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A Call for Self-Governance

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COVID-19 FORBEARANCE RELIEF AND PLS:
A Call for Self-Governance

Eric Kaplan, Michael Stegman, and Theodore Tozer

As private-label residential mortgage-backed security (PLS) transactions implement loan payment forbearance options for borrowers impacted by COVID-19, the PLS industry must demonstrate its capacity to self-govern by collaborating on a related set of uniform structural best practices. Accomplishing this will evidence PLS's responsible evolution since the Great Recession. Failure could lead to confusion, disagreements, errors, and litigation that arise from differing contractual interpretations and competing priorities. Failure could also harm consumers and further erode PLS's standing as a viable component of home financing.

Providing Forbearance in PLS

The recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act makes mortgage loan payment forbearance relief available for Federally backed mortgage loans only.[1] It does not apply to non-agency loans, including those bundled into PLS. While various states, including New York, have enacted new measures that extend mandatory forbearance to non-agency loans, they all require shorter periods of forbearance than the CARES Act prescribes.[2]

1 See https://www.congress.gov/bill/116th-congress/house-bill/748 (CARES Act), Section 4022, which makes forbearance available for Federally backed mortgage loans (i.e., loans in the agency and government mortgage channels). The CARES Act does not apply to loans in the non-agency mortgage channel. That said, any forbearance or other loss mitigation efforts in non-agency must comply with applicable law and the terms of the governing transaction documents.

2 The CARES Act generally provides for an initial forbearance period of up to six months, followed by an additional period of up to six months if requested. With respect to New York, for example, see https://www.governor.ny.gov/news/no-2029-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency. Note that federal financial regulatory agencies jointly “encourage[d] financial institutions to work constructively with borrowers affected by COVID-19,” including through the provision of loss mitigation efforts. See https://www.fdic.gov/news/news/financial/2020/fil20022.html.

Despite the inapplicability of the CARES Act to non-agency loans, many PLS industry participants have acknowledged the importance of providing forbearance relief to borrowers impacted by COVID-19. At the same time, these parties expressed concern as to whether tax laws fundamental to PLS allow forbearance relief similar to the type the CARES Act requires. Accordingly, on April 3, 2020, the securitization trade group, Structured Finance Association (SFA), requested guidance from the Internal Revenue Service (IRS) and the US Department of the Treasury (Treasury) on the tax treatment of COVID-19-related mortgage loan payment forbearance under PLS trust structures. On April 13, the IRS issued Revenue Procedure 2020-26, which confirmed that such measures generally would not violate special tax rules applicable to typical PLS trust structures,[3] effectively clearing the way for servicers to offer forbearance relief options to borrowers affected by COVID-19 whose loans are pooled in PLS transactions.

Following the resolution of this gating legal question, the first task for PLS parties to consider before providing forbearance relief is to evaluate the governing PLS transaction documents—particularly, the pooling and servicing agreement or equivalent contract—to determine whether the documents allow or condition the contemplated forbearance.[4] In some cases, loss mitigation options are contractually hard-wired and may not allow for forbearance options or may permit forbearance as an option in a cascading loss mitigation waterfall. In deals where loss mitigation is not hard-wired, forbearance relief will depend on whether the party who controls loss mitigation decisions chooses to provide it and on what terms.[5]

3 This generally refers to tax rules for Real Estate Mortgage Investment Conduits, or REMICs, the primary PLS vehicle, and other vehicles such as grantor trusts. These rules prescribe eligibility requirements for securitized assets as well as the type and terms of loss mitigation that is permissible with respect to these assets. See generally sections 860A through 860G of the Internal Revenue Code.

4 In addition to provisions specifically referencing loss mitigation and forbearance, a review of PLS transaction documents should consider the general servicer standard of care provision, which typically requires the servicer to service in accordance with "generally accepted servicing practices" or similar language. The construction of these provisions can vary by deal, with important implications for the availability of and terms governing forbearance relief.

5 In post-financial crisis PLS—also known as "RMBS 2.0" transactions—the "controlling holder" is typically the holder of the lowest-rated tranche. The controlling holder is also often assigned the role of "servicing administrator," which in many deals has authority over loss mitigation activities, among other things. In expanded credit Non-Qualified Mortgage (Non-QM) transactions, because of risk retention, the controlling holder/servicing administrator is the PLS sponsor or an affiliate of the sponsor. In prime jumbo PLS, even without required risk retention, certain conduit sponsors may also act as servicing administrator.

Non-agency PLS may face scrutiny if the governing deal documents or loss mitigation control parties do not provide for COVID-19-related forbearance relief on similar terms as the CARES Act mandates for Federally backed mortgage loans.[6] For deals that allow forbearance, there are critical structural issues that industry stakeholders must resolve to ensure fair, consistent treatment of forbearance relief within PLS trust structures. Failure to achieve consistency could open the PLS deals—and various PLS trust participants—to a wave of litigation that would likely have an outsized adverse reputational impact relative to PLS's small market share in the post-financial crisis capital markets. We address some of these issues in turn, along with recommendations for structural best practices.

Structural Best Practices and Implications of Forbearance and Delinquency Calculations in PLS

The decision to provide COVID-19-related forbearance relief in PLS raises important structural issues, including the treatment of forborne payments in PLS for delinquency purposes.[7] Different interpretations of this point affect other critical PLS structural elements, including first or early payment default provisions, breach review triggers, cash flow delinquency triggers, and advance reimbursement.

6 Legislating uniform forbearance programs throughout PLS is a difficult proposition, as the governing deal documents on a trust-by-trust basis often carry different provisions and rules regarding loss mitigation. However, it should be possible for all PLS deals to incorporate and offer forbearance or other effective loss mitigation options to affected borrowers in line with the terms of these documents. Note that in some cases, PLS servicers or sponsors are offering deferment outright, rather than forbearance. Under a deferment, deferred payments are moved to the end of the loan term and are non-interest bearing. The borrower is not considered delinquent and is not expected to reinstate or pay back the deferred payments on a repayment plan. The deal documents or empowered PLS party may direct the treatment of advancing, delinquency triggers, etc. Deferment is one option facing borrowers at the end of a forbearance period, although repayment plans, modifications, and other loss mitigation options are possible (note that the CARES Act is silent as to repayment options). We believe deferment constitutes a positive outcome for borrowers in distress due to COVID-19, and that reasonableness and sustainability must be the central focus of any repayment method. By contrast, several reports reference the conditioning of certain forbearance relief on a mandatory lump sum repayment of forborne amounts at the end of the forbearance period. We consider this to be a predatory practice that would negate the very relief that forbearance is intended to provide borrowers in distress due to the COVID-19 crisis. While these reports do not apply exclusively to non-agency loans, agency and government channel regulators have established policies that CARES Act forbearance relief will not be subject to mandatory lump sum repayment. We expect any loan servicer or holder to face deep scrutiny, if not repercussions, should it attempt to secure immediate mandatory lump sum repayment of forborne amounts.

7 We agree that servicers should not report those borrowers with loans in forbearance as delinquent with respect to forborne payments to the credit bureaus, which would align with the CARES Act.

First/Early Payment Default (FPD/EPD) Provisions. Forborne payments ***should*** be considered delinquent for FPD/EDP purposes in PLS.

FPD/EPD provisions protect loan purchasers (including PLS trusts) from purchasing a loan that demonstrates distress immediately following origination. A forbearance request indicates distress, and industry stakeholders are already seeing borrowers request forbearance shortly if not immediately following loan origination. Whether the borrower (i) was in distress at the time of origination and failed to disclose it to the lender or the lender failed to detect this distress, or (ii) suffered COVID-19-related distress prompting the forbearance shortly after origination, FPD/EPD provisions—most of which contain strict liability standards—are designed to protect the loan buyer from precisely these circumstances.

While whole loan buyers may exercise discretion and purchase an affected loan anyway, with or without pricing adjustments, reperformance carve-outs, or other conditions, there is no such party empowered to exercise such discretion in PLS.[8] If the forborne payment would otherwise have been due to the trust and falls within reach of the governing FPD/EPD provision, the loan should be subject to repurchase from the PLS trust.

FPD/EPD repurchases can strain the secondary market and lead to credit restrictions and increased borrowing costs in the primary market. Issuers could try to alleviate such stress by including FPD/EPD loans in new PLS trusts (should any be issued), which would require loosening the customary FPD/EPD provision and adding proper disclosure. However, this would transfer the performance risk of these loans to the trust and bondholders. Rating agencies would likely consider this an incremental risk under their ratings methodologies, possibly increasing credit enhancement and requiring investors to factor the risk into their participation and pricing decisions.

8 Ginnie Mae, for example, will accept loans that would otherwise constitute FPD/EPDs due to COVID-19-related forbearance depending upon the pooling date and length of the delinquency. The government corporation is authorized to exercise such discretion over its trusts. Other entities—for example, the Virginia Housing Development Authority—are now requiring origination safeguards designed to ensure that borrowers are not anticipating or intending to request forbearance at or just prior to the loan's origination date and will accept loans that constitute EPDs if these filters indicate forbearance relief is based on post-closing circumstances. The Federal Housing Finance Agency has directed Fannie Mae and Freddie Mac (GSEs) to buy eligible loans that enter forbearance post-origination, but with a loan-level pricing adjustment of either 500 or 700 basis points to reflect the increased risk and cost of these loans to the GSEs. And certain non-agency whole loan buyers routinely offer to purchase FPD/EPD loans with pricing adjustments. These examples demonstrate that where a buyer can exercise discretion, FPD/EPD purchase flexibility is possible. This discretion is absent in PLS, and provisions are therefore typically strict liability covering one- to three-month monthly payment periods. For more information on FPD/EPD provisions in PLS, see SFA's RMBS 3.0 Task Force Green Papers (6th Edition), which one of the co-authors of this article, Eric Kaplan, co-authored and co-edited as task force chair. The RMBS 3.0 Green Papers also discuss the potential inclusion in PLS deals of a party, known as a "Deal Agent," empowered to exercise discretion on a trust's behalf. https://structuredfinance.org/wp-content/uploads/2019/05/RMBS-3.0-Sixth-Edition-Final-1109.pdf.

120-Day Delinquency Breach Review Triggers. Forborne payments ***should not*** be considered delinquent for purposes of 120-day delinquency PLS breach review triggers.

RMBS 2.0 prime jumbo and prime or "near-miss" Non-QM deals typically require a breach review on any loan that reaches the 120-day delinquency mark.[9] This trigger ensures that a loan is reviewed for breach at the time the servicer initiates foreclosure proceedings.[10] However, a borrower whose loan is in forbearance is not required to make the loan payment on its due date and has, therefore, technically not missed the payment. If the borrower received forbearance for four months and was current at the time forbearance commenced, the servicer could not initiate foreclosure proceedings at the end of the forbearance period and would have to wait until the borrower subsequently was 120 days delinquent before it could do so.[11]

Furthermore, these deals are more likely to have mandatory rather than optional breach reviews upon such a trigger event. Each breach review could cost anywhere from several hundred to more than a thousand dollars. High, prolonged forbearance rates could drain a considerable amount from the trust or the PLS party ultimately charged with paying for any review under the deal documents. At some point, these payments could affect bond cash flows and ratings evaluations.

9 Expanded credit Non-QM PLS deals typically do not contain this trigger.

10 For a more in-depth discussion of PLS breach review triggers, see the RMBS 3.0 Task Force Green Papers (6th Edition).

11 Any borrower who is delinquent at the commencement of a forbearance period should remain in the applicable delinquency bucket until the end of such period, at which time the servicer should evaluate loss mitigation or other options taking into account the delinquency status. In other words, forbearance should not erase the delinquency status of a borrower, nor should it exacerbate it.

Delinquency Triggers for Cash Flow Purposes. Forborne payments ***should*** count as delinquencies for PLS bond cash flow purposes.

Forborne payments present arguably the trickiest issue in the context of delinquency triggers and cash flows. Different PLS deals have different advancing requirements, cash flow rules, and delinquency triggers that can cause interest and/or principal lockouts to subordinate bondholders. The ramifications of COVID-19-related forbearance depend on a transaction's details and its governing documents. Rating agencies have already begun to publish treatments of these dynamics in anticipation of a potential PLS forbearance onslaught of the kind IRS Revenue Procedure 2020-26 facilitates.

Loans in forbearance are in distress, and some (perhaps many) borrowers who receive forbearance are likely to require further loss mitigation efforts after the forbearance period ends.[12] Given the unprecedented income and economic dislocation caused by COVID-19, rating agencies must consider these factors and their potential impact on trust cash flows generally, but particularly on cash flows to senior tranche holders. At a time when the risk that delinquency triggers protect against is present, any structural weakness that fails to count the distress event towards the delinquency trigger would negate this protection.[13] PLS transactions that allow payments to continue to subordinate bonds as forbearance increases will put pressure on senior bond ratings as credit enhancement will not build as necessary to protect the seniors.

Where a party has discretion over loss mitigation policy—particularly in Non-QM PLS where the deal sponsor or its affiliate is likely to be the controlling holder and servicing administrator—we note the potential for "tranche warfare." The servicing administrator could offer forbearance, which aids consumers but can also benefit itself. If loans in forbearance are not considered delinquent for loss trigger purposes, then cash may keep flowing to subordinate bondholders, including the controlling holder.[14]

12 Notably, the manner in which servicers or other controlling parties require borrowers to repay forborne amounts also merits attention and will likely invite scrutiny. We are against any mandatory repayment plan that constitutes a balloon payment immediately due at the end of the forbearance period or that poses an unsustainable cost burden or payment shock, particularly where more sustainable options are legally and contractually viable.

13 PLS delinquency triggers typically include loans that fall into other loss mitigation buckets—for example, recently modified loans—but parties must consider and evaluate the impact of forbearance under the specific terms of the governing PLS documents for any particular transaction.

14 The controlling holder could also offer other loss mitigation options that would keep cash flowing to the subordinate bonds despite the risk of increased borrower distress.

Furthermore, some PLS deals may not require servicers to make advances on forborne loans if they are excluded from the deal's delinquency bucket.[15] In deals where servicers do advance, however, there may be differences in the timing and priority of advance reimbursement relative to bondholder payments.

Determining Uniform Structural Best Practices Is Critical

The PLS market faces an urgent need to collaborate and adopt a set of uniform structural best practices. Industry stakeholders are best positioned to do this, particularly given the complexity of the details. Failure to do this could lead to troubling consequences, including:

- Different rating agencies could take different views on issues, leading to material divergence in surveillance, outlook, and possible ratings watch or downgrade actions on the same transactions.
- Different PLS trust counterparties charged with making pertinent decisions or interpreting deal documents could take opposing views on materially similar PLS transactions issued off of materially similar securitization platforms.
- Different servicers in the same PLS transaction could also take opposing views, creating inconsistencies if not chaos within the transaction.

These and other circumstances could give rise to a surge of lawsuits that would likely have an outsized reputational and market-chilling impact. In 2008, it was too late to unite to solve the issues that caused the PLS litigation tidal wave. There is still time in the wake of the COVID-19 crisis to prove that the PLS industry can self-govern with consideration for the best interests of both consumers and the housing finance system.

15 Contrast this to agency and government mortgage-backed securities, where principal and interest (P&I) are guaranteed to bondholders. Because these amounts are due and owing every month, the servicer must come out of pocket and make any required advance (subject to applicable caps). Non-agency PLS deals, by contrast, are subject to shortfalls.

The Time for PLS Self-Governance Is Now

PLS created a new avenue to home financing and widened access to sustainable credit for decades until poor practices and structural weaknesses eroded it from the inside and exposed it to contagion from the outside. Post-financial crisis PLS efforts at self-governance failed to develop industrywide consensus best practices.[16] However, the COVID-19 crisis makes it imperative for the PLS industry to coalesce around the development and implementation of structural best practices regarding forbearance. This effort would help mitigate—at least within the PLS universe—the pandemic's far-reaching harm to consumers and disruption of the housing market. It would also constitute a meaningful step in the post-financial crisis struggle to justify the relevance of PLS in housing finance.

As the COVID-19 crisis resolves, there will be efforts to evaluate how well or poorly the PLS industry and market performed, and why, just as there were in the aftermath of the Great Recession. In hindsight, we will be able to determine such things as whether deal documents were sufficiently flexible to allow fair, effective forbearance and other loss mitigation, or were so rigid as to prevent meaningful consumer relief. We will know whether the PLS party with discretion over loss mitigation chose to help borrowers weather the crisis and whether it prioritized its own interests over those of the consumer and the securitization trust.

Pinpointing who was helped and who was hurt should go a long way in determining the role of PLS going forward. Successful self-governance that yields uniform structural best practices in response to the COVID-19 crisis will evidence PLS's responsible evolution since the Great Recession. Failure of the industry to meet the challenge at this moment of greatest need might just be enough for regulators and policymakers to decide that PLS is not ready to reassume a meaningful role in the future housing finance system—a position with which we would reluctantly have to agree.

16 Instead, through exercises such as the SFA's RMBS 3.0 task force, stakeholders sought to create an informed, accountable PLS market by identifying variations in deal standards, explaining the differences among these variations, and highlighting best practices wherever possible.

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