PINNACLE ROCK CAPITAL

Mortgage Default Rate Impact & Mortgage Servicing
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The mortgage default rate is the single largest factor that impacts the mortgage servicing industry. The result of a default that increases 5-10% will directly impact the servicer's liquidity due to increases in payment advances and personnel costs. The loan servicer will need to advance payments to the bond holder if the borrower does not make payment regardless of reason why. When the borrowers begin to make payments again it will take a larger personnel infrastructure to handle the increased loss mitigation options; modifications, forbearance, repayment plans, short sales, and foreclosure & bankruptcy actions. The key to success will be scalable platform that allows for a transparent risk based approach that also is able to manage a crisis that is biological in nature not created by financial maleficence. That is to say it will be imperative to treat each individual impacted by COVID -19 with patience, dignity, and respect, all the while dealing with the new compliance hurdles that will be created by investor and governmental oversight.

The cause of the economic turmoil in 2008 is different in causation and timing but the result of the COVID-19 pandemic will have very similar ramifications to the mortgage servicing industry. The actions taken by mortgage servicing companies both during and after the 2008 crisis can act as a blueprint for successful navigation for leaders and investors within the space.

Prior to 2008 the most mortgage servicers were built with an infrastructure that was designed for a mortgage default rate less than 3%. The industry standards which date back into the 1980's had a technology and personnel infrastructure that reflect those beliefs. When the 2008 Subprime Crisis hit the industry it was forced to make adjustments to assumptions that were never contemplated when the mortgage default rate increased to over 12%. The industry found itself steering a large ship in a new direction in uncharted waters. The resulting actions that moved the mortgage servicers through the 2008 Subprime Crisis were a lesson in how to remake a business model in the middle of a crisis. Some ideas worked and others failed. The mortgage servicing space saw incredible amount of consolidation amongst competitors to strengthen balance sheets and "off shoring" of personnel that allowed costs to be managed in the short term. Industry consolidation and off shoring personnel work did not prove to be a fix all solutions for all industry participants. Customer complaints and regulatory problems that came to surface proved to be more costly than the immediate cost savings by off shoring. The mortgage servicers that were rebuilt and that have been successful following the 2008 Subprime Crisis have a keen understanding of what the increased default volumes will have among all departments due to the rising mortgage default rates. These servicers with a strong balance sheet and a transparent risk based approach will be the ones to effectively manage through this "black swan event."

Government intervention events that happened in 2008 after default rate shock:

- Initial intervention by the U.S. Government with Tax Relief Bills
- Fed lowers interest rates
- Treasury/FHFA takeover of Fannie Mae & Freddie Mac
- Investment banks and companies that held counterparty risks pushed the U.S. Economy to the brink of collapse
- Congress passes $700B TARP bailout package

The mortgage industry was left with roughly 10,000,000 defaulted loans with an infrastructure in place at the time could handle about 800,000-1,000,000 loans a year. The successful mortgage servicers invested heavily in technology that could handle all types of loss mitigation outcomes based on investor requirements and government backed programs. They also created a scalable business model that can hire up associates in all departments to manage the increased work load with appropriate oversight already in place.

The actions mortgage servicers will take in the coming months will likely be similar to the actions taken in 2008. The largest difference is timing. Servicers will need to be able to respond in real time to a default rate that will spike through no fault of mortgage companies or borrowers. The events that lead to the default rate shock in 2008 took longer to impact the economy but they are strikingly familiar to what we are seeing today.

The government response that has taken place in the last 75 days as a result of COVID-19:

- Fed lowers interest rates
- Fannie, Freddie, & FHA stepped in and allowed a 3-12-month forbearance
- Fed purchases $200B in mortgage securitizations
- Congress passes $2T CARES Act

One of the main issues that will need to be addressed by the government over the coming months is mortgage servicer liquidity as it relates to payment advancing. The projections, as of the publishing of this paper, are that up 25% of borrowers will request forbearance for a period of at least three months. The question of how mortgage servicers will advance billions of dollars to bondholders is an important one that will have to be addressed. Without intervention by government bailout or bond holders changing agreements to allow forbearance by servicers, the resulting fallout and liquidity tightening to the industry as whole will create a much larger economic problem to the US economy. The assumption here is that it will be addressed by congress prior to a further weakening of the economy during a period of recovery.

The reactions by the government and borrowers due to the economic shock in 2008 and today are closely correlated. The economy is brought to the edge of collapse by unforeseen circumstances as borrowers stop making payments and the industry will need to implement a system to handle a tsunami of defaulted loans. The mortgage servicers today will need be flexible as programs are rolled out and likely change over time. It will not be possible in all instances to keep the borrower in their homes, however, given the nature of problem it will likely need to be the first outcome that will be sought. The ideal scenario will be for the servicer to go whatever lengths necessary to help the homeowner stay in their homes and when it's not possible to help them exit gracefully. This will only be accomplished through a completely transparent risk based approach that allows government regulators and investors understand what is happening at an asset level if called upon. A proactive COVID-19 response overview and compliance oversight (internal and external) will be critical to show the world the success and sometimes shortcoming of each servicing action.