[PULSE] Mortgage servicers are getting the short end of the stick under the CARES Act

Has the federal government essentially imposed the Defense Production Act on residential mortgage servicers without just compensation?

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By Laurence Platt

Many of you have read about the power of the president to invoke the Defense Production Act to acquire products or direct the activities of suppliers based on a finding that it is necessary for the federal government to intrude into the commercial market for national security reasons. When the federal government uses this authority to acquire, or direct the production of, supplies (such as ventilators, N95 masks, and pharmaceuticals in the COVID-19 pandemic context), it uses contracts and negotiates, on an expedited basis, prices and terms.

In other words, the president can force a seller to disrupt its other customers' orders to fill a government order as a priority. But the power is not absolute. It must pay for the products it procures on a priority basis. The federal government does not have to pay a premium, and the supplier may not seek to charge unjustifiably higher prices, but the federal government must negotiate the price and terms for the purchased products or supplies.

Laurence Platt
Guest Author

Mortgage servicers perhaps would fare better if their services were subjected to the Defense Production Act in order to address the global pandemic's adverse impact on residential mortgage borrowers. At least then, servicers could seek to negotiate fair and timely compensation and reimbursement of advances in connection with their necessary role in implementing the Congressional mandate to provide forbearance for up to one year to residential mortgage borrowers with "federally backed mortgage loans."

This term is defined in the Act to include residential mortgage loans purchased by **Fannie Mae** and **Freddie Mac**, as well as residential mortgage loans insured or guaranteed by the **FHA**, **VA** or the **USDA**'s Rural Housing Service. Instead, mortgage servicers are required to shoulder the short-term financial burden of the natural consequences of providing forbearance to such residential mortgage borrowers without, in the views of many, the benefit of just compensation from the federal government.

Let's accept as a given the public policy rationale justifying the broad grant of forbearance to struggling borrowers in an economy pummeled by the effects of the pandemic with increasing levels of unemployment not seen since the 1930s. Some might quibble with or balk at the specifics — who should get a forbearance? For how long? Should the borrower be required to prove hardship in making mortgage payments due to COVID-19? How are forborne payments repaid? — all relevant questions that are being debated.

But the forbearance provisions under the CARES Act are now law, and the federal agencies whose loans qualify as "federally backed mortgage loans" have announced ever-evolving guidance to implement these statutory provisions and fill out the details. Moreover, the recently House-passed HEROES Act would extend this right to forbearance beyond federally backed mortgage loans to virtually all residential mortgage loans.

But the residential housing finance system is a complicated ecosystem that relies on the synchronization of several moving parts. The Congressional grant of forbearance does not occur in a vacuum — a statutory deferral of regularly scheduled mortgage payments has ripple effects throughout the mortgage ecosystem.

In a private whole loan environment, the failure of a borrower to make a regularly scheduled mortgage payment generally means that the owner of the loan does not receive the missed payment, regardless of the reason. But in an agency mortgage-backed securities environment, the securities holder receives an amount equal to the fractional interest in the missed payment regardless of whether federal law excuses the borrower from making the payment.

Why? Because in the case of mortgage-backed securities guaranteed by **Ginnie Mae**, Fannie Mae, or Freddie Mac, mortgage servicers are required under their servicing agreements to advance the originally scheduled, regular monthly payments of principal and interest (or just interest in the case of Freddie Mac) to the securities holders, even though, as a result of the CARES Act, those payments can be forborne for up to one year and are no longer due and payable in accordance with the terms of the original loan documents.

If the servicers do not meet this advance obligation, the agency guarantee is triggered; the actual beneficial owner of the loan through its interest in a related mortgage-backed security receives its money either way.

This means that holding the proverbial bag — or at least initially bearing the economic risk of a borrower's forbearance — is either the mortgage servicer advancing the forborne payments or the agency that steps in under its guarantee if the mortgage servicer does not meet its contractual advance obligation.

For the mortgage servicer, this economic risk is not necessarily a pure credit risk of loss, but rather more of a timing or liquidity risk; eventually the servicer will be repaid its advances, by subsequent mortgagor payments, mortgage insurance, or guaranty proceeds or reimbursement by the applicable agency investor.

Nevertheless, the mortgage servicer initially has to fund the advances and then wait and wait for the reimbursement. In a COVID-19 pandemic environment, this liquidity risk likely strains the resources of most non-bank mortgage servicers, not because they lack financial strength, but because the parties did not realistically contemplate the impacts of required forbearance for the significant number of loans impacted by the global pandemic in allocating the risks in the servicing agreements.

At least the mortgage servicers are getting paid for their services in connection with the wide-scale provision of forbearance and its aftermath. Well, not exactly. As we detail below, in fact servicers are not paid a servicing fee during the forbearance period and, depending on the investor, may not get paid at all.

Below we provide more detail on servicing advance requirements and servicer compensation in the context of forbearance required to be provided under the CARES Act.

OBLIGATION TO ADVANCE

There are four major economic issues raised by this advance obligation.

1. For how long is the servicer required to make principal and interest or just interest advances?
2. When and how does the servicer get reimbursed for these advances?
3. Is the servicer reimbursed for its cost of funds in making these advances?
4. How does the servicer fund the advances?

Thankfully, the Federal Housing Finance Administration, the conservator of Fannie Mae and Freddie Mac, announced that servicers would have to advance principal and interest, in the case of Fannie Mae, and interest, in the case of Freddie Mac, for only four months of a forbearance, even though the forbearance could last for up to a year under the CARES Act. Four months is better than a year, but it still involves a lot of money as forbearance rates scale upwards towards the double digits.

But keep in mind that the servicer has no beneficial interest in the forborne loans on which it is advancing. It merely is a contract service provider where, for a fee (except as noted below), it administers the collection and remittance of mortgage loan payments and the enforcement of the mortgage loan documents. Ginnie Mae requires advances for so long as the forborne loan remains in the related pool, although the servicer may purchase the loan out of the pool (which also takes money) after 90 days and must repurchase a loan to be modified.

The Fannie Mae Servicing Guide and the Freddie Mac Seller-Servicer Guide address when and how the applicable agency reimburses the servicer for its four-months of principal and interest or just interest advances, although this information is hard, if not impossible, to find. As an interim or temporary measure, it appears that a servicer can reimburse itself for such advances from excess custodial funds due to full principal prepayments, but if there is insufficient excess the servicer has to come up with its own funds and wait for reimbursement.

It is likely that Fannie Mae will replicate its reimbursement policy for P&I advances for loans in forbearance in the same way that it handles delinquent loans following “reclassification” — namely, at the end of the four-month advancing period, as a credit against pool remittances.

On the other hand, although it is not clear in the Freddie Mac Seller-Servicer Guide, we understand that Freddie Mac does not reimburse interest advances until after a loan is worked out (including upon entering into a deferral plan) or liquidated, regardless of whether the advance obligation has ceased at 120 days, also as a credit against pool remittances.

Ginnie Mae does not reimburse the servicer for advances. Instead, reimbursement comes through mortgage insurance/guaranty claim proceeds subject to certain deductions outlined in the applicable regulations and, in the case of VA and the USDA’s RHS, the possibility of a permanent principal write down to align the claims payment with the fair market value of the mortgaged property. Claims are conditioned on foreclosure of the mortgaged property, although FHA has a process for earlier payments for “partial claims,” as does the RHS for “mortgage recovery advances.”

Fannie Mae, Freddie Mac, and Ginnie Mae do not reimburse a mortgage servicer for its cost of funds when making principal and interest advances. Maybe servicers are reimbursed indirectly by getting the float benefit on the funds in the custodial accounts, but there is no specific reimbursement for the actual cost of funds borne by mortgage servicers to make principal and interest advances.

Although they have done so in the past, neither Fannie Mae nor Freddie Mac provides servicing advance facilities to enable servicers to fund required advances. Nor has the Federal Reserve Board or **Department of Treasury** provided a mortgage servicing advance facility or guaranteed a private servicing advance facility.

Compare this to Ginnie Mae, which in March announced its “Pass-Through Assistance Program.” Under PTAP, Ginnie Mae provides short-term advance facility, as a last resort, to help servicers make advances resulting from the forbearance required under the CARES Act. But servicers that avail themselves of this option must execute a Supervisory Agreement as a condition to obtaining a PTAP line and must pay interest on the advances.

SERVICING COMPENSATION

Fannie Mae, Freddie Mac, and Ginnie Mae each provides for the payment of a servicing fee for servicing each pooled mortgage. The fee is based on, and payable only from, the interest portion of each monthly installment of principal and interest actually collected by the servicer on the mortgage. If no payment is collected from the borrower, then no servicing fee is

payable to the servicer. If a loan subsequently reinstates, including through a modification, the servicing fee is once again payable on subsequent monthly payments.

But Fannie Mae does not ever pay the accrued but unpaid servicing fee during the forbearance period (or during a subsequent delinquency). Fannie Mae, I understand, is considering whether and how it may pay this accrued but unpaid fee. I have heard third hand that it may pay such accrued fees in the case of a payment deferral.

This is in contrast to Freddie Mac. In the case of a modification, the accrued but unpaid servicing fee is payable at the time of modification either as a credit against pool remittances or as a credit for reconciliation on the modification. I understand this to be true but cannot find a source for this in the Freddie Mac Seller-Servicer Guide. I have heard informally that Freddie Mac intends to treat servicing fees accrued during the forbearance period in the same way, and yet such credits could take up to a year to be realized by the servicer based on the borrower's right to forbearance under the CARES Act.

Both Fannie Mae and Freddie Mac have publicly announced plans to pay a one-time, $500 incentive fee to a servicer upon entering into a payment deferral plan with the borrower and the borrower's resumption of regularly scheduled monthly payments.

Ginnie Mae does not pay or cause to be paid accrued servicing fees. For FHA-insured loans, the servicer can reimburse itself from partial claims proceeds if the borrower qualifies for that option. Neither the VA nor RHS presently has a partial claims process specific to forborne loans subject to the CARES Act, though both are considering. If the loan (regardless of type) reinstates and is eligible for re-pooling into a new Ginnie Mae MBS, the servicer indirectly can recover the accrued but unpaid servicing fees from MBS sales proceeds.

CONCLUSION

Given the economic pressure on servicers of "federally backed mortgage loans" subject to the CARES Act's forbearance provision, some might argue that Congress and the federal agencies indirectly have deputized private mortgage servicers as if they were public resources to mute the impact of COVID-19 on residential mortgage borrowers.

Unlike government workers or government contractors, however, they are not getting paid for their services. OK, maybe the analogy to the Defense Production Act is imperfect. On one hand, like the Defense Production Act, the federal government essentially has used federal law, albeit a statute instead of an executive order, to marshal the resources of mortgage servicers to implement the forbearance provisions of the CARES Act and its natural consequences to address a national emergency. Yet, unlike the Defense Production Act, the federal government is not negotiating with the mortgage servicing industry to compensate it fairly for the increased costs to the servicers resulting from providing forbearance and its aftermath.

Mortgage servicers are getting the short end of the stick under the CARES Act. Unlike the decade-old financial crisis, it cannot be argued that the mortgage industry created the problem underlying the need for borrower relief. Rather, Congress unilaterally altered the original mortgage loan terms without requiring a borrower to demonstrate that the borrower needs the relief.

At their own cost, servicers have to fund advances of regularly scheduled payments of principal and interest or just interest to agency securities holders, unless there is sufficient excess custodial funds to fund on a temporary basis. They have to make these advances for four months of forbearances in the case of Fannie Mae and Freddie Mac, and even longer in the case of Ginnie Mae unless they utilize Ginnie Mae's early pool buy-out options. They do not get reimbursed on a real time basis, having to wait for months to be repaid. And all the while, they are not being paid a servicing fee for the privilege. At the same time, servicers are subject to a constant barrage of criticism from virtually all corners that they are not providing enough staff and resources (for free) to help borrowers through their financial hardships.

Again, there is nothing really new about much of this servicing compensation paradigm. The difference is the scale of the obligation and the magnitude of the economic effects on the servicer as a result of federal statutory mandate to provide forbearance to borrowers for up to a year.

It is unlikely that any mortgage servicer thought it was signing up for these economic obligations and risks when it became an approved participant in the Ginnie Mae, Fannie Mae, and Freddie Mac single-family home loan programs as a mere service provider. Mortgage servicers are essential businesses in the effort to protect borrowers from the financial hardship due to COVID-19. The problem is that, in many ways, they are doing it on their own nickel. Where is the fairness in that?