Adjusting the COVID-19 Flex Mod to Deliver Payment Reduction to More Borrowers in Need

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Introduction

While most homeowners with GSE-backed mortgages have recovered from pandemic-related hardships and reinstated their mortgage, as of June 7, about 1.6% of outstanding GSE borrowers were in a state of nonpayment: about 140,000 GSE-backed loans were in COVID-19 Forbearance, and another roughly 300,000 loans were delinquent outside of forbearance.[1] For those GSE borrowers who were less than 2 months delinquent as of the onset of the pandemic who cannot resume their originally scheduled monthly payments due to ongoing pandemic-related financial hardship, the GSEs offer the COVID-19 Flex Modification (Flex Mod), which targets a 20% reduction in the monthly principal and interest (P&I) payment to create an affordable monthly payment for the borrower. Analysis from post-Great-Recession modifications provides compelling evidence that substantial payment reductions are critical to avoiding subsequent re-defaults and foreclosures.[2]

However, because of the recent rise in mortgage rates and two years of significant house price appreciation (HPA), the COVID-19 Flex Mod will not be able to reach the 20% P&I reduction target for nearly all of the remaining borrowers who need assistance. With the rise in house prices and interest rates over the past year, over 95% of borrowers are denied the tool of principal forbearance to reduce their payments and a large percentage will not be able to reduce their interest rates.

We do not expect that the GSEs can adopt a policy of providing every borrower with principal forbearance up to the 30% of UPB limit given the GSEs' sensitivity to the cost. However, borrowers with an MTMLTV between 50% and 80% should be given the choice between substantial payment relief at or close to the COVID-19 Flex Mod target and selling their home. Therefore, to provide GSE borrowers facing continued pandemic-related hardship with the substantial payment reductions that the Flex Mod targets, the GSEs should adjust the COVID-19 Flex Mod to permit principal forbearance up to an amount that creates a post-modification MTMLTV ratio of 50% or greater, rather than the current 80%. While we suggest a 50% MTMLTV cutoff, we do not have access to a distribution of GSE MTMLTVs; based on that distribution, FHFA may determine that the cutoff should be lower than 50%.

The Current COVID-19 Flex Mod

The current Flex Mod for COVID-19 Impacted Borrowers includes the following waterfall steps:[3]

1. Capitalize arrearages.
2. Set the modification interest rate to the lesser of
    a. The Fannie Mae or Freddie Mac Modification Interest Rate, or
    b. The borrower's current contractual interest rate.
3. Extend the term to 480 months from the modification effective date.
4. If the post-modification MTMLTV ratio is greater than 100%, forbear principal in an amount that is the lesser of
    a. An amount that would create a post-modification MTMLTV = 100% using interest-bearing UPB, or
    b. 30% of the gross post-modification UPB.

5. Provide or increase principal forbearance until a 20% P&I payment reduction is achieved, provided that the forbearance is limited to an amount:
    a. That creates a post-modification MTMLTV = 80% using interest bearing principal, and
    b. Does not constitute more than 30% of the gross post-modification UPB.

Interest rates have risen. Since the turn of the year, the 30-year conforming mortgage rate has risen nearly 240 basis points, from 3.41% to 5.79%.[4] The rise in rates is naturally reflected in the modification interest rate used in step 2 of the Flex Mod: at the beginning of 2022 the rate was 3.125%, but today is 5.25%.[5] Most of the loans that remain in forbearance or delinquency have a note rate below 5.25% and therefore will not get any payment relief from interest rate reduction (step 2 of the waterfall).

House prices have increased. Furthermore, since the onset of the pandemic, house prices at the national level have risen by 36%.[6] *Of the GSE-backed mortgages in loss mitigation as of February 2022, 95% had an MTMLTV below 80%.*[7] Therefore, as per the current Flex Mod waterfall, *nearly all GSE borrowers will be ineligible for principal forbearance* (steps 4 and 5), leaving term extension to 480 months (step 3) as the only available lever to generate payment reduction.

As a result, Flex Mod offers limited payment relief. In isolation, term extension offers limited payment reduction. For example, suppose a family purchased a home in late 2019 using a $250,000 4% GSE-backed mortgage with an 80% LTV at origination. Facing COVID-related financial hardship, they entered forbearance and have missed 18 monthly payments. As they exit forbearance today, if their house has appreciated at the national rate, their MTMLTV will be around 64% after capitalization of arrearages. *Extending the term of their mortgage to 40 years will reduce their P&I payment by 5%, which may not create an affordable payment*. Even if the family in our example had a HomeReady or Home Possible loan with a 97% LTV at origination, HPA would have reduced their MTMLTV to 77% and the Flex Mod would only reduce their P&I payment by 5%.

The impact of higher mortgage rates and continued HPA is evident in the amount of P&I reduction being delivered by the Flex Mod. Recent analysis indicates *that as of June 7, just 22% of Flex Mod recipients would reach the 20% P&I reduction target*, and the average recipient would receive a 16% P&I reduction.[8] The analysis was conducted as of June 7, 2022, when the modification interest Rate was 5.00%. With the modification interest rate now at 5.25%, even fewer Flex Mod recipients will be able to reach the 20% P&I reduction target today and the average P&I reduction will be lower.

Forcing borrowers below 80% MTMLTV and at or over 50% MTMLTV to sell their house or go through foreclosure is harmful. While the HPA-driven increase in equity for these borrowers will allow some facing ongoing financial difficulty to sell their home at a profit, alternative housing may be no less costly than their current mortgage payment. Rents have increased considerably in the last 2 years,[9] and continuing HPA makes finding and purchasing a less expensive home a challenge. And the increase in mortgage rates mean that even if a less expensive house is available and the consumer can qualify for a new mortgage with possibly damaged credit, the monthly mortgage payment may not be any more affordable than the borrower's current monthly payment.

Those homeowners who do not receive sufficient payment reduction from the Flex Mod and are unable to sell their home will be faced with losing their home to foreclosure or a foreclosure alternative. Foreclosures are costly to all the parties involved, including the GSEs, the mortgage servicer, the foreclosed-upon homeowner, and their neighbors. In addition to the monetary cost, foreclosure also has considerable negative side effects for the homeowner, including increased housing instability, reduced probability of future homeownership, increased delinquency on other debts, and adverse health outcomes. The GSEs can reduce the probability borrowers end up in foreclosures by adjusting the Flex Mod to provide more access to principal forbearance to reach the target 20% P&I reduction.

Low-income and Black and Hispanic borrowers between 50% and 80% MTMLTV are disproportionately impacted. Because the negative effects of the pandemic have been disproportionately borne by lower income and Black and Hispanic households, adjusting the Flex Mod to provide more GSE borrowers facing financial distress with substantial payment relief would be well-aligned with the GSEs' affordable housing mission and Equitable Housing Finance Plans. As of early June, borrowers in the lowest income quartile at origination were three times more likely to be past due or in forbearance compared to borrowers in the highest income quartile; similarly, Black borrowers were more than twice as likely and Hispanic borrowers were 50% more likely to be past due or in forbearance as compared to White borrowers.[10]

The GSEs Should Permit Borrowers to Forbear Principal if the MTMLTV is greater than or equal to 50%

To allow more GSE borrowers facing continuing financial hardship due to COVID-19 to reach the 20% P&I reduction target, FHFA should consider amending step 5 of the Flex Mod to allow principal forbearance as long as the post-modification MTMLTV remains at or above 50% rather than the current 80% limit. Taking this step would allow borrowers with an MTMLTV between 50% and 80% facing financial hardship to choose between selling their home or accepting a modification that can deliver the target 20% P&I reduction rather than making them choose between selling their home or entering foreclosure.

With the MTMLTV limit reduced to 50%, the family with the $250,000 4% mortgage from our example above would receive a 20% reduction in their P&I payment regardless of whether they made a 20% or 3% down payment. In both cases their MTMLTV would be above the 50% limit, and step 5 of the adjusted Flex Mod would forbear about $40,000 of principal to reach the 20% P&I reduction target. Note that the amount of principal forbearance required to reach the target in this example is 16% of gross post-modification UPB, well below the 30% limit in step 5 of the waterfall.

GSE cost is limited. Providing principal forbearance comes at a cost to the GSEs because the amount of forborne principal is not interest-bearing, but that cost is modest. As a rough approximation, the cost of providing principal forbearance as a percentage of UPB is equal to:

Principal Forbearance as a Percentage of UPB x Per Annum Borrowing Cost x Mortgage Duration.

Assuming the GSEs can borrow at 3% per annum and a mortgage duration of 7 years, it would cost the GSEs about 3.4% of UPB to provide the principal forbearance in our above example.

At least a portion of the cost of providing principal forbearance will be offset by fewer future losses, as the additional payment reduction would be expected to reduce foreclosures. Based on recent dispositions, foreclosing a mortgage with an MTMLTV of 80% results in a loss for the GSEs. From 2015 to 2019, the expenses net of proceeds (excluding sales proceeds) for Fannie Mae dispositions averaged 26% of UPB.[11] Even if Fannie Mae were able to sell the foreclosed-upon property at a 125% of UPB, the result would still be a small loss. Should house prices reverse course and decline, foreclosure-related losses would naturally rise.

To provide a comparison, the cost of providing principal forbearance (3.4%) is just 9% of Fannie Mae's long-term loss severity rate (38%) and just 21% of their 2021 loss severity rate (16%).[12] In the context of the much greater historical loss severities and the substantial negative impacts of foreclosure on the foreclosed-upon homeowner and their neighbors, the cost of reducing the MTMLTV limit for principal forbearance in the Flex Mod to 50% and allowing more GSE borrowers to reach the 20% payment reduction target and keep their homes would be a small but worthy investment.

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[1] https://www.philadelphiafed.org/-/media/frbp/assets/consumer-finance/reports/22-06_tracking-resolutions-of-mortgage-forbearances-and-delinquencies.pdf.

[2] See Liquidity versus Wealth in Household Debt Obligations: Evidence from Housing Policy in the Great Recession (cpb-us-w2.wpmucdn.com).

[3] https://singlefamily.fanniemae.com/media/25121/display.

[4] Optimal Blue Mortgage Market Indices – Optimal Blue as of June 30, 2022.

[5] https://sf.freddiemac.com/general/freddie-mac-modification-interest-rate.

[6] Calculated as the change in the FHFA Monthly Purchase Only Index from March 2020 to March 2022 (the most recent date available) sourced from: House Price Index Datasets | Federal Housing Finance Agency (fhfa.gov).

[7] Foreclosure Prevention, Refi, and FPM - February 2022 (fhfa.gov).

[8] https://www.philadelphiafed.org/-/media/frbp/assets/consumer-finance/reports/22-06_tracking-resolutions-of-mortgage-forbearances-and-delinquencies.pdf.

[9] For example, at the national level the Zillow Observed Rent Index increased by 21% between March 2020 and May 2022. Housing Data - Zillow Research.

[10] These statistics are for all mortgages, not just GSE-backed loans. https://www.philadelphiafed.org/-/media/frbp/assets/consumer-finance/reports/22-06_tracking-resolutions-of-mortgage-forbearances-and-delinquencies.pdf.

[11] We use the 2015 – 2019 period to avoid the foreclosure moratorium. Fannie Mae Statistical Summary Tables.

[12] Fannie Mae Statistical Summary Tables.