



Government Loan Modifications

What Happens When Interest Rates Rise?

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The Mortgage Servicing Collaborative (MSC) is an initiative led by the Urban Institute'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.¹ By calling on a broad range of perspectives and expertise, the initiative is working toward a well-grounded view of the primary policy challenges in servicing and a thoughtful approach to addressing them.

The group recently published its first brief explaining the importance of mortgage servicing and outlining issues that need reform. This second brief examines the current loan modification product suite for government loans insured or guaranteed by the Federal Housing Administration (FHA), US Department of Veterans Affairs (VA), or the US Department of Agriculture (USDA). When a delinquent borrower with a government loan obtains a modification, the mortgage rate is typically reset to the prevailing market rate, which can be higher or lower than the original note rate. When the market rate is below the original rate, providing payment reduction becomes inherently easier and less expensive for the investor. Conversely, when market rates are above the note rate, providing payment reduction becomes more expensive and challenging, making it more difficult to cure the delinquency. This can result in more redefaults and foreclosures, larger losses for government insurers, and greater distress for borrowers, communities, and neighborhoods. In addition, most government mortgage borrowers are first-time homebuyers and minorities, who tend to have limited incomes and savings, making loan modifications all the more important.

About the Mortgage Servicing Collaborative

The Housing Finance Policy Center's Mortgage Servicing Collaborative is a research initiative that seeks to identify and build momentum for servicing reforms that make the housing market more equitable and efficient.

One core MSC objective is to improve awareness of the role and importance of mortgage servicing in the housing finance system. Since 2013, HFPC researchers have studied the landscape, followed the work and policies put in place after the crisis, and assessed the impact of the servicing industry on consumers and communities. This includes loss mitigation and foreclosure actions and how servicing practices affect access to credit through tight underwriting standards. The Urban Institute has analyzed and convened forums on emerging issues in mortgage servicing, including calls for reforms, the impact of mortgage regulation, the rise of nonbank servicers, and the implications for consumers and communities. We determined that a focused effort that involves external stakeholders and resources could lead the way in developing policy and structural recommendations and bring visibility to the important issues that lie ahead.

The MSC has convened key industry stakeholders—including lenders, servicers, consumer groups, civil rights organizations, academics, and regulators—to develop an evidence-based understanding of important factors and to develop and analyze solutions and implications with a well-rounded and actionable orientation.

The MSC seeks to

- bring new evidence, data, and recommendations to the forefront;
- foster debate and analysis on issues from regulatory reform, technology innovations, cost containment, and consumer access to mortgages; and
- produce and disseminate our research findings and policy recommendations—including perspectives by MSC members—to offer policy options that can clarify and advance the debate and ensure servicing is addressed in broader housing finance reform.

For more information about the MSC or to see other publications, news, and products, visit the MSC program page, <https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative>.

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This brief explains why FHA, VA, and USDA borrowers who fall behind on their payments are unlikely to receive adequate payment relief when the market interest rate is higher than the original note rate. We explore the Flex Modification (Flex Mod) framework announced by the Federal Housing Finance Agency for use by Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs), which provides payment relief even when rates rise.² We argue that, with some changes to the loan modification options at the FHA, VA, and USDA, current and future delinquent borrowers could be better served in a high-rate environment. This brief is structured as follows:

- Description of the current loan modification product suite for government mortgage loans
- Problem statement and explanation of why government loan modifications do not serve borrowers when interest rates rise
- Discussion of potential solutions and recommendations for expanding the loss mitigation toolkit, with an explanation of how it would work
- Explanation of likely barriers to implementation and how to best overcome them

Government Loan Modifications Today

Federal Housing Administration, VA, and USDA modifications use three primary levers: (1) rate resets to market rate (subject to certain conditions), (2) term extensions, and (3) partial claims.

Resets to the market rate. The interest rate on an FHA, VA, or USDA loan is generally reset to the prevailing market rate at the time of modification, even if it results in a rate increase for the borrower.³ The modification interest rate cannot be set below the market rate because the loans have to be re-pooled into new mortgage-backed securities (MBS), which must be issued at the market rate to attract MBS investor interest. This hampers servicer ability to provide meaningful payment relief to borrowers. Market rate modifications have been a moot issue in recent years because declining long-term interest rates pushed the market rate to very low levels. As a result, crisis-era borrowers, most of whom had high-interest-rate original mortgages, have received meaningful payment reduction.

The USDA offers two types of loan modifications with distinct interest rate requirements: the traditional loan servicing modification and the special loan servicing modification (USDA 2017, attachment 18-A). Under the traditional option, the rate cannot be increased above the original note rate. But if the market rate is above the original note rate, the servicer would have to bear the cost of a below-market-rate modification, rendering the modification unattractive for the servicer and limiting its practical use. The special modification option, which can be used only after the borrower has been evaluated for a traditional modification, allows a rate increase capped at the Primary Mortgage Market Survey (PMMS) rate plus 50 basis points.⁴ Although this is more cost effective for the servicer, the rate increase does not help the borrower.

Term extensions and partial claims. Federal Housing Administration, VA, and USDA modifications can generally extend the loan term to 360 months, which helps lower the payment. In contrast, GSE Flex

Mod can extend the term to up to 480 months. The USDA’s special modification allows a term extension to 480 months with prior approval. The FHA and USDA also cover up to 30 percent of the unpaid principal balance (UPB) using a partial claim for FHA borrowers and a Mortgage Recovery Advance (MRA) for USDA borrowers.⁵ These mechanisms allow the FHA and USDA to pay the servicer a portion of the loan balance, which the servicer uses to reduce the outstanding balance on the loan, thereby achieving greater payment reduction. The borrower then repays this sum to the FHA or USDA when the entire loan is paid off. The VA does not have a partial claim or MRA equivalent. Although it offers principal forbearance, the VA does not reimburse the servicer, thus reducing servicer ability and limiting the effectiveness of this option. Additionally, Ginnie Mae does not allow loans with deferred principal balances to be included in a Ginnie Mae MBS pool. Table 1 compares the current modification options for the FHA, VA, USDA, and the GSEs.

TABLE 1

Comparison of Current FHA, USDA, VA, and GSE Modification Toolkits

| | FHA mod. | USDA mod. | VA mod. | GSE Flex Mod |
|----------------------------|---|--|---|--|
| Rate reduction | No more than PMMS + 25 bps | No more than original rate for traditional mods.; no more than PMMS + 50 bps for special mods. | Set rate to PMMS + 50 bps; rate increase capped at 1% | Set rate to lower of PMMS or original rate |
| Term extension | Extend to 360 months | Extend to 360 months for traditional or 480 months for special | Extend to 360 months | Extend to 480 months |
| Mortgage balance reduction | Partial claim of up to 30% of defaulted UPB | MRA of up to 30% of defaulted UPB (once over life of loan) | No partial claim or MRA; principal forbearance at servicer expense | Forbear principal to 100% LTV, subject to cap of 30% of UPB or 80% MTMLTV ^a |
| Postmodification pooling | Re-pool at market rate; below-market-rate mods. at servicer expense | Re-pool at market rate; below-market-rate traditional mods. at servicer expense | Re-pool at market rate; below-market-rate mods. at servicer expense | Held in GSE portfolios; below-market-rate mods. at GSE expense |

Note: bps = basis points; FHA = Federal Housing Administration; GSE = government-sponsored enterprise; LTV = loan-to-value ratio; MRA = Mortgage Recovery Advance; PMMS = Freddie Mac Primary Mortgage Market Survey; UPB = unpaid principal balance; USDA = US Department of Agriculture; VA = US Department of Veterans Affairs.

^aMTMLTV, or mark-to-market loan-to-value ratio, is the unpaid principal balance of a mortgage divided by the current property value. It is a measure of how much equity (or negative equity) a borrower has in the home.

Why Are FHA, VA, and USDA Loan Modifications Inadequate in a Rising Interest Rate Environment?

Research has shown that one of the main drivers of successful loan modification is meaningful payment relief (Schmeiser and Gross 2016). Payment reduction can be achieved by extending the term of the loan, reducing the interest rate on the loan, reducing the loan balance, or a combination of the three. Federal Housing Administration, VA, and USDA modifications cannot provide any of these aggressively enough when interest rates rise. Additionally, government modifications rely on servicer willingness to

absorb some of the costs associated with modifications (such as for below-market-rate modifications or the VA's principal forbearance). These restrictions limit the number of borrowers that can be assisted and the amount of payment reduction for borrowers who receive modifications.

A simple example illustrates the problem (table 2). The first column shows loan characteristics at the time of default. The other columns show how this loan would be modified under different programs. In this example, the original mortgage with a note rate of 3.5 percent goes delinquent when market interest rates have risen to 5 percent. Assume that the UPB at default is \$148,000 and that the borrower has missed four payments. The arrearages for this loan (delinquent interest, taxes, and insurance) add up to \$4,243, and the capitalized UPB equals \$152,243 (\$148,000 plus \$4,243). Let us now look at the modifications currently available to for FHA, VA, USDA, and GSE borrowers.

TABLE 2

Payment Relief Options under Current Modification Programs (5 Percent Market Rate)

| | Original loan (at default) | FHA mod. (partial claim) | VA mod. | USDA mod. (MRA) | GSE Flex Mod (100% MTMLTV) | GSE Flex Mod (115% MTMLTV) |
|---------------------------|----------------------------|--------------------------|-----------|------------------------------------|----------------------------|----------------------------|
| UPB at default | \$148,000 | N/A | N/A | N/A | N/A | N/A |
| Capitalized UPB | N/A | \$152,243 | \$152,243 | \$152,243 | \$152,243 | \$152,243 |
| Partial claim or MRA | N/A | \$44,400 | \$0 | \$44,400 | \$7,888 | \$19,858 |
| Interest-bearing UPB | N/A | \$107,843 | \$152,243 | \$107,843 | \$144,355 | \$132,385 |
| Interest rate | 3.5% | 5.0% | 4.5% | 3.5% traditional; 5% special | 3.5% | 3.5% |
| Remaining term (months) | 330 | 360 | 360 | 360 | 480 | 480 |
| P&I | \$699 | \$579 | \$771 | \$484 or \$579 | \$559 | \$513 |
| Taxes and insurance | \$250 | \$250 | \$250 | \$250 | \$250 | \$250 |
| FHA monthly MIP | \$167 | \$167 | \$0 | \$0 | \$0 | \$0 |
| Monthly payment | \$1,116 | \$996 | \$1,021 | \$734 or \$829 | \$809 | \$763 |
| Delinquent payments | 4 | 4 | 4 | 4 | 4 | 4 |
| Monthly payment reduction | N/A | -10.8% | 7.6% | -22.6% traditional; -12.6% special | -14.7% | -19.6% |
| P&I reduction | N/A | -17.2% | 10.4% | -30.7% traditional; -17.1% special | -20.0% | -26.6% |

Notes: FHA = Federal Housing Administration; MIP = Mortgage Insurance Premium; MRA = Mortgage Recovery Advance; P&I = principal and interest; MTMLTV = mark-to-market loan-to-value ratio; N/A = not applicable; UPB = unpaid principal balance; USDA = US Department of Agriculture; VA = US Department of Veterans Affairs. The percent payment reduction calculations for the VA, USDA, and Flex Mod exclude the \$167 MIP, which is applicable only to the FHA.

There are three take-aways from this table:

1. **Government modifications are less sustainable.** In the example above, the modification rate for FHA and USDA special modification loans is 5 percent. For VA loans, the rate is 4.5 percent, as the VA caps rate increases at 1 percent. The FHA and USDA allow partial claim or Mortgage Recovery Advance (PC/MRA), which helps offset the effect of the rate increase. In the example, the amount of the partial claim for the FHA and USDA is \$44,400, reducing the interest-bearing UPB from \$152,243 to \$107,843. The FHA and VA cap extended loan terms at 360 months. The USDA's special loan modification allows a 480-month loan term, but capital market pricing

and execution of 40-year securities is inefficient, rendering this option largely unhelpful. Although FHA and USDA modifications lower monthly payments, the reduction is below the 20 percent level typically needed for meaningful relief. The monthly payment reduction is only 10.8 percent for FHA modifications and 12.6 percent for USDA special modifications. None of this is to suggest that a smaller payment reduction will not trim redefault rates. Rather, it suggests that a larger payment reduction would cut the redefault rate even more and help minimize losses.

The monthly payment reduction under the USDA's traditional modification (22.6 percent) in the example, while substantial, comes with a big caveat: the cost of keeping the modification interest rate the same as the original note rate must be borne by the servicer, rendering this option very expensive. In other words, although payment reduction under the USDA's traditional modification is substantial, servicer ability for offering this modification is limited. The special modification, which resets the rate to market rate and results in a smaller payment reduction, is more likely to be employed when rates are higher.

2. **VA modifications have additional challenges.** The VA has made improvements in recent years to better assist borrowers, initially through the streamlined modification program in 2016 and disaster relief announcement in 2017. The VA also offers the VA Affordable Modification, which allows principal forbearance to set aside a portion of the outstanding loan balance. But servicers do not get reimbursed for the forbore amount, as they do under the FHA partial claim and the USDA's MRA. This reduces servicer ability to offer principal forbearance, limiting its use. Thus, when a VA borrower obtains a modification in a rising rate environment, the rate is reset to the market rate which, absent principal forbearance, *increases* the monthly payment. In the example, the borrower would see a 7.6 percent increase in the monthly payment.
3. **Payment relief under Flex Mod.** The last two columns show how the GSE Flex Mod would treat the same borrower. Unlike FHA, VA, and USDA modifications, Flex Mod is based on a mark-to-market loan-to-value ratio (MTMLTV), which takes into account the current property value. This metric allows GSEs to tailor loan modification to provide greater payment relief to underwater or deeply underwater borrowers. For borrowers with an MTMLTV ratio between 80 and 100 percent, after resetting the rate to the lower of the original rate or market rate and extending the term to 480 months, Flex Mod forbears principal until 20 percent payment reduction is achieved. For MTMLTV ratios above 100 percent, Flex Mod forbears principal until an MTMLTV ratio of 100 percent is achieved.⁶ If a 100 percent MTMLTV ratio, rate reset, and term extension do not yield a 20 percent payment reduction, Flex Mod provides additional forbearance until either a 20 percent payment reduction is achieved or the maximum forbearance is reached (30 percent of UPB or 80 percent MTMLTV).

Also, the GSEs have a portfolio, which enables them to buy delinquent loans out of pools and hold them indefinitely without having to redeliver back into a security. This gives GSEs additional flexibility in designing loan modification programs and reduces reliance on servicers. The FHA, VA, and USDA, on

the other hand, typically do not use a portfolio to warehouse delinquent loans, and they rely more on servicers.

Recommendations That Produce Greater Payment Relief for FHA, VA, and USDA Borrowers

Mortgage Servicing Collaborative members discussed four options that could increase payment relief available to FHA, USDA, and VA borrowers in a rising rate environment:

- Partial claim with recast for the FHA and USDA (i.e., modify mortgages within the pool to eliminate re-pooling)
- Principal forbearance for the FHA, USDA, and VA
- Extend mortgage terms to 40 years
- Create a balance sheet for warehousing modified unsecuritized loans

Members of the MSC agree that the first two options are easier to implement in the near term. The last two, while possible in the long run, are unrealistic in the near term for the following reasons.

40-year extended term. The secondary market for 40-year-term MBS is small, and securities prices in this market are less competitive. Moreover, in a rising rate environment, market participants are less likely to take on long-duration risk, making the market rate on a 40-year mortgage even less economic. We estimate that 40-year MBS rates are 50 basis points above comparable 30-year securities. That said, it is possible to develop this market over the long run, but some subsidy will probably be needed to assure economic execution during the interim period.

Balance sheet execution for modified loans. This option would allow the FHA, VA, USDA, or Ginnie Mae to purchase delinquent loans out of the pool and hold them in portfolio as whole loans, similar to how the GSEs operate. A portfolio would also facilitate a 40-year extended term, as it would provide an alternative to re-pooling. But Ginnie Mae does not have the authority to run a portfolio and is unlikely to obtain it. The FHA has statutory authority, but the VA and USDA do not. Although this option would expand the scope for more meaningful modifications, it remains a long-term option. To get there, the FHA would need additional funding to repurchase loans out of the pool and to build a new infrastructure of skilled professionals, risk managers, systems, and processes for managing a large portfolio of delinquent and modified loans.

This leaves the first two options: partial claim with recast and increased use of principal forbearance. Mortgage Servicing Collaborative members agree that these are more attainable and easier to implement in the short term.

Combine partial claim (or MRA) with recast. The FHA and USDA already use a partial claim approach. Under the current approach, the loan is bought out of the pool; delinquent interest, taxes, and

insurance are capitalized; the interest rate is set to the market rate (as applicable); the term is extended to 360 months; and PC/MRA reduces the principal balance to achieve the desired payment reduction. But resetting a 3.5 percent mortgage to, say, 5 percent, could curb the ability to achieve payment relief. In such situations, it would be advantageous to leave the loan inside the pool, apply PC/MRA funds, and recast the reduced loan balance with the remaining term and *original 3.5 percent rate*. This is similar to the GSE Flex Mod, which gives borrowers the lower of the market rate or their current rate (table 3). This option could also be combined with a reduction in the FHA Mortgage Insurance Premium for even greater payment relief. This would reduce revenues for the FHA, but if the corresponding reduction in redefault rates produces greater benefit, it would be a net positive for the Mutual Mortgage Insurance Fund.

Use of principal forbearance. This option would deploy principal forbearance in lieu of PC/MRA for FHA and USDA loans. This would be a new tool for the VA, as it does not reimburse servicers for the cost of forbearance. Under this proposal, the loan would be bought out of the pool, the delinquent arrearages would be capitalized, the interest rate would be reset to the market rate, the term would be extended, and forbearance would reduce the principal balance to achieve the desired payment reduction. The new (reduced) principal balance would be securitized while the forborne portion would be due and payable to the FHA, VA, or USDA when the loan is paid off or the property sold (as is the case for partial claims).

This is similar to FHA and USDA loans, except that PC/MRA is replaced with the less cumbersome forbearance. Processing a PC/MRA requires servicers to record a subordinate lien; forbearance does not. In lieu of the junior lien, the principal forbearance would be outlined in the modified note. Principal forbearance would be a win, especially for veterans, because the VA does not reimburse servicers for the forborne amount, reducing servicer motivation to use this option. The forbearance amount for the VA would be limited to 25 percent of the capitalized UPB because of the VA's partial guaranty. The principal forbearance options could be combined with a reduction in the Mortgage Insurance Premium for even greater payment relief.

Table 3 shows the payment reduction under these proposals for the same borrower situation as in table 2. The PC/MRA with recast within the pool would result in the largest payment reduction, as the borrower avoids the rate increase. The FHA and USDA forbearance option results in the same payment reduction as current PC/MRA but is less cumbersome to administer. Most importantly, the proposed VA forbearance option would reduce the capitalized principal balance by 25 percent (the VA's maximum guaranty), resulting in a *reduction* in the VA borrower's monthly payment, in contrast to an increase in table 2.

TABLE 3

Borrower Payment Relief Options under Proposed Solution (5 Percent Market Rate)

| | Original loan (at default) | FHA partial claim + recast | USDA MRA + recast (traditional mod.) | FHA forbearance | USDA forbearance (traditional mod.) | VA forbearance |
|---------------------------|----------------------------|----------------------------|--------------------------------------|-----------------|-------------------------------------|----------------|
| UPB at default | \$148,000 | N/A | N/A | N/A | N/A | N/A |
| Capitalized UPB | N/A | \$152,243 | \$152,243 | \$152,243 | \$152,243 | \$152,243 |
| PC/MRA or forbearance | N/A | \$44,400 | \$44,400 | \$44,400 | \$44,400 | \$38,061 |
| Interest-bearing UPB | N/A | \$107,843 | \$107,843 | \$107,843 | \$107,843 | \$114,182 |
| Interest rate | 3.5% | 3.5% | 3.5% | 5.0% | 3.5% | 4.5% |
| Term | 330 | 330 | 330 | 360 | 360 | 330 |
| P&I | \$699 | \$509 | \$509 | \$579 | \$484 | \$604 |
| Taxes and insurance | \$250 | \$250 | \$250 | \$250 | \$250 | \$250 |
| FHA monthly MIP | \$167 | \$167 | \$0 | \$167 | \$0 | \$0 |
| PITI | \$1,116 | \$926 | \$759 | \$996 | \$734 | \$854 |
| Delinquent payments | N/A | 4 | 4 | 4 | 4 | 4 |
| Monthly payment reduction | N/A | -17.0% | -20.0% | -10.8% | -22.6% | -10.0% |
| P&I reduction | N/A | -27.1% | -27.1% | -17.2% | -30.7% | -13.6% |

Note: FHA = Federal Housing Administration; MIP = Mortgage Insurance Premium; N/A = not applicable; PC/MRA = partial claim or Mortgage Recovery Advance; P&I = principal and interest; PITI = principal, interest, taxes, and insurance; UPB = unpaid principal balance; USDA = US Department of Agriculture; VA = US Department of Veterans Affairs.

Barriers to Implementation

Below, we describe barriers to implementation for the use of PC/MRA with recast and principal forbearance and propose ways to overcome them.

Barriers to PC/MRA with Recast

The main obstacle to partial claim with recast is that the Ginnie Mae MBS guide does not permit loans to be re-amortized while in a Ginnie Mae pool. This rule is governed by 24 CFR 320.5(a), which requires that “specified” payments be made to security holders. Because processing a partial claim with recast would reduce loan balances and pass-through payments scheduled to be received by MBS investors, this regulation would need to be modified. The partial claim with recast option would also require changes to FHA and USDA PC/MRA rules to permit a PC/MRA with principal curtailment. These issues are small and can be handled through rulemaking.

The bigger obstacles to this proposal are as follows:

The VA does not have partial claim authority. The VA does not have statutory authority to originate loans in its name, which is essential to using partial claims or MRA. Under the FHA’s partial claim or the USDA’s MRA, the amount by which the loan balance is reduced is used to create a subordinate mortgage in the government insurer’s name. It would take congressional action to have the VA offer partial claims in this manner. But there is a potential workaround. The VA has a loss mitigation

refunding option, which is rarely used. Under this option, the VA purchases a delinquent loan from the servicer and assumes primary servicing responsibilities. The original mortgage note is endorsed to the VA, and the mortgage is recorded as assigned to the VA. Once a mortgage is assigned under the refunding option, the VA could then offer principal forbearance to achieve greater payment reduction than is possible today.

MBS investor opposition to recast. A second obstacle is MBS investors' opposition because of the potential for a reduction in scheduled payments under the recast proposal. Investors will likely object that the ground rules under which they purchased the securities have been retroactively changed. That is, investors bought the securities assuming the loans would be pulled out of the pool before they would be modified. Investors prefer that a delinquent loan be pulled out of the pool in a rising rate environment because they can then reinvest the proceeds at the higher market rate. Investors would lose this benefit under the recast proposal. Changes to the guidelines could be made prospectively (e.g., only pools issued after a certain future date would permit recasting). Investors would then know, when they buy a pool, that it would have the recast option. But changes could also be made retroactively because the modification wave on crisis-era securities is over, and new originations are pristine with extremely low delinquency rates. In other words, making this change retroactively is unlikely to be costly for investors or disruptive to MBS markets but could help borrowers who might fall behind in the coming years.

Barriers to Expanded Use of Principal Forbearance

The barriers to the principal forbearance proposal are lower. The proposal would require Ginnie Mae to allow non-fully amortizing loans into Ginnie Mae pools. Making this change should not have a noticeable impact on investors, as the portion of loans sold to investors would be fully amortizing. There would be an additional lump sum (equal to the amount of the principal forbearance) due at payoff outside the securitization. This is economically no different than what is allowed today when pooling modified loans with PC/MRA. Although this option would create uncertainty for MBS investors, as they are unsure of the effect of principal forbearance on prepayments, much of this risk exists today with PC/MRA modifications. This change is likely to have minimal impact on securities prices.

The bigger change would be for the VA because it would need to build the infrastructure for principal forbearance and reimburse servicers under the loss mitigation refunding option. We suggest capping the amount of forbearance at the value of the VA guaranty, which is 25 percent of the home value.

Conclusion

Borrowers with FHA, VA, and USDA loans do not have access to modification programs that result in meaningful payment reduction in a high-rate environment. The recommendations in this brief could strengthen the government loan modification product suite and create better financial outcomes for borrowers and the government agencies insuring loans. The Mortgage Servicing Collaborative has

reviewed all available options and concludes that expanded use of PC/MRA with recast or using principal forbearance are the most practical near-term solutions, as they produce the largest payment reduction at the lowest cost. The amount of payment relief could be further increased by offering the borrower a Mortgage Insurance Premium reduction.

The two largest impediments to this proposal are that the VA has no mechanism for doing partial claims or reimbursing servicers for forbearance and that Ginnie Mae investors are likely to object to the recast option on the grounds that it violates securities agreements. On the first point, the VA should use its loss mitigation refunding option more frequently to give veterans the payment reductions they have earned. On the second point, it is possible to make the recast option available only on a go-forward basis, as that is better than making no change at all. But we believe that costs to investors of a retroactive change would be minimal, as the bulk of modification activity is already behind us and delinquencies on new production are low.

Notes

1. For more information about the Mortgage Servicing Collaborative, see “The Mortgage Servicing Collaborative,” Urban Institute, Housing Finance Policy Center, accessed December 28, 2017, <https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative>. For a glossary of relevant terms, see “Mortgage Servicing Glossary,” Urban Institute, Housing Finance Policy Center, accessed January 5, 2018, <https://www.urban.org/policy-centers/housing-finance-policy-center/projects/mortgage-servicing-collaborative/mortgage-servicing-glossary>.
2. Federal Housing Finance Agency, “Statement of FHFA Deputy Director Sandra Thompson on New Loan Modification Offering for Delinquent Borrowers,” press release, December 14, 2016, <https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-FHFA-Deputy-Director-Sandra-Thompson-on-New-Loan-Mod-Offering-for-Delinquent-Borrowers.aspx>.
3. For VA modifications, the interest rate increase is limited to 1 percentage point. For certain USDA modifications, the rate cannot be increased above the original rate.
4. The PMMS is a weekly survey of mortgage rates conducted by Freddie Mac and is a widely used benchmark for prevailing mortgage rates. See “About the Freddie Mac Primary Mortgage Market Survey” Freddie Mac, accessed December 28, 2017, <http://www.freddiemac.com/pmms/about-pmms.html>.
5. The USDA’s Mortgage Recovery Advance is similar to the FHA’s partial claim. Both allow a payment of up to 30 percent of the UPB of the mortgage at default. For FHA loans, the 30 percent limit applies to the life of the loan and includes any prior partial claims. For USDA loans, there is only one MRA per the life of the loan.
6. For full details and other considerations, see Freddie Mac (2017).

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