THE IMPACT OF COVID ON THE INDUSTRY

Mortgage Field Services

ABSTRACT

How COVID impacts the Mortgage Field Services and the likelihood of increased distressed asset channel opportunities.

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Background

The International Association of Mortgage Field Services (IAFST)[1] projects the US domestic mortgage space is estimated to be valued at roughly $15 trillion dollars.[2] And to that point, for roughly every one percent (01%) increase in delinquency rates within the mortgage sector, $700 Million of field services are generated.[3] As of the date of this White Paper, there are roughly 5.4 million coronavirus (SARS-CoV-2 / COVID) infections and 172,000+ deaths as a result of COVID in the US.[4] COVID has exacerbated an already fragile financial sector in the US. In fact, pre-COVID and between September 2019 – December 2019, the financial sector (including financial institutions) were the recipients of nearly $6 Trillion of overnight loans in order to keep the US economy solvent.[5]

Discussion

Since the start of the coronavirus crisis, the Federal Reserve has won admiration from many quarters for the pace and magnitude of its interventions to stabilize financial markets. Certainly, the Fed has taken crucial steps to resuscitate the liquidity facilities created back in 2008 — as well as developing some new ones. On April 28 it even expanded the Municipal Liquidity Facility[6], agreeing to purchase large volumes of short-term debt issued by small counties and cities in the United States. Equally striking has been the Fed's decision to purchase corporate junk bonds.

But little attention has been paid to one very peculiar aspect of the Fed's actions --- namely its relative lack of intervention in the private-label mortgage-backed bonds that come without (either implicit or explicit) US government guarantees. After much panhandling by commercial real estate lobby groups, the Fed has only agreed to purchase the top-rated such bonds issued prior to the crisis. Privately issued residential mortgage-backed securities have been left out of the Fed purchase programs designed to inject liquidity in capital markets.

To understand both the Mortgage Field Services Industry (Industry), as well as the Fed's actions, we must first understand the vehicle which generates the distressed assets themselves. Two fundamental terms are in play: Mortgage Backed Securities (MBS) and Mortgage Servicing Rights (MSR).

> Tomorrow morning, John Doe decides he will buy a home. He goes to a loan officer whom, in turn, prepares documents pertaining to the asset he wishes to purchase as well as all of Mr Doe's credentials such as his banking statements, driver's license, credit score, and a plethora of other documents which attest to his credit worthiness. The originating institution then, in turn, makes a determination that either Mr Doe is eligible for an FHA or other Government Sponsored

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[1] https://www.iafst.org/
[2] https://podcasts.apple.com/us/podcast/industry-relations-episode-44-what-forbearance-means/id1204450450?i=1000471115620
[3] https://www.fool.com/earnings/call-transcripts/2020/08/06/altisource-portfolio-solutions-sa-asps-q2-2020-ear.aspx
[4] https://en.wikipedia.org/wiki/Template:COVID-19_pandemic_data
[5] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200103a.htm
[6] https://www.bloomberg.com/news/articles/2020-04-27/fed-lowers-population-thresholds-for-municipal-debt-program

Enterprise (GSE) authorized mortgage or , in the alternative, offers Mr Doe what is commonly referred to as a non-Qualified Mortgage (QM). Non-QMs simply mean that Mr Doe may possess the financial worthiness to purchase the asset; however, Mr Doe is unconventional such as self-employed.

> Mr Doe's mortgage is then added to a pool of thousands or tens of thousands of other mortgages which the process is generally referred to as securitization or more commonly an MBS. The MBS is then, in turn, offered out in pieces – say $10 Million of a $1 Billion pool – to investors. Investors are guaranteed, on the GSE (or Agency) side, a fixed payment for the life of that pool which is underwritten by the US Government. Non-QM (or non-Agency) pools are similar in nature without the guaranteed payments seen in Agency pools backstopped by the US Government.

Investors – whether it be pension funds, hedge funds, or otherwise, additionally buy MSR. MSR are simply the ability to provide the intermediary vehicle to facilitate payments from the mortgagee to the investor who owns the MBS. For example, Mr Doe received a mortgage from Quicken Loans. Quicken then sold the loan into an MBS pool. That pool then, in turn, sold the MSR of the pool to yet another investor such as Wells Fargo. In the end, Mr Doe rarely, if ever, pays his mortgage to the originator.

> MSR's are sold to investors generally at a rate of one percent (01%) of the value of the total value of the piece of the MBS pool they wish to manage. An example is that Fannie Mae, a GSE, may sell MSR to ABC Loan Company. ABC ensures that the payments from Mr Doe are passed on to Fannie Mae and, in turn, they take a haircut – say $10 on $1000. ABC handles all day-to-day interactions of the mortgagee with the mortgagor. The return on investment is generally thirty percent (30%) per year with break even in three (03) years.

Unlike financial institutions who have direct access to the Fed's discount window and other institutional avenues of liquidity and the enormity of financial holdings, investors who hold MSRs are generally illiquid. These margins are quite slim even in times of prosperity. Agency backed MBS also have the caveat that even if the mortgagee does not make the payment, the MSR investor must make that payment.

Moreover, unlike in the wake of the 2008 housing crash,[7] no direct help has been announced in the form of purchasing bonds issued by cash-strapped mortgage providers and servicers. The Fed has done the bare minimum regarding real estate -- despite clear signals of a serious downturn in real estate, which will devastate homeowners as well as small and medium businesses. Not only the Fed but also the Trump administration appears unwilling to act with direct and sufficient stabilizing force to halt the storm that is brewing.

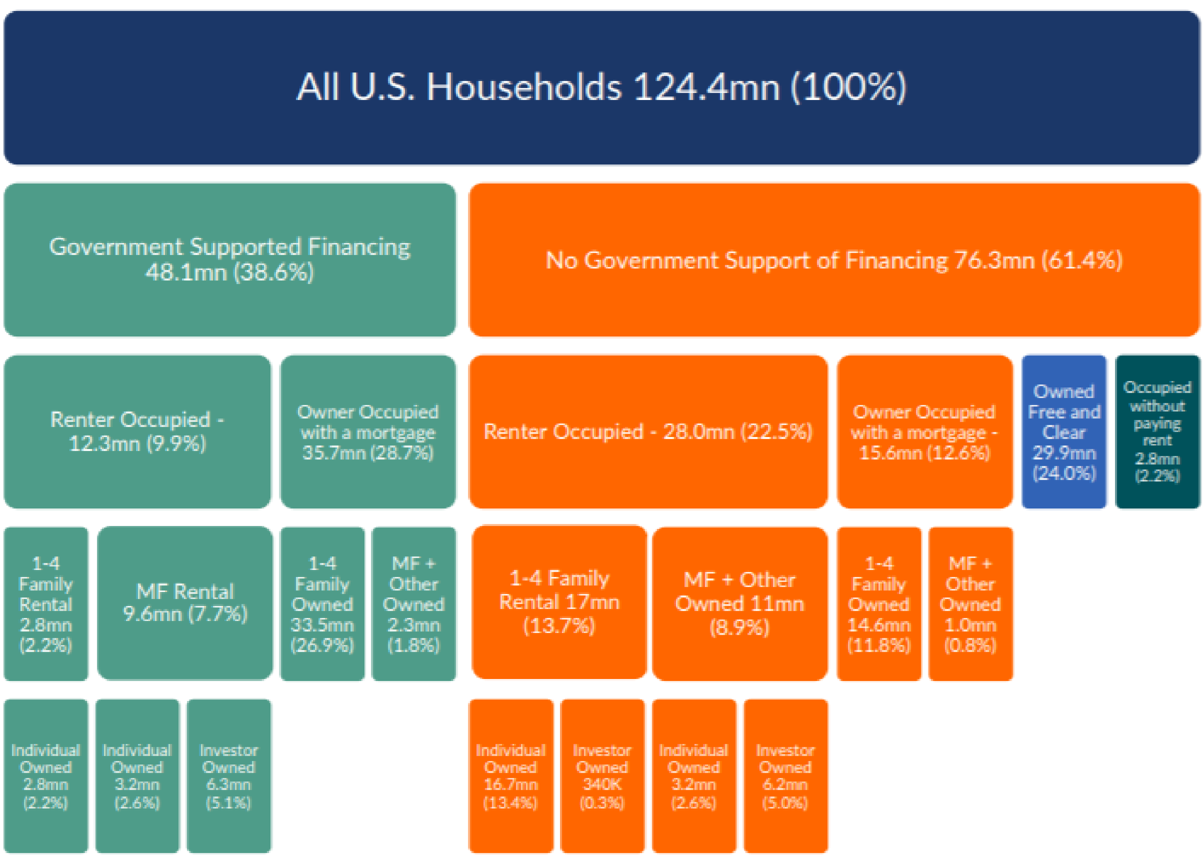
[7] https://www.housingwire.com/articles/fed-looks-ease-burden-servicing-advances/

To put this into perspective, a recent Amherst Holdings report[8] documents the simple and salient fact that 61.4 percent of all residential mortgages in the US market are not backed by the US Government. Moreover, though, that same report states the following:

> Of the 76.3mn households (61.4% of all households) whose homes are not owned or financed through these vehicles, we estimate the population at the greatest risk of eviction or foreclosure are 28mn renter households (22.5%) and 15.6mn owner households (12.6%).

That number is staggering when compared with the original statistics from the 2008 Financial Crisis wherein it took almost 4 years to approach the 10 million foreclosures level. We would consider that more of a U-shaped event. In the instant case we are looking at a straight line up --- a reverse L if you will. There will be no magic pill to reverse this course and no amount of rhetoric nor money thrown will alter this fact.

FIGURE 1: MAJORITY OF U.S. HOUSEHOLDS ARE NOT SUPPORTED BY GOVERNMENT FINANCING



[8] *COVID-19 RELIEF HELPS SOME, LEAVES OVER HALF OF HOUSEHOLDS VULNERABLE* - Amherst Report Released April 2020

At its core, any property's price is capitalized annual rent. Rents will fall if unemployed workers cannot make the payments on their homes, or if commercial businesses go delinquent due to a lack of trade. The actual and expected fall in rents thereby leads to a decline in property values. Similarly, the value of mortgages held on a lender's book as well as the prices of residential mortgage-backed securities (RMBS) would decline if future payments were expected to be interrupted or disturbed. This also means that RMBS would become less acceptable as collateral in other loan transactions, thus further fueling liquidity problems across the financial system. There is little doubt that enormous pressures on rents and returns have already accumulated in the US real estate market as a result of the coronavirus crisis.

The loss of thirty-three million jobs[9] and an unemployment rate that is expected to reach 20 percent[10] has led to forecasts of falling apartment rents and rising vacancies[11]. Months into this pandemic, the simple and salient fact remains that as of August 2020, there were still over 28 million Americans unemployed.[12] Also, crucially important is the Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed into law at the end of March. It aimed to support families by basing the declaration of mortgage payment forbearance "on the honor system." In other words, the law made it easier for borrowers of home loans to postpone mortgage payments without necessarily providing evidence of financial distress and/or lack of employment. Given the bleak prospects of recovery and employment, it is entirely understandable that many people are likely to opt into this system, even if they have not yet been laid off. It is no surprise, therefore, that by the end of April 7.3 percent of all mortgages were in forbearance[13]. The only problem here is that it only applied to Agency backed mortgages. That means that 60% of all mortgages in the US have no forbearance protection.

Adding fuel to the fire has been the US Government's cancellation of enhanced unemployment, to the tune of an extra $600 per week, as well as the cancellation of the Pandemic Unemployment Assistance (PUA) which assisted independent contractors. In response, the Federal Reserve ramped up its purchases of mortgage-backed securities issued by Fannie Mae and Freddie Mac (the two major government-sponsored enterprises which provide mortgages) as well as those guaranteed by Ginnie Mae (which is wholly owned). The Federal Reserve, however, refused to purchase any other types of MBS issued by private financial institutions, such as banks. And while these purchases may have been well intentioned, the reality is that they served to drive up pricing to astronomical levels based, in part, upon the laws of supply vs demand.

Commercial real estate debt, as a whole, amounts to a massive $3.6 trillion. Much of this debt is tied up in even more illiquid and opaque loans than the CMBS, which are publicly traded. Things look even worse in the residential mortgage-backed securities (RMBS) market. At present the Fed continues to buy only RMBS from Fannie Mae and Freddie Mac or RMBS guaranteed by Ginnie Mae. No purchases of privately issued RMBS seem to be forthcoming from the Fed even as it has announced its decision to purchase corporate junk bonds.

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[9] https://www.theguardian.com/business/2020/may/07/us-unemployment-jobless-coronavirus-economy
[10] https://www.nbcnews.com/business/business-news/u-s-jobless-claims-reach-26-million-coronavirus-hit-wipingn1190296
[11] https://cre.reis.com/covid-19
[12] https://oui.doleta.gov/press/2020/081320.pdf
[13] https://www.cnbc.com/2020/05/01/coronavirus-more-homeowners-delay-mortgage-payments-in-bailout.html

Colony Capital has reported that they are defaulting upon $3.2 Billion worth of debt secured by hotels and healthcare related properties.[14] Colony is but one firm currently experiencing inordinate margin calls due to market volatility. The question naturally arises: Why have the Federal Reserve (Fed) and the government so far failed to preempt such a crisis? The answer, as we have suggested, is deeply political. The Fed is worried about maintaining its long-term independence from Congress and the executive branch of government. Therefore, the Fed must engage in a balancing act of not doing too little to support the real estate market, while simultaneously avoiding the risk of being accused of going too far without congressional approval. Inevitably, the Fed has sought to move in lockstep with the government on the tricky business of another bailout for the real estate sector.

For the US Government, on the other hand, the problem is the bitter memories etched into working people from the bailout of bankers after the burst of the subprime mortgage bubble in 2008–9, when homeowners were left to drown first under a Republican and then a Democratic administration. Jerome Powell at the Fed and Steve Mnuchin at the Treasury are fully aware of this, as is also President Donald Trump, for whom this is an election year. The stakes could not be any higher -- and the real estate sector is political poison.

If some kind of bailout was urgently delivered, the Trump administration could be attacked by the Democrats for propping up the bankers and real estate moguls. And if the Trump administration waited until Democrats in Congress worked with the Republicans on passing legislation, the potential economic fallout from an ever-bigger crash could compromise the chances of victory in November. Therefore, the government and the Federal Reserve are caught between a rock and a hard place.

And while the Pandemic Politics continue to push multi-trillion dollar bailouts, all in the name of protecting Wall Street under the banner of Main Street, the reality is that the real economy, has, all along, been performing poorly. This is not a recent coronavirus-induced trend, but a longstanding stagnation evident in advanced economies since 2009. After a weak performance since 2009, US productivity dropped by 0.3 percent between the second and third quarters of 2019.

The panic over the coronavirus has catalyzed a long-anticipated correction in asset prices. The speed with which the virus will spread is, at this point, an unknown entity and uncertainty is the number one enemy of investment. When they’re unsure about the future, businesses, and investors are much more likely to keep their capital in cash or safe assets like gold than they are to invest in equities, whose returns are linked to economic growth, or short-term government bonds, whose yields are linked to interest rates.

The simple and salient fact that this year’s Hurricane Season is gearing up to be extremely active and well ahead of schedule.[15] Our position is that there will be no lack of money which will be thrown at these storms in both an election cycle and with the specter of COVID hanging in the air. We also opine that this will further deteriorate the housing sector.

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[14] https://www.reuters.com/article/us-colony-capital-loans/colony-capital-reports-3-2-billion-defaults-on-portfolio-loansidUSKBN22K2IN

[15] https://www.usatoday.com/story/news/nation/2020/08/17/hurricanes-two-systems-brewing-atlantic-genevieve-forms-pacific/3380960001/

Conclusion

In addressing the above information, obtained from a plethora of cited and uncited sources, the reality is that three things are on the horizon: One, there will be an enormous wave of defaults in the mortgage sector. Two, the anticipated storm activity this year will additionally cripple an already unstable mortgage sector. And finally, this perfect storm will allow for a once in a lifetime opportunity to snap up assets at extremely reduced rates. To this point, as aforementioned, the current rate of 30-day delinquencies have already generated over $2.3 Billion in field service operations.[16] Further, it is no secret that hedge funds are currently partnering with investors to leverage cash at a 10:1 ratio for new home construction as well as the purchasing of distressed assets.[17]

The IAFST projects 15.6 million defaults combined with 22.1 million evictions beginning as early as Q4FY2020. We project, in combination with new home construction, a combined market cap of roughly $50 Billion in activity, within the distressed residential channel, over the next 24 months. Additionally, IAFST projects between $39 Billion - $72 Billion in the insurance space when combining repairs attributed to civil unrest coupled with meteorological events.

The IAFST is not convinced that COVID is a mere anomaly which will be alleviated by a simple vaccine. In fact, we are of the opinion that, from a financial point-of-view, COVID will adversely impact the US economy going into Q1FY2022. From a medical point-of-view, we are of the opinion that COVID will increase in virulence going into Q4FY2020 through Q2FY2021 and with the introduction of the recent COVID D614G mutation,[18] we predict a tripling of the current statistics aforementioned through Q4FY2021.

The IAFST further states that continued civil unrest throughout US metropolitan areas will be exacerbated by continued and chronic unemployment. This, coupled with the lack of rudimentary social safety nets for socio-economically deprived individuals, will adversely impact municipal and state institutions. While potentially dire for the aforesaid institutions, IAFST believes that this will promulgate large scale investments in both distressed channels and additionally infrastructure developments associated with those same channels.

In closing, IAFST recommends that its Membership consider reorganization of their labor channels as well as heavily investing into dynamic streams of distressed and insurance-based revenue. IAFST further recommends compliance with California's recent Assembly bill 5 (AB5) which pertains to employee misclassification of independent contractors in light of the recent *Uber* and *Lyft* court judgements.[19] These

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[16] https://www.fool.com/earnings/call-transcripts/2020/08/06/altisource-portfolio-solutions-sa-asps-q2-2020-ear.aspx

[17] https://www.bloomberg.com/news/articles/2020-05-18/koch-backs-amherst-in-200-million-bet-on-single-family-rentals

[18] https://www.biorxiv.org/search/d614g

[19] https://www.vice.com/en_us/article/7kpmmy/judge-denies-uber-and-lyft-delay-in-classifying-drivers-as-employees

investments, juxtaposed with the above, will require liquidity, of which the US Government stands as the principal source of affordable capital.