldman-sees-15percent-jobless-rate-followed-by-record-rebound.html
[7] https://ipropertymanagement.com/research/renters-vs-homeowners-statistics
[8] https://www.bloomberg.com/news/articles/2019-07-17/close-to-40-of-u-s-homes-are-free-and-clear-of-a-mortgage

loans are more likely to be linked to unemployed borrowers), this number could be higher. Nonetheless, this still represents about 1 in 7 of the 35 million government-backed mortgages. It also only considers actual unemployment claims and ignores business owners who may not claim unemployment but still have a hardship, as well as underemployed individuals who otherwise claim hardship. It is thus not unreasonable to imagine that 1 in 5 borrowers, or 7 million people, might request forbearance, particularly as the US media begins to publicize stories about the forbearance opportunity.[9] Depending on the ultimate trajectory of the Covid-19 crisis, public media response and messaging from public figures, program usage could be even higher.

There is also substantial uncertainty around the duration of the forbearance. The most optimistic estimates project a V-shaped recovery, but still conclude that much damage will be done during the second quarter. Even optimistic projections regarding the lockdown do not suggest reopening of the US economy until May, and then project rolling waves of illness along with scaled-back social distancing until a vaccine can be developed, tested, approved and mass produced (at least until December and more likely until the middle of 2021).[10] Further damage from commodity price volatility (especially in the oil patch) and loss of international trade as other countries wrestle with their coronavirus epidemics may further delay full recovery. Moreover, the CARES Act mandates approval of up to an initial 6-month forbearance period upon request, with 12 months automatically approved upon further request. We therefore conclude that the minimum average forbearance duration will be 3 months, and will more likely be between 6 and 9 months.

Framing an initial set of projections requires a few more assumptions. These assumptions are crude and could be refined by stratifying the model by state and mortgage size, however the errors introduced by assuming averages are dwarfed by the other uncertainties surrounding take-up rate and forbearance duration. We thus prefer this simpler model to one which pretends at false precision.

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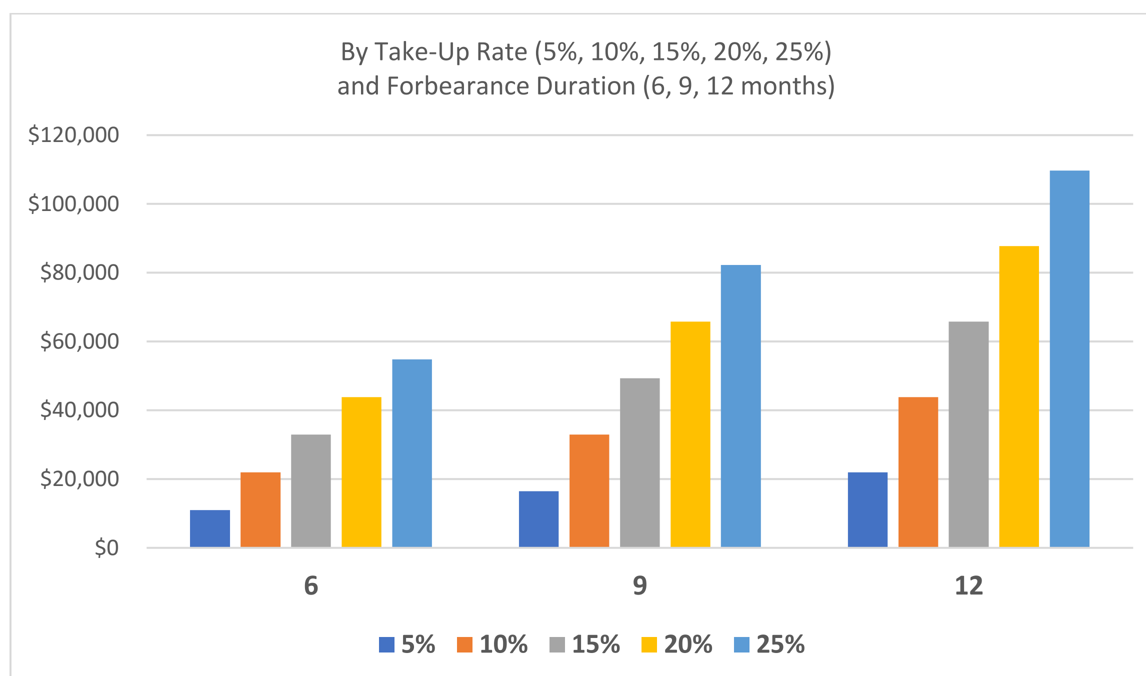
[9] https://www.npr.org/2020/03/19/818343720/homeowners-hurt-financially-by-the-coronavirus-may-get-a-mortgage-break
[10] https://www.bbc.com/news/health-51665497

Additional Assumptions

Parameter	Assumption
Average Interest Rate on Outstanding Loans	4.5%
Average Balance	$202,000
Average Term of Loan (90% are 30 year)	29
Average Annual Property Tax[11]	$3,675
Share of Homes With HOA Fees[12]	24%
Average Monthly HOA Fee[13]	$250
Average Insurance[14]	$1,200

Using the above assumptions, we can project a range of financial impacts based on a range of take-up rate and forbearance duration assumptions. We estimate both the total deferred amount of P&I at the end of the CARES Act program and the total deferred amount of payments into escrow (i.e. Tax, Insurance, HOA). As a reminder, the financial impact estimate below only account for the $6.9 trillion of government backed mortgages that are covered under the CARES Act, and do not include projections for the $4.2 trillion of non-government backed mortgages.

Financial Impact Sensitivity Analysis: Deferred Principal and Interest



[11] In 2018, the average was $3,500. Zillow reports a national average 5% increase in HPI in 2019.
[12] https://ipropertymanagement.com/research/hoa-statistics
[13] https://ipropertymanagement.com/research/hoa-statistics
[14] https://www.bankrate.com/insurance/homeowners-insurance/homeowners-insurance-cost/

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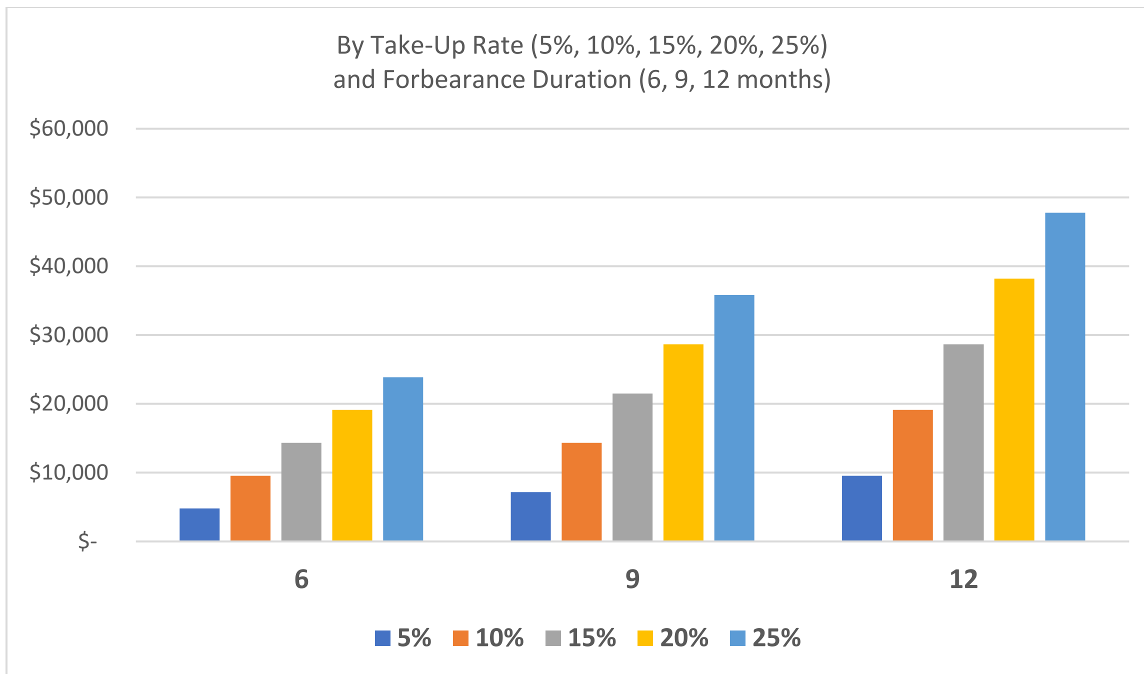
Financial Impact Sensitivity Analysis: Deferred Taxes, Insurance, and HOA



A midline estimate of the impact (about 15% take-up rate and 9 months average forbearance duration) would indicate a total peak amount of P&I in forbearance of about $48 billion, and a total peak amount of taxes, insurance, and HOA in forbearance of about $22 billion. Advancing these funds to relevant third parties clearly represents a significant financial burden for even the most financially sound Servicers.

Remaining Uncertainties: Post-Forbearance

The CARES Act is silent on how Servicers should prepare for the end of the forbearance period. Various Servicers might therefore approach the matter differently, and may choose to workout an array of different solutions for different borrowers. In support of post-forbearance workouts or loss mitigation, a Servicer might be expected to gather information and documentation in advance in order to facilitate a smooth process and more accurately project the long-term financial impact. These projections would help not only the banks, but also the FHA and other regulatory bodies by improving visibility on the magnitude of the financial impact for federal guarantee programs.

The impact of loss mitigation activity on post-forbearance financial results has the potential to be profound. If 55% of borrowers with forbearance plans require a modification, as has happened with prior natural disasters such as hurricanes, then a 20% forbearance uptake rate could result in over 3.8 million modifications. While high, this number is not outlandish. Between 2008 and 2014, the mortgage servicing

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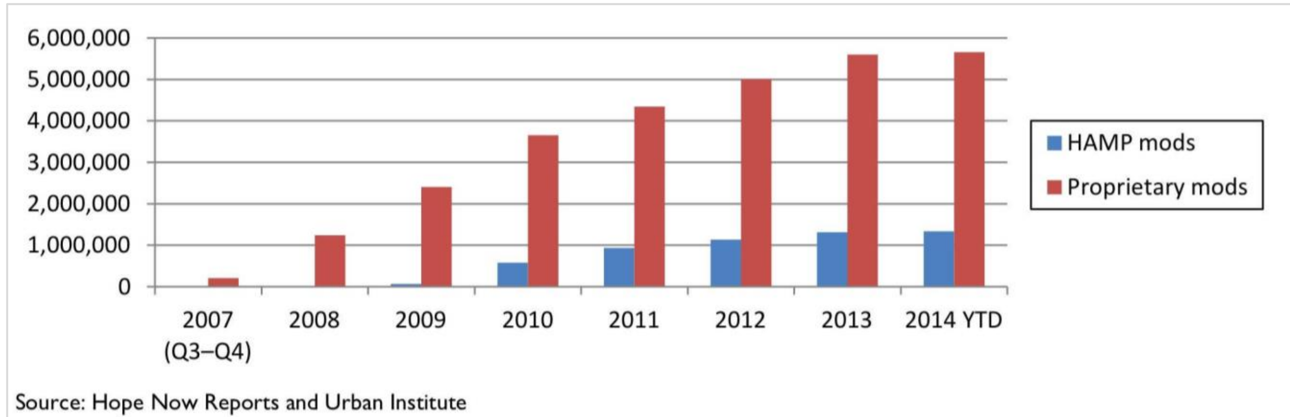
industry executed nearly 7 million modifications,[15] though many of these were repeat modifications (possibly inflating the total).

HAMP Mods vs. Proprietary Mods



Source: Hope Now Reports and Urban Institute

Although many observers do not expect the housing situation during the COVID-19 shock to approach the depth of the 2008 crisis, it's worthwhile to note that the unemployment rate peaked in late 2009 at 10%.[16] A peak unemployment rate of 15% (Goldman Sachs estimate) to 32% (Federal Reserve estimate) represents a much higher potential employment risk than the country experienced in 2009. On the flip side, we note that modifications (unlike forbearance under the CARES Act) will affect a borrower's credit. This credit score risk, along with the improved stability of the residential real estate market (greater level of equity and fewer borrowers underwater), may strongly disincentivize borrowers who apply for forbearance from seeking out a permanent modification. Nonetheless, the potential requirement for massive numbers of modifications in a short period cannot be ignored.

Although no additional guidance has been provided for the post-forbearance period, it is reasonable to expect that (without further policy responses) Servicers will be encouraged to utilize the same modifications that are most frequently used for disaster relief. The most common modification is the Extend Modification for Disaster Relief, which simply extends the term of the mortgage in the amount of payments missed (not to exceed 12 months) without capitalizing arrearages. A second common (and more extensive) modification is the Cap and Extend Modification for Disaster Relief, which recapitalizes arrearages and restructures payments, term, and interest rate in order to arrive at a monthly P&I that can be supported by the borrower's income. Servicers should be prepared to scale up these, and potentially other, modification programs as required.

[15] https://www.urban.org/research/publication/hamp-modifications-reset-risk-issue
[16] https://fred.stlouisfed.org/series/UNRATE

Given the processing costs and complexities associated with formal modification processes, it is conceivable that Congress could pass longer term programs to support borrowers that do not require formal modification. Such a program might provide for the long-term resolution of arrearages after the initial forbearance covered period without requiring modifications. For example, a long-term forbearance resolution approach might enable spreading arrearage repayment out over the term of the loan or adding payments on to the end of the loan in the same manner utilized in the Extend Modification for Disaster Relief. Some of these approaches, such as modifying the term of the loan and any lien associated with it, could require legal documentation. All of them would require significant financial support for Servicers who are committed with regard to the advances that would necessarily be incurred over a prolonged period of time, which our analysis suggests could total up to $150 billion just for the CARES Act covered loans.

As noted above, it is critical that communication in support of gathering documentation for post-forbearance resolution avoid implying that such documentation might impact or be necessary for the forbearance review. Poorly structured communication might be interpreted by a regulator as having the subtle effect (intentional or not) of intimidating borrowers. Until rules are created that provide safe harbor templates, Servicers would be well advised to communicate with care.

Nonetheless, it is critical that Servicers begin preparation for post-forbearance resolution early. The wave of resolution activity is clearly visible 12 months in advance, and with the lessons of the 2008 crisis behind us, regulators are likely to set high expectations for Servicer performance and be less forgiving of errors. Preparation should begin as early as possible, and include communication, documentation, financial impact, reporting, and compliance plans. Demonstrating competence and professionalism to regulators and investors early in the process can go a long way toward emerging from this crisis as a stronger entity.

Basic competencies should include:

- Being able to call up – at the click of a button – the entire communication record with a borrower
- Tracking the status of applications over time, and demonstrating response times that meet strong SLAs
- Tracking all exceptions and documenting exceptions with explanations
- Modeling the impact of forbearance and probable post-forbearance resolution on the Servicer's financial health, as well as the impact on third parties (investors, insurers, local governments, HOAs, etc.)
- Dealing with properties that become vacant during the process

Conclusion: The Wave Is Coming, Get Ready

Although tremendous uncertainty confronts current Servicers, they are well equipped to rise to the challenge. Servicers with the right expertise, technology, and partnerships in place can emerge from this crisis with minimal harm.

Truly exceptional Servicers have an opportunity not only to meet the coming challenge, but also to build a deeper relationship with their borrowers. Customer experience scholars have extensively documented how companies that resolve difficult situations well can build loyalty among their customers.[17] While perhaps less important to non-bank Servicers, full service and community banks may wish to consider the full customer lifetime value (CLV) when building their forbearance and resolution processes.

[17] https://hbr.org/2018/01/how-customer-service-can-turn-angry-customers-into-loyal-ones

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