Federal Housing Finance Agency
Office of Inspector General

Impact of Pandemic-Related Forbearance and Foreclosure Relief for Single-Family Mortgages on the Enterprises' Implementation of CECL

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Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) implemented the Current Expected Credit Loss (CECL) methodology effective January 1, 2020. Under CECL, the Enterprises must estimate expected lifetime credit losses on covered assets from the time the assets are acquired and update the estimates for each reporting period. Due to the COVID-19 pandemic, both Enterprises expected an increase in credit losses, which was reflected in their financial reporting under CECL.

Congress passed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was signed into law on March 27, 2020, to address some of the economic effects of the COVID-19 pandemic. The CARES Act provides single-family homeowners with Enterprise mortgages who are experiencing financial hardship due to the COVID-19 pandemic the right to forbearance from making mortgage payments for up to 180 days (which can be extended for another 180 days). The CARES Act also prohibited servicers of those mortgages from initiating the foreclosure process, moving for a foreclosure judgment, or executing a foreclosure sale for at least 60 days beginning on March 18, 2020, unless the property was vacant or abandoned. The Federal Housing Finance Agency (FHFA or Agency) subsequently extended the foreclosure moratorium for Enterprise-backed single-family mortgages until at least December 31, 2020.

Forbearance under the CARES Act does not erase what is owed by the homeowner. Missed payments from the forbearance period may be made up in a variety of ways, including repayment in full all at once, repayment over time, payment deferral, or loan modification. Some of these mortgages may ultimately default.

This white paper discusses the impact of forbearance and foreclosure relief for single-family mortgages on the Enterprises' implementation of CECL during the first and second quarters of 2020.

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ABBREVIATIONS

CARES Act	Coronavirus Aid, Relief, and Economic Security Act
CECL	Current Expected Credit Loss
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

Fannie Mae and Freddie Mac implemented the CECL methodology effective January 1, 2020, which required a substantial change in how they record credit losses in their financial statements.[1] Under CECL, the Enterprises must estimate expected lifetime credit losses on covered assets from the time the assets are acquired and update the estimates for each reporting period. Estimated losses under CECL incorporate both historical and forward-looking information, such as reasonable and supportable forecasts. Under the previous incurred loss methodology, recognition of credit losses was delayed until it was probable that a loss had been incurred, based on past events and current conditions, and the amount of the loss could be estimated. Expected future trends that could lead to additional losses could not be considered. CECL results in earlier recognition of credit losses compared to the incurred loss methodology.

Due to the COVID-19 pandemic, both Enterprises expected an increase in credit losses, which was reflected in their financial reporting under CECL. Congress passed the CARES Act, which was signed into law on March 27, 2020, to address some of the economic effects of the COVID-19 pandemic. Section 4022 of the CARES Act provides single-family homeowners with Enterprise and other "federally backed" mortgages, who are experiencing financial hardship due to the COVID-19 pandemic, the right to forbearance from making mortgage payments for up to 180 days (which can be extended for another 180 days).[2] The CARES Act also prohibited servicers of those mortgages from initiating the foreclosure process, moving for a foreclosure judgment, or executing a foreclosure sale for at least 60 days beginning on March 18, 2020, unless the property was vacant or abandoned. The timeframe in the legislation matched a foreclosure moratorium that FHFA had put in place for Enterprise single-family mortgages.[3] FHFA subsequently extended the foreclosure moratorium for Enterprise-backed single-family mortgages until at least December 31, 2020.

Forbearance under the CARES Act does not erase what is owed by the homeowner. Homeowners with Fannie Mae or Freddie Mac mortgages have multiple options for making up missed payments from the forbearance period. Homeowners may repay the forbearance

[1] For more information about the implementation of CECL by the Enterprises, see OIG, *The Current Expected Credit Loss (CECL) Methodology and the Enterprises and FHLBanks* (Sept. 24, 2019) (WPR-2019-004) (online at www.fhfaoig.gov/sites/default/files/WPR-2019-004.pdf).

[2] For more information about forbearance for Enterprise single-family mortgages under the CARES Act, see OIG, *Oversight by Fannie Mae and Freddie Mac of Compliance with Forbearance Requirements Under the CARES Act and Implementing Guidance by Mortgage Servicers* (July 27, 2020) (OIG-2020-004) (online at www.fhfaoig.gov/sites/default/files/OIG-2020-004.pdf).

[3] On March 18, 2020, FHFA directed the Enterprises to suspend foreclosures on Enterprise-backed single-family mortgages for at least 60 days.

amount all at once in full or establish a short-term repayment plan of up to a year, or longer if approved by the Enterprises. Other options may include, for example, a payment deferral, whereby the amount of their missed payments is moved to the end of the loan term, or a loan modification. Under a loan modification, the original terms of the loan may be changed to reduce monthly payments.

The Mortgage Bankers Association reported that the share of Fannie Mae and Freddie Mac loans in forbearance was 5.64% of servicers' Enterprise portfolio volume as of July 12, 2020. The mortgage software and analytics firm Black Knight estimated that 1,643,000 Enterprise loans were in forbearance as of July 14, 2020, representing $346 billion in unpaid principal balance. As FHFA Director Calabria and others have observed, some borrowers approved for forbearance continue to make monthly mortgage payments, and the number of borrowers in forbearance who may ultimately seek foreclosure is not yet known. Fannie Mae reported that, as of June 30, 2020, 5.7% of the single-family mortgages it guarantees (based on loan count) were in forbearance, the vast majority related to COVID-19, but 25% of these loans in forbearance made their monthly payments. (Therefore, approximately 4% of Fannie Mae's single-family mortgages were both contractually past due and in forbearance.) Freddie Mac reported that, as of June 30, 2020, 3.75% of the single-family mortgages it guarantees (based on loan count) were contractually past due and in forbearance.[4]

This white paper discusses the impact of forbearance and foreclosure relief for single-family mortgages on the Enterprises' implementation of CECL during the first and second quarters of 2020.

IMPACT OF FORBEARANCE AND FORECLOSURE RELIEF ON THE ENTERPRISES' IMPLEMENTATION OF CECL........................

Fannie Mae and Freddie Mac use models to estimate their expected credit losses under CECL. Generally, for their models, the Enterprises monitor the results on an ongoing basis and may make "on-top" adjustments to the models.

[4] Freddie Mac explained that its forbearance data were limited to loans in forbearance that were past due and did not include loans for which borrowers continued to make payments during the forbearance period and remained in current status. The Enterprise said that, as a result, its reported forbearance rates may be lower than rates reported by other industry participants, which generally include loans where the borrower has continued to make payments. Freddie Mac reported that, effective October 1, 2020, it would require servicers to report forbearance plans on all mortgages, including loans that were not delinquent.

Fannie Mae

According to Fannie Mae's 10-Q for the first quarter of 2020, one of the primary factors driving the Enterprise's single-family provision for credit losses for the quarter was the expected credit loss as a result of the COVID-19 outbreak, and this expected loss was included as an adjustment to modeled results.[5] Fannie Mae explained in its first quarter 2020 10-Q that, given the rapidly changing and deteriorating market conditions as a result of the unprecedented outbreak, the Enterprise believed its model used to estimate single-family credit losses as of March 31, 2020, did not fully capture expected losses related to COVID-19. Fannie Mae management adjusted its modeled results for, among other things, "the expected impact of widespread forbearance programs, including the rate of borrower participation, and the volume and type of loan modifications as a result" to increase the model's loss projections.

Fannie Mae's first quarter 2020 10-Q reported that the magnitude of the adjustment to its model results for the estimated impact of the COVID-19 outbreak was $2.5 billion for the quarter. A Fannie Mae official told us that the CECL impact of forbearance was contained in this on-top adjustment and that most of the $2.5 billion was due to forbearance. The official explained that a smaller part of the $2.5 billion adjustment related to declining interest rates, as Fannie Mae expected that prepayments would not increase as much as its model indicated.

According to the first quarter 2020 10-Q, Fannie Mae estimated that 15% of its single-family borrowers ultimately would receive forbearance due to a COVID-19-related financial hardship. In order to project the ultimate resolution of loans in forbearance, Fannie Mae looked to other historical events, particularly forbearance offered after 2017 hurricanes, and also considered how the pandemic might be different from past events.

Fannie Mae also reported in its first quarter 2020 10-Q that its provision for credit losses in the quarter was affected by its expectation for lower house price growth in 2020 due to pandemic-related market disruptions, with the Enterprise expecting near-zero growth. The impact of house prices was not part of the on-top adjustment for the quarter.

In its second quarter 2020 10-Q, Fannie Mae reported that its estimate of expected losses due to the pandemic, including both model results and non-modeled adjustments, remained relatively flat compared with the first quarter of 2020. Overall, for the second quarter, Fannie Mae reported a net estimated impact of the pandemic of a $3 million increase in expected losses. Fannie Mae did not report separately the amount of the adjustment it made to its model results as a component of its provision for credit losses in its second quarter 2020 10-Q, as it

[5] Changes to estimated expected credit losses under CECL are recorded through the benefit (or provision) for credit losses, according to Fannie Mae's 10-Q for the first quarter of 2020.

did for the first quarter. However, the Enterprise reported that it reduced its non-modeled adjustment. Fannie Mae explained that, during the second quarter, its credit loss model had "consumed data from the initial months of the pandemic" including loan delinquencies and an updated house price forecast.

Fannie Mae also reported that it reduced its estimate of the percent of single-family borrowers that ultimately would receive forbearance due to a COVID-19-related financial hardship to 12.5%, based on forbearance observed in the second quarter of 2020 and recent economic data. The Enterprise said that the effect of lower expected forbearance volume was offset by the weaker credit profile of loans entering forbearance.[6] Additionally, prepayments were higher than Fannie Mae initially expected, which had a positive impact that the Enterprise said was offset by heightened uncertainty. Fannie Mae also noted that it revised its 2020 house price forecast to reflect strong home sales, but its long-term projected house price growth estimate was reduced due to a longer projected economic recovery period.

Freddie Mac

Freddie Mac also addressed uncertainty due to the pandemic in its 10-Q for the first quarter of 2020. Freddie Mac noted that, because of unprecedented events surrounding the pandemic and the associated severe market dislocation, the Enterprise expected significant challenges in accurately forecasting key inputs to its models, such as interest rates, house prices, and defaults. Enterprise officials told us that the pandemic resulted in an immediate increase in expected lifetime losses for affected borrowers that was not built into its models. Freddie Mac reported in its first quarter 2020 10-Q that it was applying model adjustments, where appropriate, but the adjustments had an element of subjectivity and were based on complex judgments.

Although Freddie Mac's first quarter 2020 10-Q did not specify the amount of the on-top adjustment to its model, the Enterprise reported that it had a $1.2 billion provision for credit losses in the quarter due to its forecast of higher expected single-family credit losses as a result of the pandemic. Freddie Mac officials told us that the total pandemic-related CECL impact was larger than $1.2 billion, and most of it was an on-top adjustment related to forbearance. The net result considering other factors was the $1.2 billion reported. An official added that the impact of the pandemic related to house prices was captured in the model rather than in the on-top adjustment. A Freddie Mac official told us that the three main assumptions underlying its expected loss estimate for the on-top adjustment related to CECL were the rate of forbearance, the number of loans taking forbearance that then become delinquent and ultimately result in a

[6] Fannie Mae reported that, as of June 30, 2020, 21% of its mortgages in forbearance (by unpaid principal balance) had FICO scores below 680, compared to 10% of its total conventional single-family mortgages, for example.

loss, and the severity of that loss. The Enterprise told us that it estimated a range and based its on-top adjustment on the mid-point of the range.

Freddie Mac's second quarter 2020 10-Q reported on year-to-date effects of the pandemic on higher credit losses. The Enterprise stated that its provision for credit losses through the second quarter required significant management judgment to estimate the impact of COVID-19-related forbearance. These judgments included estimates of the number of Enterprise mortgages that will receive forbearance, their likely exit paths, and the number that ultimately default. Freddie Mac reported that these factors resulted in a significant increase in its provision for credit losses through the second quarter of 2020, with the majority of the increase occurring in the first quarter. In total, Freddie Mac said that it increased its allowance for credit losses for single-family mortgages by $2.1 billion in the first half of the year as a result of pandemic-related forbearance.[7] Freddie Mac also reported that the overall effect of forecasted house price changes on its provision for credit losses for 2020 through the second quarter was relatively minor, with an increase in the provision in the first quarter largely offset by an improvement in the second quarter. The Enterprise said that it expected full-year house price growth to slow in 2020 and 2021 from the 1.2% increase during the second quarter of 2020, and that the full effect of the pandemic on house prices was uncertain.[8]

The Enterprises have used credit risk transfer transactions to transfer a portion of the credit risk on their single-family mortgages to investors.[9] Freddie Mac officials told us that some losses from pandemic-related forbearance would be offset by gains from credit risk transfer transactions, which are reflected separately in the Enterprise's financial statements.

Volatility

The Enterprises have expressed concerns that CECL could increase volatility in their reported financial results. Fannie Mae, in its 10-Q for the first quarter of 2020, explained that CECL introduces additional volatility because expected lifetime losses on loans would be sensitive to fluctuations in factors such as forecasted house prices, forecasted interest rates, and events such as natural disasters or pandemics. According to Freddie Mac's first quarter 2020 10-Q,

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[7] Freddie Mac recognizes changes in the allowance for credit losses by recording a provision for credit losses (or reversal of a provision for credit losses), according to its second quarter 2020 10-Q.

[8] Both Enterprises told us that the foreclosure moratorium itself did not affect their loss estimates under CECL. According to a Freddie Mac official, the difference in timing for when property would be foreclosed would not be significant enough for the Enterprise to make an adjustment.

[9] Fannie Mae reported that it did not enter into credit risk transfer transactions in the second quarter of 2020 due to adverse market conditions resulting from the pandemic, and it did not have plans to engage in additional transactions but would continue to review its plans. Freddie Mac reported that its single-family credit risk transactions declined significantly during the second quarter of 2020, but it executed transactions early in the third quarter. The Enterprise added that credit risk transfer remained a critical part of its business strategy, but demand was uncertain during the pandemic.

the adoption of CECL may result in additional volatility in credit-related expenses because the estimate of credit losses now incorporates forecasts of some future economic conditions and expectations of credit losses over the entire contractual term of the instruments.

In contrast to these concerns, however, Enterprise officials told us that they believed CECL did not introduce additional volatility related to pandemic-related forbearance compared to the prior incurred loss methodology. Fannie Mae officials explained that, had the Enterprise used the incurred loss methodology for the first quarter of 2020, it could not have considered the full cycle of the downturn and eventual recovery that it expected at that time. As a result, the on-top adjustment might have been smaller initially under the incurred loss methodology, increasing in subsequent quarters. A Freddie Mac official said that the pandemic and its related outcomes would have created volatility under either methodology. Freddie Mac told us that, with CECL, the pandemic had a large impact in the first quarter but may cause less volatility in future periods relative to the incurred loss methodology if conditions align with the Enterprise's forecast. Freddie Mac officials noted that the Enterprise did not actually calculate what the results would have been using the incurred loss methodology.

CONCLUSION

Fannie Mae and Freddie Mac implemented the CECL methodology effective January 1, 2020, which required them to estimate expected lifetime credit losses on covered assets from the time the assets are acquired and to update the estimates for each reporting period. Both Enterprises expected an increase in credit losses on their single-family mortgages due to the COVID-19 pandemic and forbearance provided to borrowers. The expected increase in losses was reflected in the Enterprises' financial reporting under CECL for the first and second quarters of 2020.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to discuss how the Enterprises implemented CECL in the first and second quarters of 2020 in light of forbearance and foreclosure relief on their single-family mortgages. To achieve this objective, we reviewed internal FHFA and Enterprise documents as well as publicly available documents. We also interviewed FHFA and Enterprise officials.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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