

RESEARCH REPORT

Preventing Foreclosures

What Has Been Done? What Is to Come?

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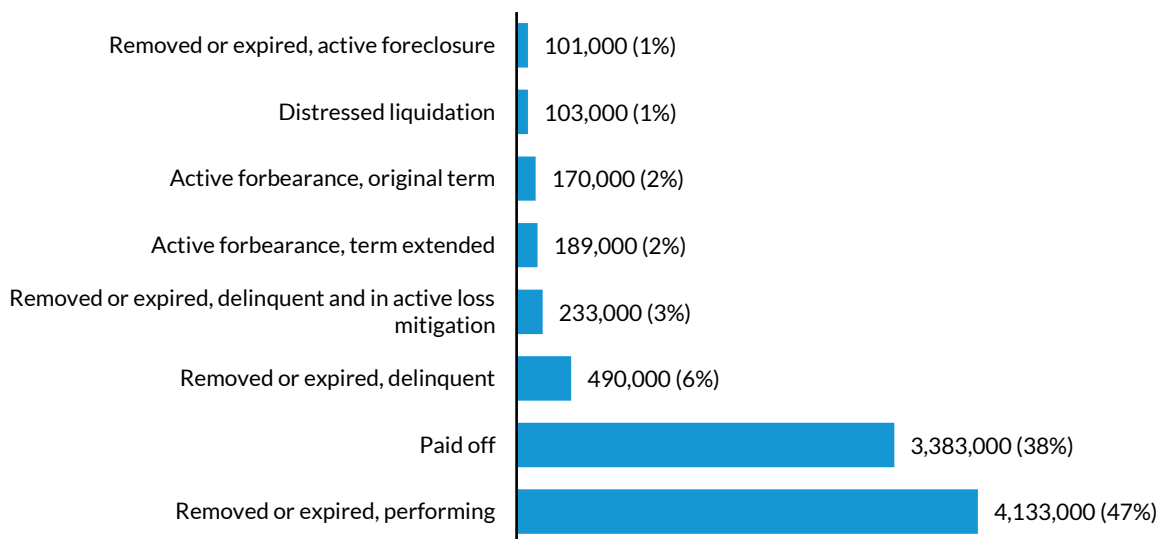
Preventing Foreclosures

Over the past 15 years, loss mitigation strategies have undergone a significant evolution, largely in reaction to economic crises. The response to the 2008 financial crisis catalyzed a paradigm shift in how mortgage distress is managed, leading to standardized tools. Among these pioneering efforts was the Home Affordable Modification Program (HAMP), aimed at providing programmatic payment relief to financially stressed homeowners. The implementation of these programs was not without its challenges, but it set the stage for a more robust and flexible response to future crises.

The onset of the COVID-19 pandemic served as a crucible, leveraging the infrastructure and hard-earned lessons from the 2008 financial crisis, as well as the experiences gleaned from a series of natural disasters in the late 2010s. The strategies implemented during the pandemic were largely extensions of earlier programs but were adapted to meet the pandemic's unprecedented scale and nature.

In the next section, we detail those pandemic-era loss mitigation strategies, elucidating their efficacy and impact. Notably, in February 2024, about 10 months after the official end of the pandemic emergency, data from ICE (2024) reveal a significant success rate, with a substantial portion of borrowers benefiting from forbearance arrangements (figure 1). Of the 8.8 million borrowers that entered forbearance, 4.1 million (47 percent) of the mortgages were performing, 3.4 million (38 percent) were paid off, and 0.36 million (4 percent) were still in active forbearance—2 percent were in the original term, and another 2 percent had their term extended. Of the remaining loans, 6 percent were delinquent, 3 percent were in active loss mitigation, and 1 percent apiece were in active foreclosure or had a distressed liquidation.

FIGURE 1
Current Status of Pandemic-Related Forbearances
8.8 million forbearances



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Source: ICE McDash Flash data through February 13, 2024.

Undoubtedly, robust home price appreciation played a role in these results. Using empirical techniques, Goodman and Zhu (2024) show that the COVID-19 loss mitigation waterfall cut the serious-delinquency-to-foreclosure rate by 46 percent, a considerable reduction in the serious-delinquency-to-foreclosure rate attributed to the COVID-19 loss mitigation interventions.

Building upon these insights on the effectiveness of the pandemic policies, we outline potential improvements to the loss mitigation toolkit, aimed at continuously strengthening our capacity to preserve homeownership stability. We also investigate alternative approaches, including streamlined modifications and mortgage reserve accounts, to further reduce default rates and bolster the resilience of our housing system.

This thorough examination aims not only to clarify the development and effectiveness of modern loss mitigation strategies but to lay the groundwork for future innovations to enhance homeowners' financial security during challenging times.

These challenges inevitably hit households with less wealth and economic stability the hardest, particularly households of color who face additional barriers from historic and ongoing systemic racism in access to employment and wealth-building opportunities. Historically, Black and Latino households have faced higher foreclosure rates than white households, as they are more likely to experience

unemployment and have less housing equity and financial reserves, contributing to the racial homeownership gap (Goodman et al. 2023; Neal, Choi, and Walsh 2020). And these structural factors can be compounded by cyclical shocks, such as the COVID-19 pandemic, which caused greater spikes in unemployment for households of color than for white households (Neal and McCargo 2020). Foreclosure itself creates further hardships, such as deterioration in wealth and credit score, which in turn leads to a cascade of economic costs in accessing credit, insurance, and employment. Consequently, if delinquent borrowers are less likely to transition to foreclosure, this will contribute to narrowing the racial homeownership gap.

These enhanced foreclosure prevention tools have another benefit. In a separate paper, we investigate how these improvements can enable enhanced access to credit (Goodman and Zhu 2024). That is, a lower transition rate from serious delinquency to foreclosure and home loss means mortgages will incur lower expected losses. This in turn suggests that, holding expected losses constant, the credit box could be expanded to approve borrowers with a higher probability of going delinquent.

The Landscape of Current Loss Mitigation Programs

The GSE Loss Mitigation Waterfall

The success of mortgage performance during the pandemic can be attributed to significant improvements in the loss mitigation waterfall, particularly since the 2008 financial crisis.

Before the crisis, there was no standardized loss mitigation toolkit, leading to confusion among borrowers regarding temporary measures, such as repayment and forbearance programs. Borrowers were often perplexed regarding the timing of repayment for temporary relief and uncertainty about the payment shock they would experience. This confusion was compounded by servicers' tendency to tack on delinquent interest and fees to the balance, which quickly ballooned the amounts owed, often making it impossible for the borrowers to catch up. The 2008 financial crisis highlighted the need for a standardized loss mitigation toolkit.

After the crisis, the US Treasury Department implemented a suite of programs under the Making Home Affordable program to aid distressed borrowers.¹ These initiatives included HAMP, which marked the introduction of a standardized loss mitigation waterfall. HAMP was designed to modify mortgages by permanently reducing borrowers' payments. Additionally, the program featured the Home Affordable Foreclosure Alternatives, offering financial incentives to servicers to pursue

alternatives to foreclosure. The standardization was important, even though only 1.7 million borrowers received HAMP modifications and an additional 6.7 million borrowers received proprietary modifications, with many taking guidance from HAMP (SIGTARP 2022).² This shift toward standardization proved beneficial, as offering a modification was ultimately more cost effective for both the borrower and those taking on the credit risk.

As a result of the lessons learned in the financial crisis, the modification processes became increasingly streamlined, with a reduction in the required documentation. By 2013, Fannie Mae and Freddie Mac both had implemented a streamlined mortgage modification process. Although these modifications boasted a higher take-up rate and greater efficiencies for the services, they exhibited a lower success rate compared with modifications that required more extensive documentation. Nevertheless, 34 percent more borrowers experienced successful modifications as a result of the streamlined process (Goodman, Scott, and Zhu 2018). These modifications became a permanent part of the toolkit.

Throughout most of the postcrisis period, short-term assistance plans such as repayment and forbearance plans remained distinct from the permanent modification plans. Borrowers were left to choose the path that best suited them, often without clarity regarding the duration of the payment disruption.

The two short-term loss mitigation options of forbearance and repayment were combined with the long-term modification options for the first time in 2018, in response to Hurricanes Harvey, Irma, and Maria. After a natural disaster, borrowers did not know the extent and duration of the disruption and whether they required temporary or permanent relief. In response, forbearance for up to two consecutive six-month terms was placed at the top of the loss mitigation waterfall for areas affected by natural disasters. Upon exiting forbearance, borrowers exiting had access to a waterfall of options depending on their financial condition. The waterfall is as follows:

1. Repay the funds immediately if able.
2. Make higher payments for a limited time.
3. Defer the missed payments to the end of the mortgage (for government-sponsored enterprise, or GSE, mortgages, the mortgage was initially extended by the number of missed payments; this was changed to be payable as a non-interest-bearing balance at the loan's maturity date or when the home is sold or the loan is refinanced or otherwise paid off).

4. Reduce payments through a mortgage modification, targeting a 20 percent reduction in payments and interest (the rate may be reduced to the minimum of the original rate on the mortgage or the market rate of interest at the time of the modification; the term may be extended; principal may be forborne).³

If the borrower could not qualify for any of the loss mitigation options, the servicer would refer the mortgage for foreclosure or a foreclosure alternative.

When the pandemic struck, the natural disaster loss mitigation waterfall was immediately adopted as the pandemic waterfall. The GSEs announced on March 18, 2020, the extension of more flexible forbearance and modification policies—originally designed for natural disasters—to be applicable during the pandemic. The GSEs would allow two consecutive six-month forbearance terms. Furthermore, the GSEs issued guidance mandating servicers to suspend credit bureau reporting of delinquencies linked to the pandemic where the borrower had elected help, including forbearance, repayment, or trial modification plans. A foreclosure moratorium was also put into effect.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, signed into law on March 27, 2020, built upon the blueprint established by the March 18 GSE announcement. This landmark legislation mandated the extension of foreclosure and eviction moratoriums while making forbearance available for up to 12 months for all federal mortgages, including those insured by the Federal Housing Administration (FHA), the US Department of Veterans Affairs (VA), the US Department of Agriculture, and the GSEs. Borrowers could request forbearance by informing their servicers about any financial hardship directly or indirectly attributable to COVID-19. Servicers were required to suspend credit bureau reporting of delinquencies attributable to COVID-19 forbearance, repayment, or trial modification plans. Upon exiting forbearance, borrowers could revert to the natural disaster waterfall described above; they could pay the entire delinquent amount back, but if they could not, the order of the other options remained open, including the option to defer paying it back until the loan was paid off.

Further enhancements were introduced to provide additional support to GSE borrowers. Borrowers who entered forbearance before February 28, 2021, were permitted to extend the forbearance for up to 18 months.⁴

Borrowers who were current or already delinquent going into the pandemic could ask for forbearance, attesting to the fact that they were affected by the COVID-19 crisis. Surprisingly, more than a quarter of borrowers who were delinquent before March 2020 opted not to request forbearance. These pandemic-era policies remained in effect until late 2023, though most of the borrowers who elected forbearance did so in April 2020.

Spurred by the success of the COVID-19 loss mitigation waterfall, the GSEs established the forbearance and deferral program as a permanent fixture in 2023.⁵ Under this program, borrowers experiencing a hardship are required to attest to their hardship, after which servicers can offer six months of forbearance, with an option to extend for an additional six months. This initiative, the “standard” program, was optional for servicers starting July 2023 and mandatory as of October 2023. Pandemic-era policies sunset as of November 1, 2023. The major difference between this standard program and the previous COVID-19 program is that the latter contained credit reporting suppression. Specifically, during the pandemic, the delinquency status did not advance, providing borrowers additional relief.

In May 2024, the Federal Housing Finance Agency made a final tweak in its program, with changes to its flex modification, step 4 of the above waterfall. These changes are to be implemented no earlier than November 1, 2024, and no later than December 1, 2024.⁶ The flex modification now targets a 20 percent payment reduction. The enhanced waterfall will allow more borrowers with equity in their homes to achieve this target reduction. The flex modification contains its own internal waterfall. First, capitalize the delinquent amount into the principal balance. Then, incrementally follow the steps below to achieve a 20 percent reduction in principal and interest.

1. Reduce the borrower’s interest rate to the lower of the original rate or the current rate, in increments of 0.125 percent (if eligible).
2. Extend the loan term to as long as 480 months.
3. Forbear principal if needed for borrowers with a mark-to-market loan-to-value (MTMLTV) ratio greater than 50 percent, up to a maximum forbearance of 30 percent of the loan’s unpaid principal balance or an MTMLTV ratio of 50 percent, whichever is less.

Borrowers with an MTMLTV ratio less than 50 percent will retain their original interest rate. The major change in this version of the flex modification was to change the MTMLTV threshold, which allows for a reduction in the interest rate and for forbearance for delinquent borrowers from 80 percent to 50 percent, allowing for more sizeable modifications for borrowers in this MTMLTV range.

FHA Loss Mitigation Programs

The FHA and VA loss mitigation programs have always been harder to implement for two reasons. First, the GSEs have a portfolio and the FHA and VA do not; the portfolio gives the GSEs more flexibility. Second, the GSEs provide both the credit guarantee on the mortgage and the securities guarantees in

one entity while the FHA and VA do the former and Ginnie Mae does the latter. This adds complexity and limitations. When a GSE loan becomes delinquent for four months, the GSEs, as a matter of policy, buy it from the securitized pool, thus retaining the loans on their own balance sheet. The GSEs have considerable flexibility to mandate how the servicer manages these loans once they are removed from the securitization. In contrast, servicers of FHA and VA mortgages have traditionally been required to buy a mortgage out of a securitized pool to execute a modification or make other changes to the loan terms. For FHA and VA loans, the servicers must come up with the cash for a buyout, not the government. This is a strain on the servicer's liquidity. The FHA toolkit includes a partial claim, which allows up to 30 percent of the loan balance to be used for loss mitigation. This partial claim is critical to the FHA's loss mitigation programs. The VA does not have explicit partial claim authority.⁷

Before the pandemic, short-term options such as forbearance and long-term options such as modifications were distinct paths for FHA mortgages, similar to GSE mortgages. For borrowers opting for the short-term solution, the objective was to pay the funds back as quickly as possible. In cases where repayment was unfeasible, the FHA's partial claim authority came into play. The payments missed during the forbearance period were paid as a balloon payment when the mortgage was paid off, using a portion of the partial claim authority to reimburse the servicer for the missed payments. For borrowers who needed reduced payments, the available options before the pandemic included a stand-alone mortgage modification or a HAMP modification. The stand-alone modification capitalized the interest; set the new interest rate on the modified mortgage, which was close to the then-prevailing market interest rate; and extended the loan term.⁸ A HAMP modification, which required significant income documentation, was geared toward achieving a target PITI (principal, interest, taxes, and insurance) or 31 percent of gross income, subject to a 20 percent reduction in PITI.⁹ The combination of these policies allowed borrowers to use forbearance to pause their payments for a period, and as they exited forbearance, they could hold their payments constant via a stand-alone partial claim or reduce payments via a mortgage modification.

Early in the pandemic, the FHA introduced the combination of partial claim and loan modification. This was a more generous version of the stand-alone modification, as it deferred the missed payments to the end of the mortgage term, extended the term itself, and then changed the interest rate to the prevailing market interest rate. This generally represented a reduction in rates during this period.

In mid-2021, the FHA further streamlined these choices, introducing the COVID-19 Recovery Modification, which targeted a 25 percent reduction in principal and interest payments with minimal documentation. The partial claim was first used to cover the arrearages. If the term extension to 30 years and interest rate change did not achieve the payment savings, the remaining partial claim

authority could be used to forbear principal. If this could not produce the 25 percent payment reduction, the term was extended to 40 years.¹⁰ If the 40-year term and new interest rate could not produce the payment reduction, the remaining partial claim authority can be used. Goodman and Kaul wrote a detailed description of these programs.¹¹ This replaced the earlier programs.

All the FHA programs discussed above required servicer contact with the borrower, and many borrowers resisted that contact. To address these borrowers, the FHA introduced the COVID-19 Advanced Loan Modification program, which did not require servicer contact. Delinquent borrowers were automatically evaluated for a loan modification. If they could achieve a 25 percent payment reduction by reducing the interest rate to the then-current interest rate and extending the term to 30 years, they were automatically offered the modification.

In the postpandemic era, the policies have continued to evolve and improve. The FHA has extended its pandemic-era policies through April 25, 2025. But during the pandemic, modifications were enabled by the fact that rates were low; in a high-rate environment, it is harder or even impossible to offer substantial payment reductions. FHA loan modifications require setting the interest rate to the prevailing rate at the time of the modification because the FHA does not have a portfolio, and the modified loan must be sold into a new securitization. This poses a challenge when the prevailing interest rate was substantially higher than the rate on the existing mortgage, making it hard to offer most borrowers a modification with significant payment relief. As a result, the FHA has introduced a new loss mitigation home retention option called Payment Supplement. If the servicer applies the COVID-19 Recovery Modification waterfall and finds that after changing the interest rate, extending the term to 40 years, and using the remaining partial claim they cannot generate a 15 percent payment reduction, they must consider the borrower for the Payment Supplement.

The Payment Supplement program uses the partial claim to supplement the borrower's mortgage payments for three years; it does not permanently reduce the interest rate. Essentially, the mortgage remains within the securitized pool, allowing the borrower to keep their original interest rate if it is lower than the prevailing market rate. This process is facilitated through the partial claim, which first covers any arrearages. The remaining balance of the partial claim can be used to supplement up to 25 percent of the mortgage payment for three years.¹² This is consistent with the 25 percent target on the recovery modification. To give more detail, the FHA payment supplement targets a 25-percent-of-mortgage-payment reduction for the three years, providing this reduction does not exceed the remaining balance of partial claim after covering any arrearages. If the maximum achievable payment reduction is less than 25 percent, that reduction will be offered. After three years, the payments revert to the initial level. Servicers could implement this program as early as May 1, 2024, and they are

required to do so by January 1, 2025. The combination of these policies allows for the creation of a waterfall similar to that applicable to GSE borrowers.

VA Loss Mitigation Programs

The VA has the most limited loss mitigation options, lacking both a portfolio and partial claim authority. The VA mortgage program was designed as a guarantee product, which would protect lenders for a portion of the losses on defaulted home loans. The VA was not intended to actively manage the loan.

During the pandemic, the VA allowed for 12 to 18 months of forbearance, in line with the GSEs and FHA. When forbearance expired, the borrower was offered a traditional modification: the arrearages were capitalized, the term was extended, and the mortgage rate was lowered to the current interest rate (DeMarco 2024). Beginning in July 2021, the VA acquired funds to allow for the use of a partial claim to cover the arrearages, but those funds expired in October 2022. The VA also introduced its COVID-19 Refund Modification program, which could be used in combination with the partial claim to defer the arrearages; this program was much like the FHA's COVID-19 Recovery Modification. But with rising interest rates, providing modifications became increasingly challenging. This program was operated on and off after the VA partial claim authority expired in July 2022.

On November 17, 2023, the VA extended its COVID-19 Refund Modification program until May 2024. Despite this extension, few borrowers saw sizeable payment reductions, as interest rates had risen substantially. Additionally, the VA urged servicers not to foreclose on borrowers, aiming for a more permanent solution.

In April 2024, the VA announced the Veterans Affairs Servicing Purchase (VASP) Program. Servicer participation in VASP can occur as early as May 31, 2024, with mandatory participation effective October 1, 2024. VASP is the last step in the loss mitigation toolkit, after the servicer has determined that the borrower does not qualify for a repayment plan, a special forbearance, or a loan modification. But for most borrowers, VASP is the only option, as all the other options will increase their payment amounts. For example, in a repayment plan, the borrower will pay back the missed payments over a period of time, by making higher payments each month. A special forbearance gives the borrower extra time to pay back the missed payments. The loan modification gives the borrower a new 30-year mortgage at the then-current interest rate. For most VA borrowers, a loan modification will increase their payment, as the prevailing market rates are higher than the rates at loan origination.

Under VASP, the VA purchases the defaulted loans from the servicer and lowers the interest rate to 2.5 percent, provided the borrower receives at least a 20 percent payment reduction. If lowering the interest rate to 2.5 percent does not meet the 20 percent reduction requirement, the VA will extend the loan term to 40 years. This plan allows veterans and active-duty service members to benefit from a home retention program that is more generous than the one the GSEs offer.

Despite its merits, the VASP plan, which was the subject of a February 2024 congressional subcommittee hearing,¹³ has two major weaknesses. First, offering a one-size-fits-all approach may increase program costs. Without a deferral option, borrowers who need relief but with the ability to resume their original payments may opt for the more generous payment reduction, which could increase the number of borrowers who elect loss mitigation and the costs of providing it. Second, all loans the VA acquires must be transferred to a single VA servicer, which could lead to capacity issues and potentially delay and increase the likelihood of errors in lending to veterans and active-duty service members.

What Can Be Done to Further Improve These Programs? Are There Alternatives?

The GSEs, FHA, and VA have implemented programs that operate effectively in the pandemic's aftermath. Nevertheless, there is continual scope for refinement to ensure these initiatives optimally assist borrowers experiencing financial distress. Below are some overarching guidelines, aspects of which are already included in these programs.

1. **Streamlined processes.** It is crucial to ensure that loss mitigation processes are standardized and simplified. By reducing complexity, borrowers can navigate assistance options more easily. Streamlining documentation requirements and making the application process more user friendly can contribute to a smoother experience for borrowers seeking help.
2. **Enhanced communication and outreach.** Effective communication and outreach are key to ensuring that borrowers are aware of available assistance programs and how to access them. This involves more than providing information; it is about reaching out to borrowers, providing clear guidance, and addressing any questions or concerns they may have. Personalized communications, enhanced borrower education materials, and proactive engagement by servicers can all play a role in improving communication and outreach efforts.

3. **Collaborative partnerships.** Foster partnerships with housing counseling agencies, nonprofit organizations, and community groups to identify and implement best practices in loss mitigation and provide comprehensive support services to mortgage borrowers. Collaborative efforts can enhance outreach, education, and counseling efforts, ultimately helping borrowers, especially underserved populations, achieve sustainable homeownership.

We also have recommendations for each program so these programs can enhance their effectiveness in providing timely, tailored assistance to borrowers facing financial hardship.

Potential Enhancements to Postpandemic GSE Programs

The postpandemic GSE programs (i.e., the standard programs) are similar to the pandemic waterfall, with one significant exception: the treatment of credit reporting. During the pandemic, when a borrower entered forbearance, the delinquency status was not advanced. That is, if a borrower was current when they entered forbearance, they remained in a current status throughout the entire forbearance period. Similarly, if they were 30 days delinquent when they selected forbearance, they would remain 30 days delinquent during the forbearance period. In contrast, in the standard postpandemic program, the actual status is reported to credit bureaus. Therefore, if a borrower was current upon entering forbearance and did not make a payment for six months, they would be reported as 180 days delinquent. With the pandemic waterfall and with the standard postpandemic waterfall, if the borrower exited forbearance and resumed payments, they would be current again. That is, the resumption of payments means “paid as now agreed.” It applies whether the borrower is making a higher payment, as they are paying back the forborne amount over a short period; making the same payment, as a payment deferral was deemed the best course of action; or making a lower payment because of a mortgage modification.

The pandemic-era credit reporting and the standard credit reporting policies each have advantages and disadvantages. Forbearance is not costless, though it is cost effective.¹⁴ Extending the program to borrowers who do not need it would make it a less cost-effective program. Not providing any borrower credit accommodation for forbearance eliminates this moral hazard—that is, only borrowers who really need the forbearance are likely to take it, which curbs the number of borrowers who are willing to take forbearance. But electing forbearance in the standard program and having one’s credit rating show increasing delinquencies is likely to leave the borrower with a very low credit score, making it difficult and more expensive to access other forms of credit. This would, in turn, curb the demand for

forbearance. The key question remains whether it curbs demand so much that borrowers who legitimately need the help do not apply for it. We will continue to monitor this issue.

Potential Enhancements to the Postpandemic FHA Programs

The FHA program has undergone significant adjustments, particularly with the extension of pandemic-era policies through April 25, 2025, and the implementation of the Payment Supplement Partial Claim program. These developments bring the FHA close to mirroring the GSE waterfall, though with notable distinctions.

A key feature of the Payment Supplement Partial Claim program is its payment reduction period of three years rather than for the remaining lifespan of the mortgage, as it would be with a GSE loan modification. The FHA forbearance provisions, a part of the pandemic-era policies, now extended to April 25, 2025. The program extension does not include credit suppression, though the CARES Act forbearance provisions did. This raises the same issues we discussed above in the context of GSE loans.

We expect that the FHA will propose permanent measures before the end of 2024. The permanent measures need to be in place before April 25, 2025, and servicers need a few months' notice to implement the new measures. We recommend that the FHA retain the pandemic-era flexibility of the stand-alone partial claim to cover the arrearages. That is, under the prepandemic program, unless the borrower lost their job and could qualify for the special unemployment forbearance, which allows for as much as 12 months of forbearance, they were limited to either 3 or 6 months of forbearance under informal and formal forbearance agreements, respectively. We would recommend the permanent measures allow for 12 months of forbearance, with the stand-alone partial claim available for borrowers who cannot afford a mortgage payment increase. This is consistent both with GSE measures and with current provisions for special unemployment forbearance.

Before the pandemic, the FHA had two modification tracks: one for borrowers willing to provide extensive documents (FHA-HAMP) and one for those who were not (FHA modifications). These tracks were merged during the pandemic, with the COVID-19 Recovery Modification usually at least as generous as the HAMP modification. We would urge the permanent modification consist of one streamlined program. The evidence on the success of streamlined programs is overwhelming (Goodman, Scott, and Zhu 2018). The FHA has already said the Payment Supplement will remain as is and will be used in conjunction with the postpandemic modification program. That is, if the borrower cannot achieve a certain payment reduction using the postpandemic waterfall, they would be considered for the Payment Supplement. This will be the last step of the postpandemic waterfall.

The only question is what the postpandemic modification waterfall looks like. The FHA has several options. It can begin by capitalizing the arrearages or can apply the partial claim, as the COVID-19 Recovery Modification does now. Once the modification's first step is decided, the servicer will calculate the borrower's payment extending the term to 30 years and changing the interest rate—with and without forbearing principal—and perform the same calculations for a 40-year term. The FHA needs to determine whether the term extension from 30 years to 40 years occurs before or after the remainder of the partial claim is used.

As we improve loss mitigation tools and make them permanent, servicers are bearing some of the costs and it is straining their liquidity. Specifically, during an FHA loan's forbearance period, it remains in the Ginnie Mae pool and obligates the servicer to continue advancing the monthly principal and interest payments. When the forbearance is resolved through the partial claim or mortgage modification, the servicer will be reimbursed. But given that nearly 95 percent of all Ginnie Mae loan origination is done by independent mortgage bankers with no source of backstop liquidity, this presents an important issue that should be addressed (Financial Stability Oversight Council 2024).

Potential Enhancements to the VA Servicing Purchase Program

On May 31, 2024, the VA launched a new VASP program. VASP is a new last-resort tool in the VA's comprehensive suite of home retention options for VA loans. This program is slated to become mandatory after October 1, 2024. VASP allows the VA to purchase defaulted VA loans from mortgage servicers, modify the loans to a 2.5 percent interest rate, and then place them in the VA-owned portfolio as direct loans. Notably, VA borrowers cannot apply directly for VASP. Instead, mortgage servicers must first screen the loans and identify qualified defaulted borrowers.

Despite VASP, the suite of VA loss mitigation options remains limited compared with the other programs. In particular, there is no option that allows for a delinquent borrower to keep their payment amount constant while adding the arrearages to the end of the loan term. Additionally, in the event of a modification, there is no option that allows for any payment other than the flat 2.5 percent interest rate. Moreover, there is a lack of clear servicer guidance regarding the interpretation of "exhausted all other options," which gives servicers a good deal of discretion and assures that implementation will be uneven.

The program's inflexible design partially stems from the fact that the VA program is a guarantee program, not an insurance program. Even so, the VA, with its existing authority, could have introduced a more flexible modification rather than using the flat 2.5 percent for all modifications. The VA could have

modified the loan by reducing the interest rate to the extent required to reach a 20 or 25 percent payment reduction target, with a 2.5 percent rate floor. This would have limited the amount of assistance provided to borrowers whose interest rates are high and reduced the cost to the government.

To address these limitations, particularly the lack of a deferral option, Congress needs to grant the VA partial claim authority and allocate funding to establish a more robust loss mitigation waterfall framework similar to what GSE and FHA borrowers currently access. Moreover, increasing the number of VA-approved servicers would reduce the burden on individual servicers and mitigate capacity issues. This could involve recruiting additional servicers and providing training and support to ensure they effectively handle VA loans. The VA could also approve some of their large current servicers, alleviating the need to transfer loans from one servicer to another, which is always disruptive.

In addition to these proposed changes and enhancements, other preventive measures, such as streamlined refinances and mortgage reserve accounts, could be considered to further mitigate foreclosure and strengthen the overall stability of the loss mitigation programs.

Streamlined refinances are effective loss mitigation strategies, as extensive research has confirmed that streamlined refinances can prevent defaults. For example, the evidence is near universal that the Home Affordable Refinance Program—which allowed lenders to refinance mortgages in a streamlined fashion, reducing borrower payments—reduced default risk (Abel and Fuster 2018; Karamon, McManus, and Zhu 2017; Mitman 2016; Zhu 2014). More recently, Gerardi, Lowenstein, and Willen (2020) argue that the reduction in default risk owing to reduced payments would allow for the system to refinance mortgages, provide some cash to borrowers, and keep the default risk constant.

There is considerable friction in the current refinancing process, with full documentation required for GSE refinances. The FHA and VA have streamlined programs that do not require appraisals, credit score verification, or income verification on FHA-to-FHA or VA-to-VA refinances. Borrowers of FHA and VA mortgages must have no more than one delinquency over the preceding six months and must pass a borrower benefit test. Moreover, the FHA does not allow the refinancing expenses to be rolled into the new loan amount. The GSEs are unlikely change to their streamlined refinance program until the Consumer Financial Protection Bureau changes its ability-to-repay/qualified mortgage rule, which requires lenders to make a good-faith determination of a borrower's ability to repay the loans. (This is not a problem for government loans. FHA, VA, and US Department of Agriculture loans are subject to their own qualified mortgage rules, which are developed by each agency. Moreover, the Dodd-Frank Act includes explicit permission for the FHA's and the VA's streamlined refinance programs.) These

refinance frictions have resulted in large racial disparities in refinancing activity. Gerardi, Willen, and Zhang (2020) found that Black borrowers paid interest rates that were almost 50 basis points higher than those for white borrowers, but the differences in rates at origination were small, and differences in refinancing behavior accounted for most of the 50 basis-point differential.

We believe this is the time for the Consumer Financial Protection Bureau to exempt streamlined refinances from its ability-to-repay program and for the GSEs to implement a streamlined refinancing process. We argue that while interest rates are high, there is not a lot of demand for refinancing, making this the ideal time to make program changes.¹⁵ Making the program easier would enhance take-up among less sophisticated borrowers. It would particularly benefit borrowers with low-balance loans and borrowers whose opportunity to refinance has been diminished because of a loss in income or employment, a credit score decline, or property value decline.

Mortgage reserve accounts can also reduce default risk. The idea is that the borrower could put down a smaller down payment and leave the funds in a reserve account, making them available for home repairs or other life events. Considerable research shows that reserves can reduce default risk. A JPMorgan Chase study of customers with savings accounts and mortgages found that the likelihood of default for homeowners with less than one monthly mortgage payment in reserve is 2.45 percent (Farrell, Bhagat, and Zhao 2018). This is seven times the 0.36 percent default rate for borrowers with four mortgage payments in reserve. These trends applied regardless of income or debt-to-income ratio. But there has been no widespread adoption. Fannie Mae researchers found that the median borrower reserve amount in a sample of 1.1 million owner-occupied mortgages the agency acquired in 2020 was 2.33 percent of the home's sale price (Mota and Palim 2021). For first-time homebuyers, the median reserves were 1.44 percent of the sales price, and for low-income first-time homebuyers, median reserves were 1.28 percent. The researchers concluded that borrowers with higher reserves were less likely to default, all else equal.

These findings raise the question of whether reducing the down payment requirement for borrowers with low incomes and using the savings to boost reserves could result in more sustainable homeownership. Few programs have tested it. Self-Help has a program that is in the early stage (Zinn and Neal 2023), as does Prosperity Now (Goodman et al. 2023). Fannie Mae and Freddie Mac have both noted in their early Equitable Housing Finance Plans that they would be willing to pilot a mortgage reserve account. Fannie Mae discontinued its initiative, and Freddie Mac is moving slowly on its initiative. Freddie Mac has committed to finalizing a proposal by the end of 2024. Although neither GSE has been explicit about the problems it has encountered, it is likely that finding a standard program that

works for many borrowers is an issue. Scalability generally requires standardization. Moreover, improvements in the loss mitigation toolkit have made the need for these products less acute.

Conclusion

The pandemic-era improvements to the loss mitigation toolkit have proven highly effective and have become permanent integral components. The GSEs have made permanent their pandemic loss mitigation waterfall; the FHA has extended the pandemic waterfall to April 2025, and we recommend it make the program permanent. The FHA has also introduced a modification tool tailored for high-interest-rate environments. The VA, operating within the constraints of its legislative authority, has introduced the VASP program, marking a significant step forward. Some work remains: the FHA has to finalize its permanent programs. The VA would benefit from more legislative authority. As government forbearance programs become permanent, we need a permanent solution to address nonbanks' liquidity needs.

Nonetheless, these programs have collectively contributed to a reduction in the transition rate from serious delinquency to foreclosure. This reduction in turn has far-reaching implications in terms of pricing mortgage credit risk. In particular, the hugely positive impact of these programs has not been priced into the market. Additionally, the observed decrease in transition rates opens opportunities for expanding the credit box at the mortgage origination stage (Goodman and Zhu 2024).

The evolution of loss mitigation not only enhances borrower assistance but reshapes the landscape of mortgage lending, offering opportunities for broader access to credit while mitigating risk. As we move forward, continued innovation and improvement in the loss mitigation toolkit will be essential for maximizing the effectiveness and inclusivity of these initiatives.

Notes

- ¹ “Making Home Affordable (MHA),” US Department of the Treasury, accessed July 8, 2024, <https://home.treasury.gov/data/troubled-assets-relief-program/housing/mha>.
- ² See also Karan Kaul, “Is the 2020 Toolkit for Helping Homeowners in Crisis Better Than What We Had in 2008?” *Urban Wire* (blog), Urban Institute, March 20, 2020, <https://www.urban.org/urban-wire/2020-toolkit-helping-homeowners-crisis-better-what-we-had-2008>.
- ³ The modification has changed. Early in the pandemic, the GSEs targeted a minimum 20 percent reduction in payments, reducing the interest rate to the lower of the contractual rate or the modification interest rate and extending the maturity to 480 months. Principal could be forborne if the postmodification mark-to-market loan-to-value ratio was above 100 percent. Additional forbearance was possible if the 20 percent payment reduction was not met or the postmodification-payment-to-income ratio was greater than 40 percent. Later, the target was changed to a 20 percent payment reduction, with a waterfall to follow to achieve exactly that reduction.
- ⁴ A review of the timeline for the introduction and changes in the forbearance programs is contained in Goodman et al. (2023).
- ⁵ Federal Housing Finance Agency, “FHFA Announces Enhanced Payment Deferral Policies for Borrowers Facing Financial Hardship,” news release, March 29, 2023, <https://www.fhfa.gov/news/news-release/fhfa-announces-enhanced-payment-deferral-policies-for-borrowers-facing-financial-hardship>.
- ⁶ Fannie Mae, “Updates to Determining the Flex Modification Terms,” lender letter to all Fannie Mae single-family servicers, May 29, 2024, <https://singlefamily.fanniemae.com/media/39201/display>.
- ⁷ The VA also does not have the budget to fund partial claims.
- ⁸ Early in the pandemic, the interest rate on a mortgage modification was equal to the Primary Mortgage Market Survey rate plus 25 basis points. This 25 basis-point markup was later dropped. We refer to the then-prevailing interest rate on a modification as the “market rate of interest”; it may or may not contain the 25 basis-point spread.
- ⁹ Under HAMP, the missed payments were capitalized into the mortgage, the term was extended to 30 years, the interest rate was changed to the current interest rate (which tended to be lower than the original rate because rates generally trended down during the pandemic), and the partial claim was used to forbear principal, ensuring the required reduction in payments, subject to the 30 percent maximum claim amount.
- ¹⁰ A 50 basis-point markup over the Primary Mortgage Market Survey rate is permitted on 40-year mortgage modifications, while no markup is allowed for 30-year mortgage modifications.
- ¹¹ Laurie Goodman and Karan Kaul, “The FHA’s New Loss Mitigation Waterfall Will Offer Much-Needed Relief to Borrowers Exiting Forbearance,” *Urban Wire* (blog), Urban Institute, August 25, 2021, <https://www.urban.org/urban-wire/fhas-new-loss-mitigation-waterfall-will-offer-much-needed-relief-borrowers-exiting-forbearance>.
- ¹² US Department of Housing and Urban Development, “Federal Housing Administration Launches New Option to Help Struggling Borrowers Keep Their Homes,” press release, February 21, 2024, https://www.hud.gov/press/press_releases_media_advisories/hud_no_24_033.
- ¹³ “Subcommittee on Economic Opportunity Oversight Hearing: ‘Sink or Swim? A Deep Dive into the Current State of VA’s Home Loan Program in a Competitive Market,’” House Committee on Veterans’ Affairs, accessed July 8, 2024, <https://veterans.house.gov/calendar/eventsingle.aspx?EventID=6372>.
- ¹⁴ The costs of forbearance are outlined in the appendix of Goodman and Zhu (2024). This includes the cost of the deferral for the borrowers who were ultimately successful, as well as the borrowers who took forbearance and

would not have gone seriously delinquent if it was not available. It also includes the cost of a longer timeline for borrowers who took forbearance and were ultimately foreclosed on. Payments to servicers are included in these estimates. These costs are roughly 25 percent of the losses avoided by borrowers who ultimately would have liquidated were it not for this program.

¹⁵ Laurie Goodman, Ted Tozer, and Alexei Alexandrov, “Today’s High-Rate Environment Offers an Opportunity to Streamline the Refinancing Process,” *Urban Wire* (blog), Urban Institute, May 1, 2024, <https://www.urban.org/urban-wire/todays-high-rate-environment-offers-opportunity-streamline-refinancing-process>.

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