Strategic Forbearance and Unintended Consequences of the CARES Act

Contact Author: Dr. Michael J. Seiler, mjseiler@wm.edu, 757.585.6100

Synopsis

In the first quarter of 2020, the Novel Coronavirus (COVID-19) spread from Asia throughout most of the world, and unleashed its devastating impact on the United States in terms of both human casualties and economic consequences. The economy experienced mass layoffs, furloughs, and assorted other job, wage, and hour reductions. Unemployment filings rose dramatically, stock market volatility increased and levels plummeted into bear market territory.

On March 27, 2020, an overwhelming bipartisan consensus in Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act authorizing the direct injection of over $2 trillion into the economy, and further authorized the Federal Reserve System (FED) to provide additional liquidity to financial markets estimated at over $4 trillion. Despite this massive intervention, conventional wisdom maintained that many borrowers would not be able to make their required mortgage payments. To address this concern, the CARES Act made specific provisions to allow for all residential mortgages owned by Fannie Mae, Freddie Mac, the Veteran's Administration (VA), and the Federal Housing Authority (FHA) to go into forbearance with significantly reduced (or entirely eliminated) negative consequences for both borrowers and lenders.

As of early 2020, the U.S. residential mortgage market consisted of approximately 50 million loans with a total outstanding mortgage balance of roughly $11 trillion. CARES ACT covered mortgages represent approximately 62% of that total. The average mortgage payment (principal, interest, taxes and insurance) across these loans was roughly $1,250 per month. Because servicers of these loans lack the labor force to receive, process, and evaluate the financial need of millions of forbearance applicants, the Act calls for borrowers to follow the "honor code" and only ask for mortgage forbearance if their income was adversely affected by the COVID-19 pandemic.

To alleviate borrower hesitancy to participate, unlike traditional forbearance arrangements, interest does not accrue during the forbearance period, which may last up to 12 months. To engage in this mortgage forbearance program, all a borrower has to do is stop paying his mortgage and notify his servicer. Since lenders must statutorily (1) apply no penalties, late fees, or interest, (2) halt all evictions and foreclosure sales of borrowers, and (3) suspend reporting to credit bureaus of delinquency related to forbearance, there is virtually no direct cost to the borrower to engage in CARES Act qualified forbearance.

From a policy perspective, however, one major concern with this opportunity is that with a cost near zero, the game theoretic optimal solution is for nearly every borrower, including those who are not experiencing a COVID-19 related financial hardship, to self-select into the program, thus resulting in a moral hazard problem costing taxpayers potentially billions of dollars per month. One mechanism to help combat this potential free rider problem is to require forbearing borrowers to sign a 1-page document stating they are "experiencing a COVID-19 related decline in income." After the pandemic is over, the servicer/lender may then perform a post-mortem

review of all mortgage forbearance cases, and if the borrower is found to have participated withOUT experiencing a COVID-19 related decline in income, stiff penalties could be enforced.

To assess the potential efficacy of such an approach, we conducted an experiment into whether a single page attestation to financial hardship with recourse would curb participation in the CARES Act forbearance program by those who do not need payment assistance. Our results show that when borrowers know their feet will be held to the fire, a simple acknowledgement that free riding will not be allowed statistically significantly reduces the moral hazard problem, thereby potentially saving billions of dollars in federal bailout funds each month.

We are also concerned that borrowers who choose to forbear, whether in financial need or not, could easily take this money and allocate it toward unintended purposes. For example, might some borrowers choose to invest these funds into a potentially undervalued, yet highly volatile stock market in the hopes of making up for losses in other areas of their balance sheet? If such a gamble proved effective, the borrower would reap all the benefits and pocket any gains. On the other hand, if the market declines and the gamble does not pay off, the borrower simply defaults and walks away from (or modifies) the mortgage they can no longer afford, and the costs of the resulting bailout could potentially be many times greater. Consistent with this concern, evidence reveals many borrowers would be willing to use their forgone mortgage payments to invest in the stock market (7.91%). Some would select low risk investments like TIPS/CDs (6.12%), while others would use the money to pay down various consumer debts including student loans (4.29%), auto loans (4.98%), and credit cards (11.61%) – essentially using the CARES Act forbearances as a government sponsored debt consolidation program.