Black Knight's Deep Dive Part 3: How Housing and Mortgages Move On

By: Jann Swanson | Mon, Apr 13 2020, 11:49 AM

In this third article summarizing an analysis by Black Knight of the potential impacts of the COVID-19 pandemic housing the company looks at **mortgage defaults and servicing.** It also reviews some of the actions that have already been taken to curb potential harm to housing and makes suggestions about ways technology can be of help. Part 1 of this series can be read here and Part 2 here.

Layoffs and business closures have sent unemployment claims soaring by an aggregate of more than 17 million over the last three weeks and will **certainly have an impact on mortgage delinquencies.** FHA and the GSE's Fannie Mae and Freddie Mac quickly directed servicers to make forbearance available to distressed borrowers and the $2 billion Federal CARES Act will provide funds that may help homeowners with mortgage payments. It also codifies the forbearance directives as well as eviction moratoria. Forbearance, however, **may have unforeseen impacts on servicers' - particularly non-bank servicer**s - ability to make principal and interest advance payments to investors. Since Black Knight wrote this, Ginnie Mae has stepped forward to announce it will advance funds to issuers for this purpose, but servicers for private label securities and for the GSEs appear to be still at risk.

Another challenge facing lenders is margin calls. Lenders hedge their interest rate risk by forward-selling mortgage-backed securities (MBS). When the market rallies quickly and with such magnitude as it recently has, that hedging can quickly become deeply unprofitable. Usually this is offset as the loan on the other side of the trade grows in value. However, processing times have increased significantly due to volume and other factors so funds from the sale of loans are often delayed beyond the time lenders have to pay their hedges. Further, **when the market rallies, the lenders owe margin to the dealers.** As the MBS market climbs, lenders need more and more cash reserves to cover these timeline gaps.

Servicing values (MSR) are getting materially lower, and the same widening of margins occurring at the retail level also happens at the investor level where lenders are realizing are much lower prices than anticipated. This is causing serious strain on lenders, and especially independent mortgage banks. MSR buyers, (Real Estate Investment Trusts in particular) can become capital constrained and halt purchases of servicing assets. For those retaining servicing, discount rates and delinquencies had to increase because of a disrupted market and expectations of the impact of COVID-19. Together, these factors deteriorated servicing values far beyond what a rate shock could have predicted, in some cases going all the way to zero.

The **record low delinquency levels of recent years, while positive, have also allowed servicers to reduce the staff necessary to manage default operations.** This is potentially a problem as more homeowners struggle to make payments and additional public and private programs are put in place to help them do so.

The company concedes that predicting the future fallout of this pandemic using information from the past is as much art as science. It is uncharted territory. Using the Great Recession as a model, when unemployment and mortgage delinquencies both soared to 10 percent, and seven million homes were lost to foreclosure and it took years for home prices and mortgage performance to rebound is not a perfect comparison. The instigating factors were much different as were the housing and mortgage markets.

The credit quality of borrowers is significantly higher now than then and the loan mix is very different. There are far fewer adjustable rate mortgages (ARMs) and **virtually no subprime originations**. Any ARM reset today might result in homeowners seeing a rate decline rather than the payment shocks of the Great Recession.

Black Knight makes some recommendations to manage the immediate crisis, help in the recovery, and look forward to preparing for what many in health care suggest could be an era of epidemics.

- Real estate professionals, from MLS organizations to individual agents need to leverage technology to allow business to continue with little in-person contact. Virtual showings, interactive communication with clients and seamless, online integration with other partners in the real estate transaction are critical in this environment.
- Real estate and mortgage companies should be actively seeking **automated technology solutions** for the present reality. From mobile inspection technology where the homeowner provides property photographs and other information to help the appraisal process, to eSignature and remote online notarization capabilities, there are already solutions that can help.
- Keeping title and closing office operations flowing may be the key to limiting revenue losses during this time. Title providers - and the real estate and mortgage professionals with whom they do business - would do well to seek out the most digitally-capable options for title, escrow and closing.
- Currently, 23 states allow the use of two-way audio-visual communication and/or remote online notarization to securely execute

documents. The recently introduced SECURE Act would go a long way toward enabling this functionality nationwide. This technology is key to helping the real estate and mortgage sectors continue to operate in the COVID-19 era.
- Those lenders who have made investments in both consumer-facing and origination underwriting technology digital mortgage technology stand the best chance of weathering this crisis. Consumers have come to expect digital points of sale, interactive loan officer technology and - critically - robust eClose functionality. Those lenders that have not implemented such digital technologies should do so as soon as possible to not just remain competitive, but to remain in business.
- Mortgage servicers should be ramping-up both staffing and technology to handle defaults. While what that volume might become is unclear, but it is evident that additional resources will be needed to implement the myriad of programs being enacted to assist distressed borrowers.
- Servicers should also be proactive in **preparing for increased attrition in their portfolios as the 30-year rate falls.** Recent rate increases have provided a needed delay in run- off but this may be temporary as the potential for still lower rates remains. Servicers should enact data-driven strategies to proactively identify attrition risk and make efforts to retain those loans to stabilize, and even build, servicing portfolios.
- Portfolio performance modeling should leverage historical recession data, not just recent information, to capture appropriate both short- and long-term default risk rates and this modeling needs attention and resources. Today's environment increases both prepayment and default risks and understanding these will be critical, as lenders will seek to retain lower risk product, even more so than they do in periods of "normal" market dynamics.

The company ends on a hopeful note. It says it is important to remember that, while much is still unknown, the pandemic may prove to be only temporary. "When the smoke clears and the economy regains its footing, there is likely to be massive pent up demand for housing. Moves the industry makes today to meet the specific challenges of the day could also help pave the way for a more seamless real estate transaction in the future."

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