Mortgage Servicers Will Bear Brunt Of CARES Act Relief

By Greg Halm (June 2, 2020)

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Many American homeowners are hurting as a result of the economic shutdown in response to COVID-19. The federal government has enacted legislation aimed at providing these homeowners some temporary relief on their mortgages.

Regrettably, the program design chosen to deliver this help is flawed in two important respects: It provides assistance to some borrowers who do not need help, and it requires the wrong entities, mortgage servicers, to finance a large portion of this assistance.

Starting in March, federal, state and local governments began imposing severe restrictions on commerce in response to the COVID-19 pandemic. These restrictions have caused sudden economic contraction and an unprecedented increase in unemployment.

Since March 21, more than 36 million jobless claims have been filed. To put the magnitude of these claims in perspective, during the same period in 2019, 1.7 million jobless claims were filed. Even during the worst eight-week stretch of the Great Recession, total jobless claims were 5.2 million.[1]

In response, Congress passed the Coronavirus Aid, Relief and Economic Security, or CARES, Act on March 27. Among other provisions, the CARES Act allows borrowers with federally backed mortgage loans to delay their monthly payments by 180 to 360 days without fees, penalties or interest[2] merely by claiming "a financial hardship caused by the COVID-19 emergency."[3]

Federally backed mortgage loans include loans held or guaranteed by Fannie Mae and Freddie Mac — the government-sponsored enterprises, or GSEs, both of which have been under the conservatorship of the Federal Housing Finance Agency since 2008 and paid $301 billion to the U.S. Department of the Treasury since 2008.[4]

Federally backed mortgage loans also include loans held, guaranteed or insured by the Federal Housing Administration, U.S. Department of Veterans Affairs and the U.S. Department of Agriculture, the vast majority of which are packaged in Ginnie Mae securities.

Altogether, federally backed mortgage loans represent approximately 62% of the $11 trillion of outstanding mortgage loans secured by one to four family residences in the U.S.[5]

Although these mortgage loans are backed by the federal government, they are serviced by private companies. Historically, most mortgage loans have been serviced by banks — such as Wells Fargo & Co, Bank of America Corp., JPMorgan Chase & Co. and smaller banks — with a minority serviced by nonbank entities, such as PennyMac Financial Services Inc., PHH Mortgage Corp., Quicken Loans Inc. and Mr. Cooper, formerly known as Nationstar Mortgage LLC.[6]

However, since the Great Recession, the proportion serviced by nonbanks has increased.

The overall servicing market today is approximately evenly split between banks and nonbanks. Yet for federally backed loans, nonbanks have a larger share than banks.[7]

The primary source of revenue for loan servicers is a loan-servicing fee calculated as a percentage of outstanding loan principal. The servicing fee percentage can range from 0.19% to 0.6% for federally backed mortgage loans but is usually on the lower end of this range.[8] Because this primary revenue source is a percentage of the current loan principal balance, it declines over time for any given loan.

A secondary source of revenue for servicers comes in the form of interest. When borrowers pay servicers before they are obligated to remit those funds to investors, insurance companies and taxing authorities, servicers can earn interest while they hold the borrower's funds.

However, when borrowers stop making payments on their mortgages, servicers lose this secondary revenue source, but still must pay insurance premiums and property taxes on behalf of borrowers, and also must make principal and interest payments to the investors who own the loans, at least for a period of time.

Servicers generally finance these advances on behalf of the borrowers with debt. Nonbank servicers tend to have higher financing costs and more constrained access to capital than bank servicers.

Further, when borrowers stop paying on their mortgage loans, servicing becomes significantly more labor intensive, increasing the servicer's operating costs. All in all, nonperforming loans are much more expensive to service than performing loans. For example, just before the onset of the COVID-19 emergency, the Mortgage Bankers Association estimated the cost of servicing performing loans at about $150 per year and nonperforming loans at $1,645 per year.[9]

The structure of mortgage servicer compensation and funding functions reasonably well under normal market conditions. However, the dichotomy between the servicing of performing loans and nonperforming loans results in significant financial strain on servicers when there is a large increase in nonperforming loans, such as we are seeing presently.[10]

With the unprecedented reduction in commerce and the increase in unemployment stemming from government actions related to COVID-19, a significant increase in nonperforming loans became inevitable.

Under normal circumstances, when a borrower misses a payment, a servicer will contact the borrower to explore the reasons for the missed payment, and it will do what it can to help the borrower get back on track and keep their home. A borrower might also proactively contact the servicer before a payment is missed.

The Consumer Financial Protection Bureau website provides general guidance to borrowers who are concerned that they might not be able to make a mortgage payment. This webpage instructs borrowers to first call their mortgage servicer and to be prepared to explain: (1) the reason for being unable to make the payment; (2) whether the problem is temporary or permanent; and (3) details about income, expenses and other assets like cash in the bank.[11]

Servicers have tools available to help borrowers who have missed a payment or expect to, such as offering repayment plans, forbearance or loan modifications.

The CARES Act changes this normal process in a significant way. Under the CARES Act, borrowers do not need to explain why they are unable to make a payment or advise the servicer, to the extent they are able, how long their inability to pay will continue.

Nor do they need to provide information about their financial condition, for example, their available savings. Rather, borrowers need only claim "a financial hardship caused by the COVID-19 emergency."[12]

Further, the type of forbearance automatically available to borrowers under the CARES Act (i.e., without interest or penalty) confers a quantifiable economic benefit on a borrower. For example, on a hypothetical 30-year $300,000 mortgage loan with a 4% interest rate, a six-month forbearance provides the borrower with a benefit worth $71; a one-year delay provides a benefit worth $306.[13]

The program design creates an economic incentive for borrowers who do not need help making their mortgage payments to nonetheless seek the benefits available from loan servicers under the CARES Act.

With no documentation or explanation needed to obtain forbearance, there is no way to screen out these borrowers. The very real risk that the program will be exploited by borrowers who do not need it is shown by looking at past and present government assistance offers.

For example, in 2009, when the federal government rolled out the Home Affordable Modification Program, the initial goal was to provide quick relief to struggling homeowners. As such, borrowers were allowed to enter into trial modifications based on their verbal representations without documenting their need for assistance.

When servicers undertook to collect the requisite documentation, they discovered that many in this first wave of borrowers could not support their verbal representations and were actually not eligible to receive permanent modifications.

Similarly, there have been numerous recent reports about businesses applying for and receiving loans under the Paycheck Protection Program, also authorized by the CARES Act, that apparently did not need the loans, or perhaps were obtaining the loans only as a precautionary measure.[14]

Thus far, a significant number of borrowers have taken advantage of the forbearance offer under the CARES Act. As of May 8, Black Knight Inc., the most widely used loan-servicing technology platform, estimated that 7% of GSE loans and 12.4% of FHA and VA loans were in forbearance, and that collectively these loans required servicers to make monthly advances amounting to $3.6 billion of principal and interest, as well as an additional $1.5 billion of tax and insurance payments.[15]

A recent publication analysis by Urban Institute and Moody's Analytics projects total servicer advances in connection with COVID-19, including for nonfederally backed loans, at between $33 billion and $118 billion, with $18.1 billion to $65.1 billion of this financed by nonbank servicers.[16]

Thus far, the federal government has been unwilling to fully fund its generous mortgage assistance offer, insisting that servicers fund a large portion of this assistance. For example, on April 10, Ginnie Mae offered some degree of liquidity to mortgage servicers, but describes its liquidity program as a last resort option.[17]

Thus far, neither the FHFA nor the GSEs have offered any such option. In an April 7 interview, the head of the FHFA stated, "I've seen zero [evidence] to suggest that there's a systemic crisis across the nonbank servicers."[18]

On April 21, the FHFA conceded to only require servicers to advance the GSEs four months of payments.[19] However, it did not say when servicers would be reimbursed for these four advanced payments. Thus far, the federal government has not explained why it is requiring servicers to finance its mortgage assistance offer in the CARES Act.

In summary, the structure of the mortgage assistance program in the CARES Act will tend to increase the proportion of nonperforming loans and cause mortgage servicers to bear the cost. However, unlike the federal government, loan servicers do not have virtually unlimited access to capital.[20]

Given the financial pressure already being placed on servicers, and most acutely nonbank servicers, from such a large wave of delinquency and forbearance, there is a real danger that the CARES Act may have an unintended consequence: It could force servicers to exhaust their finite capital to provide assistance to borrowers with federally backed loans who do not need it, and thereby impair their capacity to provide assistance to other borrowers who do need it, but whose loans are not backed by federal entities.

Correction: A previous version of this article incorrectly described the type of residences securing the mortgage loans analyzed in this article. The error has been corrected.

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[1] Initial Weekly Claims data retrieved from Federal Reserve Bank of St. Louis, Economic Research, retrieved from: https://fred.stlouisfed.org/series/ICSA.

[2] That is, 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.

[3] CARES Act, Sec. 4022(c)., "Requirements for Servicers," retrieved from: https://www.congress.gov/bill/116th-congress/house-bill/748/text?loclr=bloglaw#toc-H4D5728D599DE43C1B10376E596A41BCE.

[4] Per data published by FHFA at https://www.fhfa.gov/DataTools/Downloads/Documents/Market-Data/Table_2.pdf.

[5] Board of Governors of the Federal Reserve System, Mortgage Debt Outstanding data

series (December 2019), retrieved from: https://www.federalreserve.gov/data/mortoutstand/mortoutstand20191231.htm.

[6] See Kaul, Karan, Goodman, Laurie, McCargo, Alanna, and Hill-Jones, Todd, "Options for Reforming the Mortgage Servicing Compensation Model," Urban Institute (April 2019), retrieved from: https://www.urban.org/sites/default/files/publication/100131/options_for_reforming_the_mortgage_servicing_compensation_model_0.pdf.

[7] Based on Mr. Cooper Group's April 30, 2020, Q1 2020 earnings presentation, approximately 51% of mortgage loans in the United States is serviced by banks, and 49% by nonbanks. Retrieved from: http://investors.mrcoopergroup.com/Cache/IRCache/785da0f9-c402-75c6-4f7b-155387faecb4.PDF?O=PDF&T=&Y=&D=&FID=785da0f9-c402-75c6-4f7b-155387faecb4&iid=4401869. Because the 51% servicing market share held by banks includes most of their loan portfolios (which constitute approximately 24% of mortgage loans based on Mortgage Debt Outstanding data; see endnote v above), it is necessarily the case that the majority of federally backed mortgage loans are serviced by nonbank servicers.

[8] Kaul et al. (2019).

[9] Sinnock, Bonnie, "Will servicers be able to better control costs in the next downturn?" National Mortgage News, Feb. 26, 2020, retrieved from https://www.nationalmortgagenews.com/news/will-servicers-be-able-to-better-control-costs-in-the-next-downturn.

[10] The vulnerability of the mortgage servicing market to poor loan performance is also discussed in Kaul et al. (2019).

[11] Consumer Financial Protection Bureau, "If I can't pay my mortgage loan, what are my options?" (Aug. 25, 2017), retrieved from: https://www.consumerfinance.gov/ask-cfpb/if-i-cant-pay-my-mortgage-loan-what-are-my-options-en-268/.

[12] CARES Act, Sec. 4022(c)., "Requirements for Servicers," retrieved from: https://www.congress.gov/bill/116th-congress/house-bill/748/text?loclr=bloglaw#toc-H4D5728D599DE43C1B10376E596A41BCE.

[13] This benefit is calculated as the change in net present value of the mortgage loan.

[14] Widely publicized examples of entities that borrowed funds under PPP but agreed to repay the funds are the Los Angeles Lakers, Shake Shack, and Ruth's Chris. See, e.g., Cohen, Ben, "Los Angeles Lakers Received and Returned Their Coronavirus Loan," The Wall Street Journal (April 27, 2020), retrieved from: https://www.wsj.com/articles/los-angeles-lakers-received-and-returned-their-coronavirus-loan-11588010014; and Rudegeair, Peter, Haddon, Heather, and Simon, Ruth, "Ruth's Chris to Repay Loan Amid Outcry Over Rescue Program," The Wall Street Journal (April 23, 2020), retrieved from: https://www.wsj.com/articles/public-companies-have-to-repay-small-business-rescue-loans-11587670442?mod=searchresults&page=1&pos=10.

[15] Black Knight, "4.7M Homeowners Now in Forbearance, But Pace is Slowing Considerably" (May 15, 2020), retrieved from: https://www.blackknightinc.com/blog-posts/4-7m-homeowners-now-in-forbearance-but-pace-is-slowing-considerably/.

[16] See Goodman, Laurie, Parrott, Todd, Ryan, Bob, and Zandi, Mark, "The Mortgage Market Has Caught the Virus," Urban Institute (May 2020), retrieved from: https://www.urban.org/sites/default/files/publication/102225/the-mortgage-market-has-caught-the-virus.pdf.

[17] Ginnie Mae, "Ginnie Mae Announces Changes to its Pass-Through Assistance Program in Response to COVID-19 National Emergency," press release (April 10, 2020), retrieved from: https://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=196.

[18] Ackerman, Andrew, "Fannie, Freddie Unlikely to Aid Mortgage Companies as Payments Dry Up, FHFA Chief Says," The Wall Street Journal (April 7, 2020), retrieved from: https://www.wsj.com/articles/fannie-freddie-unlikely-to-aid-mortgage-companies-as-payments-dry-up-fhfa-chief-says-11586289067.

[19] Federal Housing Finance Agency, "FHFA Addresses Servicer Liquidity Concerns, Announces Four Month Advance Obligation Limit for Loans in Forbearance," new release (April 21, 2020), retrieved from: https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Addresses-Servicer-Liquidity-Concerns-Announces-Four-Month-Advance-Obligation-Limit-for-Loans-in-Forbearance.aspx.

[20] Neel Kashkari, President and Chief Executive Officer of the Federal Reserve Bank of Minneapolis, recently commented that "there is an infinite amount of cash in the Federal Reserve." See Chappatta, Brian, "Fed's 'Infinite Cash' Put to the Test in a World of Leverage," Bloomberg (March 23, 2020), retrieved from: https://www.bloomberg.com/opinion/articles/2020-03-23/coronavirus-fed-s-infinite-cash-tested-in-world-of-leverage.