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Mortgage Servicing in the Age of COVID-19

FORBEARANCE

BY JASON BUSHBY, ESQ. AND GREG PIPES, ESQ.

ON PAGE 8 of the September–October issue, we discussed the COVID-19 forbearance landscape and related compliance challenges for mortgage servicers. In this article, we unpack the post-forbearance world, focusing on the transition out of forbearance and into other forms of loss mitigation assistance, including, but not limited to, payment deferrals, repayment plans, loan modifications, etc. This article also examines the interplay between investor/insurer requirements, federal law, and select state laws.

Background

Under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, servicers of federally-backed single family mortgages are required to provide forbearances to borrowers impacted, directly or indirectly, by COVID-19. Borrowers that meet this criteria and request assistance during the covered period are entitled to an initial forbearance period of up to 180 days and a one-time extension of 180 days (or less if the borrower chooses). Some state and local jurisdictions have also enacted forbearance requirements that are similar to, or expand upon the CARES Act provisions.

With a few exceptions—covered later in this article—federal and state forbearance requirements do not dictate how servicers should handle forborne amounts after the forbearance period ends. In keeping with industry standard, most lenders and servicers require the borrower either to repay the forborne amounts as a lump sum at the end of the forbearance period or enter into some additional form of loss mitigation. Servicers transitioning into this post-forbearance landscape must evaluate a patchwork of federal, state and investor/insurer requirements to determine which options to offer and how to offer them legally and efficiently. With increasing numbers of COVID-19 forbearances set to expire each month, these issues are relevant now more than ever.

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Common Post-Forbearance Scenarios

Borrowers exiting COVID-19 forbearances in the current environment will likely have a mix of post-forbearance options that include traditional loss mitigation options and unique COVID-19 programs developed by the investor/insurer. A list of common post-forbearance options/pathways and a brief description of each is included below. Of course, the types of options and specific terms available to any one borrower will depend on loan type, local laws and investor/insurer requirements.

- **Reinstatement**–the borrower pays back all payments that were missed under the forbearance plan. After the reinstatement, the borrower continues to pay his or her contractual payment under the original terms of the loan.
- **Repayment Plan**–the borrower resumes making his or her regular monthly payments, plus an additional portion of the missed amount each month, until the missed amount is paid off. Repayment plans can vary drastically in length and amount.
- **Payment Deferral / Partial Claim**–missed payments and, in some cases, other amounts (e.g. servicing advances paid to third parties) are deferred to the maturity date as a non-interest-bearing balance. The deferred amount is due on the maturity date (or earlier whenever the home is sold, or the loan is refinanced or otherwise paid off). Once the deferral is processed, the borrower resumes making his or her regular contractual monthly payment.
- **Loan Modification**–the terms of the mortgage loan are modified to reach an affordable payment solution for the borrower. Loan modifications can take many forms but typically include capitalization of arrearages, a reduction in interest rate and/or a term extension.

Servicers should keep in mind that these options can produce drastically different financial results for borrowers. As such, the borrower's financial circumstances often play a large role in determining the appropriate post-forbearance relief option. For example, borrowers with longer forbearance periods may find it difficult or impossible to reinstate the loan when the forbearance ends. Similarly, borrowers with ongoing hardships may not be able to resume making the contractual payments contemplated by most deferral programs and instead need to explore a loan modification. Ultimately, servicers must defer to investor/insurer guidelines and applicable local law when making decisions about which options to offer.

Compliance Considerations

Investor/Insurer Requirements

Investor/insurer requirements play a critical role in servicers' post-forbearance approach. Indeed, Fannie Mae, Freddie Mac (together, the "GSEs") and the Federal Housing Administration ("FHA") were the first major industry players to step in and attempt to fill the post-forbearance void left by the CARES Act. On April 1, 2020, FHA introduced its COVID-19 National Emergency Standalone Partial Claim, which allowed eligible borrowers to defer the repayment of forborne amounts through an interest-free subordinate mortgage due when the first mortgage is paid. On May 13, 2020, Fannie Mae and Freddie Mac followed suit and unveiled COVID-19 payment deferral programs, allowing servicers to defer up to 12 months of delinquent mortgage payments to the end of the loan term as a non-interest-bearing balance.

Borrowers must meet specific eligibility criteria to take advantage of these options. For example, under the Fannie Mae COVID-19 Payment Deferral, the borrower must have resolved his or her COVID-19-related hardship and be able to resume making the contractual payment but not have enough funds to reinstate the mortgage. Unless an exception is granted, the loan must have been current or less than two months delinquent as of March. 1, 2020, the effective date of the National Emergency declaration related to COVID-19, and not more than 12 months delinquent as of the date of evaluation.

Servicers must review and evaluate the borrower for a payment deferral without requiring a complete borrower response package. These eligibility criteria—particularly the borrower's financial condition and hardship information—can be difficult to track and manage, especially when the conversation takes place over the phone. Detailed policies and procedures are required to ensure customer-facing personnel understand the requisite criteria and notate the servicing system accordingly. Servicers of both GSE and non-GSE loans may also have to juggle multiple sets of eligibility criteria for their private and GSE portfolios, which introduces yet another layer of complexity.

Servicers of GSE loans must also consider quality right party contact (QRPC) and loss mitigation hierarchy (i.e. waterfall) requirements. With respect to QRPC, the GSEs require that servicers initiate contact attempts no later than 30 days before the expiration of the forbearance period. Servicers are directed to take the following steps as part of QRPC:

1. Determine the reason for the delinquency and whether it is temporary or permanent in nature;
2. Determine whether or not the borrower has the ability to repay the mortgage loan debt;
3. Educate the borrower on the availability of workout options, as appropriate; and
4. Obtain a commitment from the borrower to resolve the delinquency.

Item 3 is critically important and requires that servicer personnel have good understanding of which options are available to the borrower and the potential legal and compliance ramifications of electing one option over another.

If the servicer is unable to achieve QRPC, the servicer must evaluate the borrower for and offer, if appropriate, a deferral and/or modification. If QRPC is achieved, servicers must navigate a COVID-19-specific loss mitigation hierarchy. Unfortunately, this hierarchy does not always fit neatly into existing GSE guidance. For example, Fannie Mae's COVID-19 guidance requires that the servicer evaluate the borrower for a repayment plan before reviewing for a payment deferral. Under the servicing guide, however, if the loan is greater than 90 days delinquent—which is likely to be the case in most forbearance scenarios—the borrower must submit a complete borrower response package in order to be evaluated for a repayment plan. This is seemingly at odds with Fannie Mae's mandate that the borrower does not need to submit a complete borrower response package to be considered for a payment deferral.

Federal Law: CFPB Interim Final Rule on COVID-19-Related Loss Mitigation Options

Servicers offering post-forbearance options must also be cognizant of Regulation X's loss mitigation requirements. As a refresher, Regulation X's anti-evasion clause imposes significant restrictions on the types of loss mitigation options that can be offered when a borrower has submitted an incomplete loss mitigation application. The CFPB made it clear early in the pandemic that conversations about forbearances and post-forbearance options—like those that take place during QRPC—will almost certainly constitute an incomplete loss mitigation application under Regulation X. The tension between these requirements created significant headaches for servicers looking to offer long-term post-forbearance relief options quickly and efficiently. The issue finally came to a head when the GSEs introduced their payment deferral program which expressly directed servicers to offer deferrals without obtaining a complete borrower response package.

Thankfully, the CFPB responded to the industry's concerns by issuing a new interim final rule on June 23, which gives servicers increased flexibility to offer COVID-19 relief options. At a high level, the new rule eases the tension created by Regulation X's anti-evasion clause by creating a temporary exception for certain payment deferral options. To qualify for the new exception, the payment deferral option must meet certain conditions that generally align with the COVID-19 payment deferral programs announced by the GSEs. The rule further provides that if a borrower accepts an option pursuant to the new exception, the servicer is not required to continue reasonable diligence efforts to obtain a complete application or provide an incomplete acknowledgment notice.

Under the new rule, the following criteria must be satisfied for the servicer to offer a post-forbearance loss mitigation option based on an incomplete application:

- The option must permit the borrower to delay paying "covered amounts" until the loan is refinanced, the mortgage property is sold, the term of the loan ends, or for mortgages insured by FHA, the mortgage insurance terminates. For purposes of the rule, "covered amounts" are generally defined as all principal and interest payments due and unpaid or forborne as a result of a COVID-19 hardship;
- The amounts that are delayed must not accrue interest, the servicer may not charge any fee in connection with the deferral option, and the servicer must waive all existing late charges, penalties, stop payment fees, or similar charges promptly upon the borrower's acceptance of the loss mitigation option; and
- The borrower's acceptance of the offer must end any pre-existing delinquency.

While the rulemaking was welcomed by the industry, there are some potential pain points worth noting. First, the rule is limited to deferral and partial claim-type arrangements and does not extend to most loan modifications options.

Accordingly, servicers still need to collect a complete loss mitigation application before making a loan modification offer, unless the servicer is making a blind offer (i.e. not based on an evaluation of any information provided by the borrower). Second, the provision that requires the servicer waive all fees and similar charges has caused considerable confusion and uncertainty amongst mortgage servicers. It seems likely that the CFPB intended to address charges that penalize a borrower for failing to make a periodic payment by the due date or the end of any grace period. However, the ambiguity inherent in the phrase "similar charges" combined with the fact that a servicer must waive "all existing" fees creates uncertainty as to what amounts must be waived.

Finally, under the current version of the rule servicers do not need to provide an acknowledgement letter if the borrower "accepts an offer." While the CFPB's intent with this provision–reducing the burden on servicers–was admirable, its practical application is limited. When an acknowledgment letter must be sent, it must be done within five days (excluding legal public holidays, Saturdays, and Sundays) of receiving the application. Because most servicers offer a borrower a period of time in which to accept or reject a COVID-19-related loss mitigation offer, servicers may not know whether the borrower has actually accepted it before the window in which an acknowledgment letter must be sent closes. As a result, many servicers may resort to sending an acknowledgment letter with the loss mitigation offer, which could confuse the borrower.

State Law

With movement on the proposed follow-up legislation to the CARES Act at a standstill in Congress, some states and local jurisdictions—particularly those with aggressive consumer protection agendas—have stepped in to address the post-forbearance landscape. As of the date of this writing, New York, Massachusetts, Oregon, and D.C. have all enacted requirements aimed at the treatment of post-forbearance amounts. This article provides a brief overview of New York's post-forbearance requirements to illustrate the types of issues servicers may face at a local level.

Servicers should closely assess the applicability and impact of *all* local laws, however, as each presents unique challenges. Servicers that have adopted the GSE post-forbearance model should pay close attention as some local laws arguably conflict with GSE requirements.

Under recently enacted New York Banking Law Section 9-x, regulated mortgage servicers must offer borrowers with non-federally-backed loans three options for paying the arrears accumulated during a forbearance: (1) extend the term of the loan for the length of forbearance period, without "additional" late fees or penalties on the forborne payments; (2) pay back the arrears accumulated during forbearance (without late fees or penalties) in monthly payments for the remaining term of the loan; or (3) negotiate a loan modification or other option for repayment.

Section 9-x further provides that if the lender and borrower are unable to "reasonably agree" on a loan modification (and presumably any of the other options listed above), then the lender shall offer to defer the accumulated arrearage as a non-interest-bearing balloon obligation due at the maturity of the loan. A lender's compliance with all of these provisions is a condition precedent to pursuing foreclosure, and the borrower can raise non-compliance as a defense to the foreclosure. No guidance is provided on how a lender can establish compliance with the law.

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Section 9-x law raises a number of potential concerns. First and foremost is whether the law is even constitutional. Under the Contracts Clause, state law cannot impose a significant impairment on contracts unless the law is drawn in an "appropriate" and "reasonable" way to advance "a significant and legitimate public purpose." While the New York law arguably advances a legitimate public purpose in assisting borrowers during a global pandemic, one could certainly argue that mandating specific repayment options, including an option that alters a fundamental contractual term like the maturity date, constitutes an unreasonable impairment on private contracts. The law's ambiguous language regarding the possibility of a loan modification introduces related concerns.

Under Section 9-x, a servicer can only default to requiring repayment as a balloon obligation if the servicer and borrower are unable to "reasonably agree" on a loan modification. The word "reasonably" suggests there are circumstances where the borrower could argue that he or she has a statutory right to a certain type of loan modification. That upsets long-settled principles of both basic contract law (that a court cannot impose a contract on unwilling parties) and loan modifications in particular (that no borrower has a right to receive a specific loan modification option).

Setting aside constitutional issues, Section 9-x goes well beyond the GSE post-forbearance model in several important respects. Notably, the law allows the borrower, rather than the investor, to drive the decision-making regarding post-forbearance treatment. While some form of borrower preference is arguably baked into the GSE ability-to-pay assessment, servicers using the GSE model must still evaluate the borrower according to a specific waterfall. In contrast, Section 9-x expressly states that the servicer must offer, and the borrower may choose, any of the enumerated options when exiting forbearance. The law also introduces two repayment options that are not currently endorsed by the GSEs in the COVID-19 context–term extensions and repayment plans over the life of the loan.

This presents significant challenges for servicers that have followed the GSE approach and prioritized a streamlined payment deferral as the preferred post-forbearance option. As an initial matter, it's not abundantly clear whether a servicer can even offer a payment deferral under Section 9-x without first evaluating the borrower for a modification. Either way, the law still gives the borrower the opportunity to elect two post-forbearance options. This is either a repayment plan over the life of the loan, or a loan modification. The loan modification option will almost certainly fall outside the scope of the CFPB's interim final rule and therefore arguably require a complete loss mitigation application. Servicers with loans in New York and other jurisdictions with post-forbearance requirements should carefully consider how these local requirements fit into the federal and investor/insurer framework.

Conclusion

In the current environment, it is critical that servicers have a firm grasp on the legal and compliance ramifications of transitioning borrowers into post-forbearance solutions. These transitions will likely receive significant scrutiny moving forward as legislators, regulators, and consumer advocacy groups seek to ensure borrowers are not put in positions that undermine the benefits of forbearance relief. Servicers should also stay alert, as there will likely be more developments on this topic in the months to come ■.

ABOUT THE AUTHORS

JASON BUSHBY, ESQ., is a Partner in the Birmingham, Alabama office of Bradley. Jason practices in the firm's Financial Services practice group and, in so doing, provides regulatory compliance, examination, and enforcement assistance to a range of financial services clients across the country. Jason assists financial services entities as they bring their operations into compliance with various obligations imposed on them by the CFPB and other federal and state regulators. He advises clients on compliance matters related to a host of federal and state regulations, including TILA, RESPA, FCRA, ECOA, etc. Jason has advised some of the nation's largest financial institutions in all aspects of their CFPB examinations. Jason also defends financial institutions in investigations and enforcement actions initiated by the CFPB and other regulators. Reach him at **jbushby@bradley.com**

GREG PIPES, ESQ., is an Associate in the Birmingham, Alabama office of Bradley. Greg practices in the firm's Financial Services practice group and, in so doing, assists banks, mortgage originators and servicers, and other financial service providers with examinations, investigations, and enforcement actions initiated by the CFPB and other federal and state regulators. His practice focuses on helping clients navigate all aspects of the regulatory examination and enforcement process. Greg also helps clients assess the impact of new rules and regulations and adapt to changes in the regulatory environment. Reach him at **gpipes@bradley.com**.