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What Will New Mortgage Modification Options Mean for Buyouts?

By year end, over half of Government-Sponsored Enterprise "GSE" (conventional) forbearance plans and approximately 70% of Ginnie Mae forbearance plans are estimated to expire. Conventional buyouts have been minimal thus far, but an updated Flex Modification option could lead to future GSE buyouts. Buyout risk for Ginnie-backed mortgages remains greater than conventionals, especially as a recently-introduced COVID-19 modification program for FHA loans could increase buyouts. However, these modification options are unlikely to drastically impact the market.

Buyouts have been a non-event in conventional mortgages because the GSEs pledged not to buyout loans until they are at least 24 months delinquent (subject to several exceptions, including modification). Additionally, the loss mitigation protocol that conventional servicers must follow prioritizes keeping these loans in the MBS. The first step requires servicers to attempt to resolve (or "cure") a borrower's delinquency through a lump sum repayment of the missed amount. If a borrower cannot afford that, the second option is curing through a gradual repayment plan. The third option is a payment deferral in which missed payments are deferred until maturity. Each of these options results in no change to the underlying MBS; loans stay in the pool and investors continue to receive principal and interest. The last option to cure delinquency before a loan is referred to short sale or foreclosure is modification, which results in a buyout.

Conventional modifications have not been prevalent because they were fairly inaccessible until recently. The GSEs removed their regular modification program after payment deferrals were introduced in July 2020. The Flex Modification program proved largely unworkable as well because it required an LTV above 80, disqualifying those whose LTVs dropped with recent home price appreciation. However, the Federal Housing Finance Agency recently expanded Flex Modifications to all qualified borrowers impacted by COVID-19 regardless of LTV effective August 31, 2021. As a result, modifications may be a viable option for borrowers exiting forbearance in the coming months.

Flex Modifications allow a longer, 40-year, amortization period. They also use the lesser of the borrower's existing mortgage rate or the prevailing primary mortgage rate and allow borrowers to forbear missed payments as non-interest-bearing loans. The result is at least a 20% reduction in monthly payments, which makes this an attractive path for borrowers to cure delinquency. As a result, we could see an uptick in GSE buyouts related to Flex Modifications as early as this fall. This does not mean a wave of GSE buyouts is around the corner. The majority of loans exiting forbearance are expected to do so via the payment deferral option. Additionally, loans being modified because they failed to cure in one of the earlier loss mitigation stages would probably have required a buyout due to short sale or foreclosure anyway. Finally, GSE forbearance terms expire on a rolling timeline based on when forbearance was initially requested.

Buyout risk in Ginnies remains much greater than conventionals for a variety of reasons. The share of Ginnie-backed mortgages in forbearance is more than double that of GSE-backed mortgages despite ongoing buyouts in Ginnies. Unlike conventionals, Ginnie servicers can buyout any loan that is 90 days or more delinquent regardless of whether it is in forbearance or expected to cure through a loss mitigation option. The curing rate is also lower in Ginnies due to the nature of Ginnie's programs and the credit quality of the borrowers.

Unlike conventionals, the highest priority loss mitigation option for FHA loans, which make up the bulk of Ginnie-backed mortgages, is modification through the COVID-19 Advance Loan Modification program "ALM" introduced in late-June. Any borrower able to bring their mortgage current and reduce their monthly payment by at least 25% via a 30-year rate and term modification at the prevailing primary mortgage rate qualifies for ALM. Servicers are

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required to review loans within 30 days of forbearance expiration and offer this modification to any that qualify. Once modified, the loan must then be bought out of the MBS. This could make buyout risk more imminent because forbearance for most FHA loans expires in Q4 2021 and the remaining in Q1 2022. However, at current mortgage rates, a small portion of loans likely qualify for ALM because of the 25% payment reduction requirement. The aggregate impact on Ginnie securities should be minimal with buyouts happening primarily in higher coupon pools.

Both of these modification programs are unlikely to materially change the outcome of loans exiting forbearance. Conventional loans bought out due to Flex Modifications would likely have required a buyout anyway. ALM buyouts should also be limited because many servicers already bought out delinquent loans, particularly in higher coupons, and only a small portion of remaining loans likely qualify. Rather than ominously increasing buyout risk, these modification programs may instead serve to bring existing buyout risk forward beginning as early as fall 2021.

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