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LOSS MITIGATION CHALLENGES MORTGAGE SERVICERS CANNOT UNDERESTIMATE

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I. RISING INTEREST RATES AND WANING CONFIDENCE IN THE LOAN MARKET

The US mortgage market remains in the grip of uncertainty. The pandemic had a clear impact – it was estimated in March 2022 that 8.5 million borrowers had asked for loan forbearances to postpone their mortgage payments.[1] A year later, the unprecedented growth nationally in housing prices came to a halt, presenting sudden challenges for the mortgage servicing industry. Specifically in March of this year, the unadjusted national S&P CoreLogic Case-Shiller rose 1.30%, which is only 3.60% below the June 2022 peak. While this shows tempered growth, year-over-year prices in many western states have started to decline for the first time in over 10 years.[2]

These trends, combined with rising inflation and fears of a recession, have brought mortgage servicers and borrowers center stage to tackle rising loan defaults for the first time since 2008. Prior to the 2008 mortgage crisis, the average 30-year fixed mortgage rate had never been below 5% and ranged between 6-8%,[3] so loss mitigation strategies (i.e., adjustments to loan terms and balances to avoid foreclosure) were predominantly ruled by lowering interest rates.

As a result, borrowers enjoyed lower monthly payments, thus encouraging loan performance while allowing servicers to keep Unpaid Principal Balance (UPB) untouched. This was a best-case scenario for servicers since UPB is the dominant metric considered by secondary market purchasers when acquiring loans and MSRs (mortgage servicing rights).

Over the past decade, however, the average 30-year mortgage rate has not risen above 5% and fluctuated between 3.50-4.50%, meaning that servicers are now limited to address loss mitigation requests by offering lower interest rates. The variables in calculating mortgage payments are principal, interest rate, and term. As interest rates are limited, servicers will have to strategize how to provide borrowers relief by leveraging unpaid principal balance (UPB) and mortgage terms.

There have also been substantial technological advances since 2008 in the domains of data management and analytics, servicing software, and automation that servicers may incorporate into their procedures to improve the quality of their offerings and provide efficiency to their processes. In conjunction, to beat the competition in today's market, servicers will have to develop new techniques and incorporate automation and data-driven decision-making into their organizational loss mitigation strategy.

II. LOSS MITIGATION TECHNIQUES

Stagnation in diligent loan servicing is becoming a widespread problem. Early this year, the Consumer Financial Protection Bureau (CFPB) reported that 16 large mortgage servicers informed them that at the end of 2021 that over 330,000 borrowers' loans remained delinquent with no loss mitigation solutions in place.[4] By the end of Q4 2022, the seasonally adjusted mortgage delinquency rate increased to 3.96%, up 51 basis points from the third quarter, but still 69 basis points lower than the same period a year earlier. Also, in Q4 2022, a lower percentage of loans – 0.14% – were subject to the first steps toward foreclosure.

A growing concern are the actions being taken by the Federal Reserve. Effective July 26, 2023, the Federal Reserve raised short term interest rates by a quarter of a percentage point. The federal funds rate now finds itself in a target range of 5.25% to 5.50% – the highest level in 22 years.[5] With the Fed's sights set on targeting inflation at 2%, this will trickle down to loan origination activity where homebuyers will incur higher monthly payments with this latest rate hike (tenth this year) – and overall demand will thus be curbed.

To adjust to this market tightening while addressing the gaps in loss mitigation, servicers will need to assess the feasibility of the following strategies when working alongside borrowers.

Interest Rates. When interest rates are low, and borrowers have no issues maintaining monthly payments, there is little to no incentive for borrowers to change the status quo. For example, seeking refinancing is rarely a consideration as holding the existing debt is cost-effective. Again, in 2008, this was an easy plug and play solution for servicers to turn non-performing borrowers into consistent payers.

Conversely, when interest rates are high, borrowers tend to struggle with decreasing UPB, thus enduring greater financial stress. For many borrowers, who have a growing track record of delinquency and feel there are no other options for recovery, filing for bankruptcy to avoid foreclosure is seen as a failsafe.

For disengaged borrowers who simply throw in the towel and do not respond to delinquency notices, pursuing collection of UPB and late fees becomes time consuming and costly. Servicers not only endure obstacles like non-responsiveness to achieve loan resolution, but they also usually see a surge in demand for loan modifications and forbearances from borrowers who are adamant that they will not resume payments unless relief is granted.

With interest rates expected to continue to rise, servicers must regularly assess both a borrower's ability and willingness to make mortgage payments at the portfolio and individual loan levels when deciding to approve loss mitigation requests. From a macro perspective, this ongoing loan analysis and decision-making needed from servicers is on par with current banking industry concerns.

According to the Federal Reserve's quarterly Senior Loan Officer Opinion Survey (SLOOS) released in May, 80 large US banks reported that they are tightening lending standards, which means home purchases, car purchases, and other larger purchases will be less common this year.[6]

For established homeowners, the mortgage market's primary driver of demand and supply for loan modifications and forbearance is interest rates. Fluctuations in interest rates impact servicers' decision-making and trickles down to borrowers. Depending on the nature of a given loan, servicers are paid differently. In contrast to servicers of private-label securities (PLS) who are paid a proportion of the outstanding principal balance, government-backed loan servicers (such as FHA, VA, or USDA) are paid a flat fee per loan. The various incentives have an impact on how servicers prioritize and use their resources for loss mitigation.[7]

In the next section, the regulations for loss mitigation options for government-backed loans are outlined to provide insight into this methodology of fee income, which is a bedrock for servicers. As a result of these regulations, borrowers currently have more relief options available. While the incentives are present for servicers to extend these options, it may come at the cost of overlooking new ways to approach loss mitigation that can save costs in the long run.

Defer Unpaid Principal Balance (UPB). Generally, UPB is interest bearing and must be paid at loan maturity. However, when UPB is deferred, it can become non-interest-bearing, and any form of deferment presents obstacles for servicers. If the deferred UPB is interest-bearing, this portion of the loan balance would be due at maturity, or when the loan is settled either through refinance or sale of the underlying collateral. If the deferred balance is set aside without interest and not amortizing, this portion would be due in the form of a balloon payment.

Either way, understanding how interest rate changes can affect loan performance and key metrics (UPB) in the event of financial hardship or default is important for both borrowers and servicers. In particular, loan-to-value (LTV) is under threat as the likelihood that servicers will not be able to recover their losses in the case of a foreclosure is increasing with deteriorating housing market conditions. As of June 2, 2023, US home sales fell by 22.60% from the previous year.[8]

As LTV calculations are a foundation for loan modifications, this is troublesome for loss mitigation specialists. Higher LTVs, especially those above 100%, are a red flag for servicers as it means a lower likelihood of recovering UPB down the road. To counteract high LTV situations, servicers are highly incentivized to keep loans performing, and deferring UPB supports this while benefiting both borrowers and servicers.

Borrowers get relief in reduction of monthly payments, and servicers can keep loans performing while preserving the right to collect on the deferred principle in the case of future refinance or home sale. However, the cost of UPB deferment is currently becoming riskier for servicers to inherit because of decreasing collateral value.[9]

Extending Loan Term. A loan modification in the form of a maturity extension allows borrowers additional time to improve performance and make plans for a loan payoff. Loans with longer terms that begin to enter the territory of 30 years have higher interest payments because full recovery is pushed out, and income from monthly principal and interest payments needs to offset that risk.

Furthermore, longer loan terms increase the likelihood that something will affect the borrower's financial situation before the loan is entirely repaid. This is why it is important for servicers to take a wholistic approach when evaluating a borrower's loss mitigation application that goes beyond running a credit report and obtaining real estate appraisals.

When it comes to utilizing maturity extension as part of a loss mitigation strategy, it remains a low-yield solution. As of April 1, 2022, HUD now allows mortgagees to modify qualifying loans to 40-year terms, which is an increase from the traditional 30-year term. This shift will likely prolong actualizing returns on loans for mortgage servicers.

III. STRATEGIC APPROACHES TO CURRENT REGULATIONS AND MORTGAGE POLICIES

DEFAULT SERVICING AUTOMATION

In light of rising rates and inflation, combined with fears of a recession, it is essential that servicers begin to review their loss mitigation toolkits. Specifically, they need to revamp their policies and systems to respond to the expected rise in defaults. The current unprecedented rise of delinquencies in the car loan market, often an indicator for the housing market, shows that servicers need to start preparing for a rise in delinquent home loans.[10] To better prepare for unfavourable economic cycles, digitization and automation in loss mitigation can help reduce costs and provide better analysis for loss mitigation decision-making.

Having systems that automate matching eligible borrowers to loss mitigation options and streamline associated documentation requests can save time and promote operational efficiencies.

From a compliance standpoint, automated solutions combined with more centralized data can provide a roadmap for servicers to appropriately identify proper and approved loan workout methods. Organization-wide adoption of programs improving the management and analysis of servicers' data can improve a servicers ability to quantify and measure the drivers of borrowers' defaults.

Leveraging key trends in real-time such as local market movement, job loss, DTI, and LTV promote a proactive rather than reactive approach to default servicing and loss mitigation. Since much has changed since the 2008 mortgage crisis, servicers must review their policies and procedures, including leveraging automation, to thrive in the current market.

DATA-DRIVEN LOSS MITIGATION

Beyond all the common loan metric data (UPB, Interest Rate, Default Rate, Fees, Loan Term, Lien Positions, etc.), developing a solution that integrates market data and additional borrower insights into loss mitigation practices can help servicers recapture the most value possible for defaulted loans. Through data analytics, lenders can segment borrowers based on payment tendencies, income demographics, and key performance indicators (KPIs) based on loan type to prepare for a continued rise in defaults.

By the end of Q4 2022, the total delinquency rate for conventional loans increased 26 basis points to 2.78% over the previous quarter. The FHA delinquency rate increased 209 basis points to 10.61%, and the VA delinquency rate increased by 45 basis points to 4.16%.[11] Servicers must factor in these variations in the market to effectively develop strategies for maximizing return while mitigating risks.

One permutation that can be integrated into servicers' strategies is identifying income streams more succinctly, in particular, differentiating gig earners, who commonly present more challenges to income verification than W-2 earners. As noted earlier this summer in the New York Times: "Most estimates, including from federal data and academic studies, suggest that 10 to 15 percent of US workers rely on or participate in alternative or gig work, though some tallies suggest as many as a third of US workers occasionally receive some kind of supplemental income from this work."[12]

Calculating and soliciting alternative income streams from applicable borrowers can improve DTI ratios and make loss mitigation solutions more attainable. Depending on the information received by servicers and the accuracy of the documentation, data models that utilize factor rating and weighting can help mitigate risk while considering that more than a third of the working population generates income by freelancing. This must be considered for loss mitigation strategies as debt servicing capabilities from the borrower side continue to evolve along with the definition of work.

As far as market data, local unemployment and regional job growth are strong indicators of the future financial strength of borrowers. Conversely, dips in these metrics can be an indicator of probable defaults in the future, especially for jobs that are being replaced by AI and machine learning.

Categorizing jobs by industry and assigning stability ratings can make a difference for servicers who have large portfolios of loans to manage and cannot accelerate efforts on certain subsets of defaulted borrowers. For instance, it has been suggested that the top industries to be impacted by AI are banking and finance, media and marketing, and legal services.[13]

Taking a step further and understanding the impact on AI job replacement for financial advisors and accountants, data-entry roles, news personnel, and paralegals could pinpoint loans with a higher risk of default and empower servicers to offer more comprehensive loss mitigation solutions.

IV. CONCLUSION

The current housing market differs substantially from the 2008 housing market, meaning servicers cannot simply 'dust off' prior strategies. Advances in data management and analytics permit servicers to leverage key indicators to develop strategies to target specific sections of the housing market offering borrowers more tailored solutions that better fit their circumstances.

Servicers who leverage their data properly can better identify potential risks allowing for a more proactive approach to default servicing and loss mitigation. To overcome the challenges facing servicers, they must consider the techniques available in the face of rising interest rates and seek to leverage automation and data-driven loss mitigation to maximize returns while controlling risks.

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