PERSPECTIVES

FORBEARANCE MEANS NEW FACTORS FOR TODAY'S MBS MARKET

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By John Bastoni, CFA, Vice President

Recently passed government financial relief packages related to the COVID-19 virus provide payment forbearance to mortgage borrowers. While the provisions benefit cash-strapped borrowers, they also place onerous new financial obligations on mortgage loan servicers. The implications are uncertain for a mortgage-backed securities (MBS) market that was reshaped by regulatory changes following the Great Financial Crisis (GFC) of 2008-2009.

Forbearance measures require loan servicers to assume principal and interest (P&I) and tax and insurance (T&I) payments for borrowers during the term of the forbearance. P&I payments represent an immediate obligation and keep mortgages from defaulting. Servicers draw on escrow accounts for T&I payments. When escrow is depleted, they must cover T&I or tax liens and insurance cancellations ensue. While smaller relative to P&I, T&I payments are still significant.

Under current relief provisions, borrowers can apply for six months of forbearance without any documented financial hardship. Servicers advance the monthly P&I. Ultimately, they are to be reimbursed by the government sponsored enterprises (GSEs, which are Federal National Mortgage Association and Federal Home Loan Mortgage Corporation (FNMA and FHLMC, respectively) and Government National Mortgage Association (GNMA)).

As it relates to MBS, servicer-financed forbearance helps keep loans in MBS pools and can slow prepayments, both favorable factors for MBS and their investors. On the other hand, a change in the mortgage servicing market following the GFC could complicate business conditions for many of today's mortgage servicers.

Often referred to as shadow banks, smaller, non-bank servicers such as Quicken Loans, Loan Depot and others have taken majority market share from larger, bank-sponsored mortgage loan servicing units after the GFC. Stringent capital rules made it more costly for bank servicers to operate in this space, thus opening the door for shadow banks which are not subject to the same capital rules. Generally, the non-bank mortgage loan servicers are not as well capitalized as their bank counterparts, so there is heightened concern about how these servicers will be able to handle the sheer amount of forbearance related advancing.

Through April of 2020, non-bank servicers administer about 60 percent of all GNMA mortgages. According to JP Morgan. They also administer approximately 50 percent of all conventional mortgages, those issued by the FNMA and FHLMC, respectively.

The total amount of loans that may need assistance heightens market concerns. During April, some estimates set forbearance expectations at about 9 percent for GNMA loans and 6 percent for conventional loans. However, estimates vary widely with JP Morgan recently estimating that total forbearance will be in the 7 percent to 15 percent range. At the higher end of that range, total P&I and T&I payments by issuers could reach past $10 billion a month, per JP Morgan.

Due to their increased presence in the mortgage servicing business, the potential size of the obligations they may assume under forbearance, and their relatively lower capitalizations, investors are concerned about the ability of the servicers to meet their P&I and T&I obligations and the potential negative consequences for the housing and MBS markets. Some market participants suggest establishment of a government-backed lending facility to help these servicers meet the increasing capital they will need to perform their duties. To date, it is unclear if such a facility will be created.

Recent developments that may point to some interim steps to manage the potential fallout of forbearance include:

The Federal Home Financing Agency (FHFA), the regulator of agencies issuing conventional mortgages, announced that the GSEs will continue to buy loans that have recently closed, need forbearance, but have not yet sold to the GSEs for ultimate securitization into MBS securities. The announcement helped reassure the market after GSEs stepped back from buying these types of loans, suggesting mortgage origination will continue.

FHLMC, historically, required servicers to advance only four months P&I and T&I. FNMA required 12 months. FHFA policy now aligns both GSEs to a 4-month requirement, enabling more effective capital allocation planning for servicers. The FHFA also extended the terms of qualified repayment plans to 36 months, which could keep loans in pools longer for borrowers both entering and exiting COVID-19 related forbearance plans. From an investor's standpoint, keeping loans in pools increases chances of a workout of loan and pushes MBS loan buyouts (prepayments) further down the road.

These actions will also allow the GSEs to focus their attention, and their balance sheets, on performing loan modifications for borrowers who have seen more severe job and income losses as the result of the COVID-19 related shutdowns and ensuing recession. The approach is viewed as supportive of housing and MBS markets.

We will be watching for further information about a lending facility for servicers. We also are monitoring the sheer rate of forbearance needs, getting insight into how many of those can be worked out, and how that translates into buyout related prepayments.