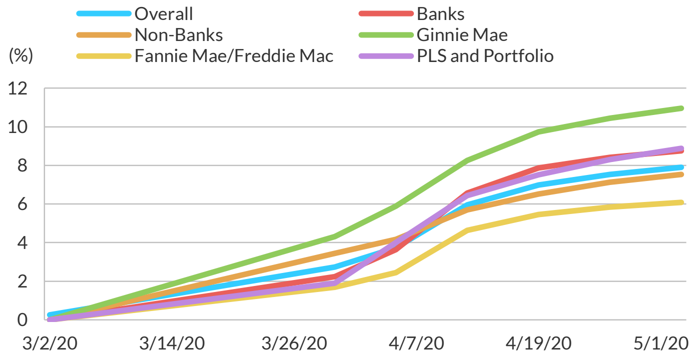
FitchRatings

Structured Finance
RMBS
U.S.A.

What Investors Want to Know: Coronavirus-Related Forbearance Plans in U.S. RMBS

Looking Past the Payment Holiday

Residential Mortgage Loans in Forbearance



Source: Fitch Ratings, Mortgage Bankers Association.

The coronavirus pandemic is triggering widespread use of forbearance plans, or "payment holidays," in the U.S. mortgage market. This report will help RMBS investors understand the programs and their potential impact on notes.

RMBS Documentation May be Ambiguous

Treatment of coronavirus-related "forbearance plans" RMBS documentation is likely to be unclear or absent. Often, any reference to forbearance in transaction documentation is limited to the treatment of forborne principal as a result of loss mitigation effort of a servicer. "Payment forbearance," or a payment holiday, has a different meaning and treatment in RMBS.

Advance Reimbursement May Add to Stress

Missed payments that form part of a payment forbearance plan allowing them to be deferred as a lump sum payment due at maturity may be deemed a modification by the servicer in private label securitization (PLS) transactions. Once modified, the servicer may reimburse principal and interest (P&I) advances from principal portion of collections. This could result in permanent writedowns to the bonds to the extent excess spread is not available and potentially impact ratings. Non-qualified mortgage (NQM) deals that benefit from excess spread to cover losses may be less vulnerable to this risk than prime jumbo RMBS.

Fitch's Revised Analytics Reflect Rising Risk

Fitch announced its intention to apply new delinquency timing stresses, increased loss expectations, and their potential impact on U.S. RMBS ratings in its Exposure Draft and Related Research listed at left. Heavy utilization of coronavirus-related forbearance plans may skew some RMBS performance-related triggers. Fitch may adjust its analytical assumptions as more information becomes available.

Related Research

Exposure Draft: U.S. RMBS Coronavirus-Related Analytical Assumptions (April 2020)

Projected Impact of U.S. RMBS Coronavirus-Related Assumption Changes (April 2020)

Analysts

Suzanne Mistretta
+1 212 908 0639
suzanne.mistretta@fitchratings.com

Roelof Slump
+1 212 908 0705
roelof.slump@fitchratings.com

Ryan O'Loughlin
+1 212 908 0387
ryan.o'loughlin@fitchratings.com

What is forbearance?

Forbearance can be used in multiple ways depending on the context. Forbearance or a payment holiday is a temporary period of suspended mortgage payments typically due to some form of hardship like a natural disaster or the coronavirus pandemic. In this context forbearance can also describe the status of the loan.

In PLS RMBS, forbearance often relates to principal forbearance as a result of a loan modification that factors into realized losses. These are typically defined terms in the transaction documentation, whereby payment forbearance, or payment holidays, is not typically defined in the transaction documents. Treatment for terms or plans not defined in the transaction documents is subject to interpretation of the documentation.

Payment Forbearance or Payment Holidays

Payment forbearance, or payment holidays, refers to various federal and state government and private mortgage relief programs where borrowers can defer mortgage payments for the duration of the forbearance period, which is typically up to six months. The forbearance period may be extended up to an additional six-month period depending on the details of the relief program. This is often referred to as a forbearance plan.

A general inquiry from a borrower about forbearance without a request for forbearance does not automatically define the loan as in forbearance. Furthermore, a loan may be in forbearance whether or not a borrower makes his/her first payment (for example, a borrower requests forbearance but continues to make their payments).

The forborne P&I payments on the mortgage loan are due at the end of the forbearance period to be repaid through reinstatement, a payment plan or a variety of loan modification options.

Payment Deferral

Payment deferral refers to a plan that moves the borrower's missed payments to the end of the mortgage loan. Like a principal forbearance modification, the deferral is non-interest bearing. The borrower is reported as "current" by the servicer and, therefore, does not trigger advancing requirements where applicable.

Scheduled P&I is not advanced to the PLS trust as the scheduled loan is considered current. Payment deferrals also do not hit delinquency triggers or impact representation and warranty (R&W) repurchase mechanisms. Fitch views payment deferrals in PLS as an additional risk to the trust since the lack of advancing increases liquidity risks and under-reporting of issues that could potentially mask performance.

Principal Forbearance

Principal forbearance is a long-standing loss mitigation tool for servicers. It typically is a defined term in PLS and refers to a type of loan modification whereby the servicer and borrower agree to reduce the amount of principal used to calculate interest payments. The forborne principal does not accrue interest but is still due upon repayment or maturity of the mortgage loan.

In PLS, realized loss is typically a defined term and with respect to modified loans and refers to the amount of principal forborne in most programs.

What considerations go into establishing a forbearance plan?

Government-sponsored enterprises (GSEs) have issued guidelines for servicers to implement the Coronavirus Aid, Relief, and Economic Security (CARES) Act forbearance provisions for all agency loans. These may come in the form of lenders letters, bulletins, service guide updates, FAQs or scripts and may be updated from time to time. The GSEs have directed servicers to consider the following factors:

- **Nature of the Hardship:** The servicers should determine if the financial hardship is directly or indirectly related to the coronavirus national emergency;
- **Explaining Forbearance**: The servicers are directed to ensure the borrower understands a forbearance plan does not mean payments are forgiven.
- **Establish Length of Forbearance:** The servicers agree to an initial forbearance period. The length of the forbearance can be adjusted if the borrower's financial situation changes.
- **Partial Payments:** The servicer should inform the borrower that they can submit partial payments during the forbearance period that will reduce the amount to be repaid later.
- **Repayment Options:** Repayment options will be contingent on the borrower's ability to afford paying the forborne amount either in one lump sum payment or over time. Options generally include reinstatement, payment plans or loan modification programs.

Parameters for forbearance plans in PLS vary based on the issuer's and servicer's guidelines. Fitch expects some variability based on the various programs, but the general principles described in the GSE guidelines should apply.

How do U.S. RMBS transactions account for the liquidity strain from forbearance?

Prime Jumbo and Non-Qualified Mortgage (NQM) Transactions

Servicers are expected to advance P&I during the payment forbearance period and report the borrower as delinquent. NQM RMBS typically limit advancing to six months and most prime jumbo RMBS have unlimited advancing. If the borrower fully reinstates the missed payments or is put on a short-term repayment plan, servicers can reimburse themselves from the recoveries. However, if the borrower is allowed to defer the missed payments either as a lump sum amount due at loan payoff or with a term extension, the servicer is likely to deem the loan as modified and look to recover advances.

Payment deferrals will impact PLS cash flows. As noted, borrowers are considered current and servicers will not advance delinquent P&I. Credit enhancement for deals that employ this strategy will have to be sufficient to cover timely interest to the 'AAAsf' and 'AAsf' classes and structural features that provide for principal to pay timely interest will be needed; otherwise, interest shortfalls could arise.

Re-Performing Loan (RPL) Transactions

Fitch rated RPL RMBS do not have servicer advances of delinquent P&I; rather, available cash is used to pay timely interest to the 'AAAsf' and 'AAsf' rated bonds. Fitch applies its delinquency and default timing assumptions to test the adequacy of the cash flows to pay timely interest to the 'AAAsf' and 'AAsf' classes and ultimate interest to all classes below.

Non-interest bearing principal resulting from payment deferrals is accounted for in the net weighted average coupon (WAC), whereby the net WAC is paid only on the interest bearing portion of the underlying principal balance.

GSE Credit Risk Transfer (CRT) Transactions

Payment forbearance plans that do not result in a modification will have no impact on the CRT interest payments or principal losses in "actual loss" transactions. If loans are modified resulting in non-interest bearing principal or a rate modification, the lost interest will be passed through the waterfall starting with the most junior class of interest and then principal. In "fixed severity" transactions, losses due to modifications are not passed on to noteholders.

How do borrowers repay forborne or missed payments?

Borrowers owe the forborne amounts at the end of the forbearance period and can typically repay as a lump sum payment (reinstatement) on a defined payment plan or through a loan modification.

Servicers are expected to properly handle both the initial forbearance request and the ultimate recovery of the forborne amounts. The current protocol employed by most servicers for handling forborne amounts is to first explore reinstatement of past due balances, second to pursue a repayment plan, third to use a payment deferral (a lump sum payment equal to the number of periods missed due at maturity), fourth to consider a modification to maintain with a term extension or reduce the monthly payment to an affordable level, and lastly a liquidation.

For GSE CRTs, payment deferrals for borrowers rolling 30–60 days delinquent after the forbearance period can have those payments deferred and the loan not considered modified for cash flow purposes. The same is true if the term is extended for purposes of repaying the missed payments.

Most private label RMBS servicing agreements are either do not clearly state or have ambiguities regarding payment holidays. Servicers will likely look to issuers or GSE programs for guidance or employ proprietary plans that are more tailored to the borrower's circumstances and repayment ability.

The length of the pandemic's economic impact and the resulting depth and breadth of unemployment are currently unknown and may impact whether alternative servicer options are devised to help borrowers retain their homes and return to performance.

When can servicers reimburse advances?

Generally, servicers that have advanced on a loan during the forbearance period can recoup those advances once the borrower is contractually current — at the completion of the loss mitigation event:

- **Full Reinstatement:** The borrower fully pays all missed amounts at the end of the forbearance period and begins paying according to the original loan schedule.
- **Repayment Plan:** After the borrower pays as agreed under a repayment plan and, in some instances, after the equivalent of one full missed monthly payment has accumulated in the servicer's account.
- **Deferrals:** The missed payments become due at loan maturity or payoff as a lump sum payment. In some PLS transactions, the servicer can deem a payment deferral as a modification and then the advance reimbursement is at the time of modification via principal proceeds. When the borrower resumes making monthly payments, the servicer would consider the borrower contractually current and the loan modified for purposes of advance recovery.
- **Loan Modification:** The borrower and servicer agree to new loan terms to either maintain or lower the current payment due to hardship. The modification may involve a reduction in the interest rate (either temporary or permanent), a term extension (extending maturity by the length of the forbearance period), forborne principal or a different type of loan (e.g. ARM to fixed rate), with the goal of reducing the payment to an affordable level. Advances are not reimbursed under typical "trial modifications" prior to a formal loan modification in PLS transactions.
- **Foreclosure or Liquidation:** Servicers are reimbursed from liquidation proceeds.

How do servicer reimbursements impact RMBS noteholders?

The impact on the deals will depend on the number of borrowers needing forbearance, the length of time of the forbearance period, the proportion of borrowers that require loan modification or other loss mitigation and RMBS transaction structural mitigants that limit the impact of advance reimbursement.

At the end of the payment holiday, borrowers will bring the loan current through reinstatement (i.e. lump sum payment after forbearance period) or a repayment plan. If those two options are not feasible, a deferral of the missed payments to the end of the loan's term could be offered.

When borrowers resume making payments, servicers can recoup advances from the trusts' cash flows. In liquidations, they are repaid from sale proceeds; for payment forbearance plans, advances are repaid from recoveries of missed payments when borrowers fully reinstate or repay the missed amounts with a repayment plan.

However, in PLS, if the missed payments are added to the end of the loan with a term extension and the borrower resumes making its scheduled payments, the loan may be deemed modified by the servicer to allow it to recoup advances from principal portion of the trust's cash flows. Recoupment of advances from available funds rather than from recoveries of missed payments can cause class writedowns due to the mismatch between loan-level amortization and the trust balance staying static until the servicer fully recovers its advances. Absent structural mechanisms such as excess spread, periodic writedowns may be needed to bring the trust balance in parity with the collateral balance.

Servicers will deem current paying loans with deferred amounts as modified despite no change in the monthly payment and the expected recovery of missed amounts at loan payoff. This is due to provisions in the RMBS servicing agreements that allow servicers to recover advances from available funds only when a loan is modified, per most documents reviewed by Fitch.

In prime and NQM transaction documents reviewed by Fitch, servicers can recoup advances prior to a borrower's repayment of the missed amount(s) if the loan is modified. Thus, deeming the deferral of missed payments to the end of the loan as a modification allows servicers to recover advances sooner. Otherwise, advance reimbursement would be limited to recoveries of missed payments and servicers would have to wait until deferred amounts are recouped from borrowers at loan payoff or maturity.

While inconsistencies within the transaction documents may exist or be subject to interpretation, Fitch believes servicers will reimburse themselves the full amounts advanced for borrowers who have their missed payments deferred to the end of the loan term.

NQM deals with large concentrations of self-employed borrowers may be more vulnerable to containment measures and need more forbearance plans; however, excess spread may absorb shortfalls and help prevent under collateralization.

Prime jumbo deals do not benefit from excess spread, but the number of borrowers requesting a coronavirus-related forbearance plan may be low given the very strong credit profiles, high liquid reserves and incomes.

Historical RMBS Performance with Surge in Modifications

Rapid increase in loan modifications and advance recovery programs by servicers historically had an impact on both RMBS cash flows and principal losses. In the aftermath of the subprime RMBS crisis, there were instances where RMBS experienced interest shortfalls or principal write-owns due to a rapid increase in loan modifications and aggressive servicer recovery policies.

- In May 2008, certain subprime RMBS transactions were subject to interest shortfalls impacting interest payments to senior notes. The portfolios were recently acquired by a servicer that then executed extensive loan modifications including principal and interest reductions.
- In July 2011, a prominent servicer announced an update to its servicing advance recovery policy intended to minimize cash shortfalls on current investment-grade rated non-agency RMBS bonds. This announcement was in advance of an impending acquisition with the CEO noting "we often execute loan modifications at a higher rate than the prior servicer, which generally results in a temporary step up in servicer advance recoveries".

How will servicers report coronavirus-related forbearance plans?

Fitch expects most servicers to report loans subject to a coronavirus-related forbearance plan as delinquent in the PLS trustee reporting. Typically, any mortgage loan is considered delinquent when a scheduled payment due on a due date is not received. As such, Fitch expects the best practice for servicers will be distinguishing between coronavirus related forbearance plans and truly delinquent loans in the regular reporting.

In April, many PLS servicers began separately identifying loans under coronavirus forbearance plans and have made this information available to other parties, including master servicers, issuers and some investors.

However, industry standards have not been finalized for formally reporting this information, including in trustee reports, and some content/format inconsistencies may be anticipated in the near term. Fitch believes that the market would be best served if reporting was standardized for these purposes.

The GSEs issued guidance on reporting mortgage loans where the borrower has experienced a hardship associated with the coronavirus by using pre-existing delinquency codes to work within the existing reporting framework.

What types of U.S. RMBS performance triggers could be impacted by classifying coronavirus forbearance plans as delinquent?

Delinquency Triggers

Prime jumbo and NQM deals have delinquency triggers that, if breached, redirect all principal to the most senior class outstanding. Delinquent P&I and modifications over the past 6–12 months are also counted in the delinquency trigger. When the triggers are no longer failing, payments resume under the waterfall distribution when triggers are passing.

R&W Review Triggers

Some U.S. RMBS deals include an automatic review of loans based on a delinquency trigger. These reviews are conducted by a third party as part of transaction R&W enforcement and may bring additional costs. File reviews can be triggered in cases where the loan is classified as delinquent for 120 days, the servicer modifies the loan or stops advancing or the loan is foreclosed. However, file reviews may not be triggered in transactions issued within the past several years where personal borrower assistance is being received due to a FEMA disaster.

Fitch does not believe that borrowers on a coronavirus-related forbearance plan should trigger an automatic R&W review.

First/Early Payment Default (FPD/EPD) Considerations

Loans becoming 30 days or more delinquent within 90 days of origination are EPDs. EPDs are usually covenants in U.S. RMBS rather than a representation so there is no dispute mechanism; however, loans marked as delinquent due to a servicing transfer are carved out of the EPD covenant since it is unrelated to borrower performance and administrative in nature.

Fitch believes that payment forbearance would be considered delinquent for FPD/EDP purposes in newly issued PLS. Therefore, the EPD covenant should have language to address coronavirus-related forbearance and outline a remedy; otherwise any loan in forbearance within 90 days of origination would be in breach of the EPD and require repurchase.

Concentrations of loans in new PLS under a forbearance status is seen as additional risk and are considered in Fitch's coronavirus-related criteria assumptions. As additional information becomes available, those assumptions may be further adjusted.

How will Fitch analyze loans subject to coronavirus-related forbearance plans in U.S. RMBS transactions?

During the Forbearance Period

In the Exposure Draft, Fitch proposes to analyze U.S. RMBS loan losses for borrowers on a coronavirus-related forbearance plan as a current borrower in its analytical process for existing ratings. If the issuer, trustee or master servicer does not specify which loans reported as delinquent are on a coronavirus-related forbearance plan, then Fitch will treat those borrowers as delinquent.

After the Forbearance Period

After the forbearance period, if the borrower is converted to reinstatement or a payment plan, then the loan will continue to be treated as current. This is also applicable to loans with payment deferrals if borrowers resume making monthly payments.

If the payment history of a loan on a coronavirus-related forbearance plan is shown as delinquent but not specified that it relates to the coronavirus, then Fitch will analyze the loan as a previously delinquent loan.

Assigning New Ratings

Fitch expects issuers to identify borrowers on a coronavirus-related forbearance plan in the initial data tape. Borrowers identified on a coronavirus forbearance plan will be treated as a current borrower. Others will be analyzed as a delinquent borrower.

Fitch will look to identify additional risk factors and potential adverse selection by examining the credit characteristics of the pool and comparing borrowers subject to coronavirus-related forbearance plans to the credit characteristics of the remaining pool. Fitch will adjust its analytics to address future risk factors as appropriate.