[PULSE] Passing the hot potato of forbearance

Where should the risk fall?

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So, what do you do if you are an arm of the federal government that has to manage your own balance sheet and yet implement the Congressional mandate under the CARES Act to provide forbearance to borrowers with federally-backed loans? Add to that, these borrowers only need to state they are experiencing a negative impact resulting directly or indirectly, from COVID-19.

Do you assume all of the financial risk because your very existence is predicated on furthering public policy to promote single-family homeownership? Do you allocate all, or a portion of, the financial risk through either higher pricing to consumers or mortgage lenders or sharing credit losses with those lenders?

We recently have addressed some of the consequences to mortgage servicers resulting from the COVID-19-related grant of forbearance.

But, what about post-origination, pre-loan sale/insurance endorsement consequences resulting from borrowers who qualified for a loan as of loan closing but then seek forbearance soon thereafter?

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Complications:

Under the CARES Act, the borrower does not have to prove a financial hardship due to COVID-19 that materially impaired the borrower's ability to make mortgage payments. Nor

does the borrower have to attest to or document a material change in financial circumstances post-closing, such as the loss of a job or an extended illness.

The CARES Act is crystal clear on the borrower's right during the "covered period" to forbearance on a federally backed loan based solely on an attestation of financial hardship due to COVID-19. This means that a borrower has a statutory right to forbearance the day after loan closing if the borrower makes the required attestation.

The CARES Act does not make it a crime for a borrower to make a false attestation. Indeed, given the percentage of loans in CARES Act forbearance status that remains contractually current under the loan terms, it appears that many borrowers are seeking forbearance as a form of insurance to protect them in the case they ultimately are unable to make regular mortgage payments due to COVID-related economic issues. They are not trying to scam the system. Rather, they are trying to build their defenses in case of subsequent adverse consequences based on existing negative impacts of COVID-19 that may impact their ability to make timely mortgage payments in the future.

Federal entity responses:
FHA and **FHFA** each recently confronted this conundrum in determining whether to insure or permit purchase of residential mortgage loans that a lender in good faith closed based on a borrower's documented income, but then the borrower sought forbearance in accordance with the CARES Act soon after loan closing. FHFA first declared that the GSEs could not purchase loans in forbearance, but then back-tracked and instead permitted the purchase of forborne loans subject to hefty loan-level pricing adjustments.

FHFA did not extend this new direction to cash-out re-financings that are in forbearance at the time of sale. FHA recently announced that it would insure loans in forbearance, but the lender has to agree to indemnify **HUD** for the losses. That could amount to 20% of the initial loan amount if the borrower fails to make two or more payments when due under the terms of the mortgage at any point within two years from the date of endorsement and the borrower remains in default until the FHA insurance claim filing, unless the forborne loans reinstate or are modified.

In both cases, the federal entity at some level sought to share the risks of forbearance with the mortgage originator or seller.

But this approach begs the question of why should a lender or seller share any of the risk of a borrower's exercise of a statutory right to forbearance?

Should the lender share any risk?
Think about it. As written, forbearance only is available to borrowers under federally backed mortgage loans, which term is defined in the CARES Act to mean loans sold to the GSEs or insured or guaranteed by FHA, **VA** or RHS.

But, a loan originated with the specific intent to become a federally backed mortgage loan does not enter through the gate of federal backing under the CARES Act unless and until the loan actually is sold to the GSEs or insured or guaranteed by the FHA, VA or RHS. If these federal entities choose to post a "keep out/no trespassing" sign to forborne loans, they may be violating the spirit of the CARES Act but not its explicit provisions. Given their own balance sheet concerns and constraints, why should they voluntarily assume the risk of potential losses on loans for which a borrower has attested to financial hardship due to COVID-19, even if the borrower did not either document this hardship or attest to its impact on the borrower's ability to make regular monthly mortgage payments?

After all, the lender owns the loan, shouldn't it bear the risk?

On the other hand, the lender or seller did not do anything wrong either. If it did fail to underwrite the loan properly in the first place, that is a separate issue, and all of the federal agencies and GSEs have remedies in place, such as indemnification or repurchase, for such origination defects. But, if the lender did originate the loan in accordance with investor/insurer requirements, why should a post-closing change in circumstance resulting directly from a Congressional act impair the lender's or seller's ability to fulfill the original intent to cause the loan to be a federally backed mortgage loan?

Law often addresses who should bear the risk as between two innocent parties, and public policy often is the driving force. So, what's the operative public policy in this case?

One point to note is that the FHA and the GSEs would fully bear the risk of forborne loans if the loans were insured or sold simultaneously with their closing. Unfortunately, there usually is a timing gap between closing and insurance or sale, depending on the applicable approvals of the lender or the time to conduct post-closing quality reviews and the mechanics of closing, purchasing and selling loans. Maybe lenders or sellers can mitigate the risk by seeking to shorten this timing gap, but an overly exuberant quest to "mind the gap" may undermine the lender's or seller's post-closing quality reviews. That result is not in the interest of any of the relevant stakeholders.

Reasonable people may differ on this one but, for my money, the federal government should bear the risk of a borrower seeking forbearance soon after loan closing in accordance with the CARES Act. The alternative creates an unhealthy disincentive for lenders not to lend or selectively increase prices at the very time the economy needs to foster lending to help the economy.

Let's take the FHA for example. Requiring the lender to bear a portion of the credit risk of loss for two years on a loan that went into forbearance after closing but before insurance endorsement essentially converts the full insurance program of the FHA to a co-insurance program. Yet, the FHA keeps the entire mortgage insurance premium. This is akin to a reinsurance arrangement where the risk of loss slice is based, not on the amount of the loss, but the timing of a forbearance election–and, again, without a sharing of the mortgage insurance premiums to compensate the lender for assuming this risk of loss. By the way, the FHA eliminated its co-insurance program for single-family mortgage loans many years ago.

Front-end loan level pricing adjustments required by FHFA on GSE loans may be even worse than back-end partial indemnities because this cost immediately is absorbed in full while an economic loss under an indemnity is realized only if the loan does not reinstate or is not modified. By definition, there will be fewer forborne loans that fail to reinstate or get modified than there are forborne loans. This means that the dollars may not be great in the FHA context, but no one reliably can predict the magnitude of potential losses to be covered by the partial indemnity while the COVID-19 pandemic still rears its ugly head. Moreover, one can't help but wonder whether this uncompensated risk-sharing arrangement may serve as a template for future efforts to insulate the Mutual Mortgage Insurance Fund from credit losses through a re-allocation of risk to the lender.

Maybe it is commercially reasonable for a governmental entity to avoid the risk associated with buying or insuring/guaranteeing a loan in forbearance when it is not legally required to do so. But, is it right from a public policy perspective? FHA is not a private mortgage insurer. It exists solely to promote a public purpose. Similarly, as much as FHFA may want the GSEs ultimately to be privatized, they presently rely on their quasi-governmental status for a number of benefits and must meet public policy housing goals in its purchase of loans.

If mortgage lenders and servicers were entitled to act in a purely commercial manner, they would not grant forbearance to borrowers who fail to demonstrate need and they would

synchronize the duration of any such forbearance with the duration of the demonstrated need.

Unfortunately, by virtue of the CARES Act, private lenders and sellers do not have the luxury to operate in a commercially reasonable manner—they must afford borrowers the rights granted to them under federal law.

Furthering the public purpose behind the CARES Act should prevent the federal government from asserting that it has no responsibilities to take on a loan that is intended to be a federally backed mortgage loan, as defined by the CARES Act, but, because of some short-term timing delays, has not yet achieved that status.

All of the housing-related federal entities deserve kudos for many of their quick and decisive initiatives to help borrowers in light of COVID-19 and the CARES Act. This, however, in my judgment, is not one of them.