Offering Effective Relief to Troubled Borrowers of Government-Insured Mortgages When Interest Rates Rise

20%

AMOUNT THE PAYMENTS MUST BE REDUCED FOR EFFECTIVE RELIEF

10.8

MILLION MORTGAGES INSURED BY THE US GOVERNMENT

3

FEDERAL AGENCIES INSURE MORTGAGES (FHA, VA, AND USDA)

THE PROBLEM

The current options available to help borrowers who fall behind on their mortgage payments for a government-insured mortgage do not do enough in a rising interest rate environment to get borrowers back on track.

When borrowers cannot pay their mortgage, lenders, under the direction of the insurer or guarantor, can modify the loan by reducing the loan's term or its principal amount. To modify a loan, the lender must first buy back the loan from the mortgage-backed security it has been packaged and sold into.

The modified loan must then be repackaged and sold into a new mortgage-backed security, which must be issued at the market rate to attract investors. If rates have risen since the original loan was issued, the new higher interest rate may wipe out any relief offered through the modification.

PROPOSED SOLUTION

1. Recast delinquent loans. Use agency partial claim funding (available at the USDA and FHA) to temporarily reduce the principal on a delinquent loan, which reduces the borrower's monthly payments. Keep the loan in its original security pool and "recast" the reduced loan using the original rate.

- How can this change be made? This option could be made available by regulatory modification through Ginnie Mae agency rulemaking, or Congress could make this option available through legislation.
- Who might object? Ginnie Mae investors who own FHA, VA, and USDA mortgage-backed securities might worry about this solution, but there are ways to address their concerns.
- What about the VA? The VA does not offer partial claim funding. Congress could make this funding available through legislation. Or the VA could, under its loss mitigation refund option authority, purchase delinquent loans from servicers and offer principal forbearance.

2. Reduce the FHA Mortgage Insurance Premium for delinquent loans. The FHA could reduce its fee, the Mortgage Insurance Premium, which would further lower the borrower's monthly payment. This solution would reduce income to the FHA, but it could help prevent expensive foreclosures.

EXAMPLE

If a delinquent loan has an unpaid principal balance of $148,000, an original interest rate of 3.5 percent, and a current market rate of 5 percent, modifying the loan using existing tools will result in a 13 percent decrease for a USDA-insured loan and an 11 percent decrease for an FHA-insured loan.

By using the first proposed solution above—staying in the original security pool and recasting the loan—the loan retains the lower interest rate, which reduces monthly payments more significantly in a rising rate environment. In the example above, this would result in a 20 percent decrease for a USDA loan and a 17 percent decrease for an FHA loan.

For a VA loan, for which partial claim funding is not available, using the loss-mitigation refund option authority to offer principal forbearance of about $38,000 would result in a 10 percent decrease.

WHY IS THIS IMPORTANT?

Borrowers who use government-insured mortgages are disproportionately first time-homebuyers and people of color. Government-insured mortgage borrowers also tend to have lower incomes and limited savings. When these borrowers run into trouble paying their mortgage, effective loan modifications can be critical to their financial survival, and ineffective loan modifications can be financially ruinous.

ABOUT THE MORTGAGE SERVICING COLLABORATIVE.

This fact sheet is based on "Government Loan Modifications: What Happens When Interest Rates Rise," a research brief published by the Urban Institute's Mortgage Servicing Collaborative (MSC). The MSC is an initiative led by Urban's Housing Finance Policy Center that brings together lenders, servicers, consumer groups, civil rights leaders, researchers, and policymakers who appreciate the impact servicing has on the health of the housing finance system and how well it serves consumers. The MSC seeks to develop a well-grounded view of the primary policy challenges in servicing and a thoughtful approach to addressing them. For more information, go to http://urbn.is/2DaLcHp.

Note: FHA = Federal Housing Administration; USDA = US Department of Agriculture; VA = US Department of Veterans Affairs.