

# The Risk of People Helping People

*Pandemic Brings Increased Potential for Elevated Credit Risk*

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Never before has “People Helping People,” the embodiment of the credit union industry, been tested like it has in 2020.

The shelter-in-place mandates implemented across the country to contain COVID-19 have affected all facets of work and life. Historically high unemployment has many credit union members struggling to meet their financial obligations, including their mortgage payments.

Credit unions have met the challenge by granting payment relief to tens of thousands of members. Payment relief helps members in need during these trying times, but it also poses new challenges for credit unions to manage.

A marked increase in members needing payment relief implies the potential for elevated credit risk that didn’t exist before March 2020.

How does the number of loans you have under payment relief compare to other credit unions and banks? How much credit exposure are you, the credit union industry, facing? What is the potential impact on earnings? How many more requests for payment relief will you receive? Will there be a second wave? What questions will you get from auditors and regulators? This article attempts to shed light on these and other questions being asked by management teams across the country.

FHN Financial Capital Assets Corp. (Capital Assets) has been conducting a nationwide study to assess the potential risk associated with millions of payment relief plans that were implemented starting in March.

Capital Assets has conducted dozens of Forbearance Risk Assess-

ments (FRAs) on mortgage portfolios throughout the country. The FRA results are the primary source for this article, which focuses on forbearance and payment deferrals beginning March 2, 2020.

By tracking the date each loan went into payment relief and comparing the characteristics of those loans to the remaining portfolio, clues emerge as to why certain borrowers request payment relief and others do not. Using the results of the analysis, we can estimate the potential impact on credit risk and earnings.

### WHAT IS PAYMENT RELIEF?

Payment relief is an agreement whereby the owner of a loan grants permission for the borrower to defer (skip) scheduled payments. The key elements of the agreement are how many payments the borrower can defer and how those deferred payments are repaid.

Forbearance in this article refers to deferred payments on loans sold to Fannie Mae or Freddie Mac. Forbearance agreements are a form of a loan that require full repayment at the end of the deferral period. Payment deferral is a form of a loan modification and typically refers to loans held in portfolio.

There are many types of deferral plans, but the common theme is that the deferred payments are not expected to be repaid in a lump sum. The deferrals are typically added to the loan balance (capitalization) and repaid over the term of the loan. The FRA study assesses both loans in payment deferral and forbearance.

### FORBEARANCE STUDY

**Data Source and Scope:** The results shared in this article are based on a compilation database comprised of 161,655 residential mortgages having an average balance of \$203,946. Participants in the study provided a loan level database, a current list of loans under a deferral plan and the date the loans entered the plan.

This pool of \$35 billion in mortgages is a carefully selected subset of a larger database to avoid over-concentration in any one geographic area and prevent a few very large-size mortgage portfolios from skewing the results.

The loans are located in 49 states and had an average seasoning of 39 months. The borrower demographics are current as of June 30, 2020.

**Methodology:** The FRA process is essentially a sophisticated method of comparing and contrasting shelter-in-place payment deferral loans to the remaining loans. Similarities and differences in key metrics such as age, product type, liquidity, credit score, and Loan-To-Value (LTV) reveal clues as to why certain borrowers seek payment relief and others do not.

The credit and liquidity characteristics of the loans in forbearance are important components to estimating probability of default and loss severity (or loss given default).



*Payment relief for a member in need is not new to credit unions. ... However, no one was prepared for the massive surge in payment relief requests that resulted from financial hardships due to COVID-19.*



Additionally, a sample subset from 14,000 imaged loan files has been reviewed to gather borrower demographics not typically available on a loan-servicing database. Valuable insights have been gained by evaluating information such as borrower age, W2 vs. self-employed, first-time homebuyer and the borrower's employment industry.

### PAYMENT DEFERRAL RATES

Payment relief for a member in need is not new to credit unions. For many years, credit unions have helped members face life events that can cause a member in good standing to have temporary financial difficulties. However, no one was prepared for the massive surge in payment relief requests that resulted from financial hardships due to COVID-19.

The first instances of payment deferrals began in early March when the COVID-19 outbreak spread and shelter-in-place orders occurred.

### CREDIT UNIONS CAN JOIN STUDY

Any credit union that wishes to participate is welcome to join the FHN Financial Capital Assets Corp. nationwide study to assess the potential risk associated with millions of payment relief plans that were implemented starting in March.

There is no cost, and individual data is never shared. However, we require that your data be merged with the total database. As more credit unions participate, the database becomes larger and more diverse, with better results to share with everyone. Info: [www.fhnfinancial.com/contact](http://www.fhnfinancial.com/contact)

Several credit unions have gained insight from the study results or taken advantage of FHN Financial's services. Here is what some of them have said:

"Technology Credit Union strives to get as much perspective on all matters that affect our membership and the credit union," said Richard Hanz, CFO at the Technology CU. "We were concerned about the long-term impact that payment deferral requests might have on our mortgage portfolio, so participating in the study was useful in confirming our assumptions as to the depth and severity of risks associated with COVID-19. Having data to help support any adjustments to loss reserves or other metrics will be key to maintaining our financial strength as the year unfolds."

"Through our collaboration with FHN and their comprehensive approach, we were able to quantify and predict the potential credit risk associated with recent loan forbearance activity," said Howard D. Brady, SVP & CLO at American Eagle Financial Credit Union. "This work is an important component of our strategy to effectively anticipate and manage future loan losses due to COVID-19."

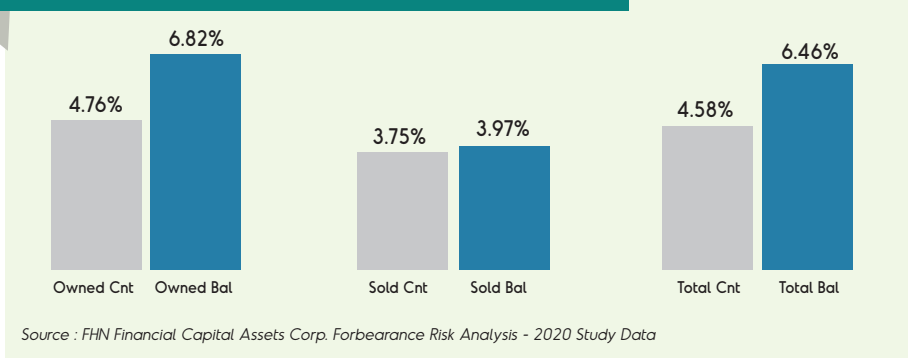
"Our primary focus was to provide immediate mortgage payment relief to our members affected by COVID-19," said Charles Goss, EVP & CLO for Security Service Federal Credit Union. "A 90-day forbearance is the industry standard in providing payment assistance during a disaster; however, the CARES Act allows homeowners to extend a forbearance up to 12 months. Those provisions, combined with the spread of the pandemic, created an uncertainty of the financial impact to our credit union. As a result, we are leveraging origination and servicing data analytics, such as the forbearance risk analysis provided by FHN, to assist us in forecasting and planning for any potential long-term impact."

Fannie Mae and Freddie Mac, working in concert with the FHFA, quickly developed a forbearance program for loans sold to the GSEs. At the same time, credit unions were receiving calls from increasing numbers of members concerned about their ability to make mortgage payments, and quickly upgraded existing payment deferral plans to accommodate what was clearly occurring on a much larger scale.

The chart below reflects the national average of portfolio loans in payment deferral and sold loans in forbearance by loan count as of June 12, with balances as of April 30.

Every participant in the study has experienced a higher instance of payment deferrals on portfolio loans than forbearances on sold loans. Forbearances typically average about 80% of payment deferrals. The number of sold loans in forbearance is significantly lower than what Fannie Mae and Freddie Mac have experienced.

### FORBEARANCE PERCENTAGE OF LOANS ANALYZED BY LOAN COUNT VS. BY CURRENT BALANCE



### COMPARE AND CONTRAST

By early May, we began to see recurring patterns, particularly related to loan quality. In 100% of cases, the average balance of deferrals and forbearances is higher than the remaining loans, and loans entering a payment relief plan were of slightly lower credit quality when compared to the remaining loans.

For example, in the deferral loans, the LTV is slightly higher, credit score lower, Debt-To-Income ratio (DTI) slightly higher, and the historical payment history is not quite as good. In most instances, these differences are marginal but nevertheless consistent.

Another consistent pattern is that the characteristics of loans in payment relief—such as age, loan type, loan purpose (purchase vs. refi) and property type—pretty much mirror the remaining portfolio, indicating they have no bearing on a member seeking payment relief.

### COMPOSITION OVERVIEW

| Product Type    | %Of Total | Loan-To-Value* |            |           | Seasoning   |               | Balance      |                  |               |
|-----------------|-----------|----------------|------------|-----------|-------------|---------------|--------------|------------------|---------------|
|                 |           | Curr Avg.      | Orig. Avg. | Curr 80%+ | Avg.in Mos. | %Below 3Years | Curr Average | % Over \$510,400 | % Over \$1.5M |
| <b>NON-FORB</b> | 94%       | 66%            | 74%        | 21%       | 39          | 56%           | 216,628      | 37%              | 4%            |
| <b>FORB</b>     | 6%        | 69%            | 76%        | 22%       | 40          | 54%           | 317,019      | 55%              | 8%            |

| Product Type    | Curr/Hist DQ |     | Occupancy |     |     | Credit Score* |        |           |           | Purpose Code |           |                 |     |
|-----------------|--------------|-----|-----------|-----|-----|---------------|--------|-----------|-----------|--------------|-----------|-----------------|-----|
|                 | 0            | 30+ | 0/0       | 2ND | NOO | % W/ Score    | %< 620 | %Over 780 | Avg Score | Purch        | Refi-Cash | Other/Not Coded |     |
| <b>NON-FORB</b> | 97%          | 3%  | 93%       | 3%  | 4%  | 90%           | 1%     | 40%       | 760       | 51%          | 25%       | 25%             | 13% |
| <b>FORB</b>     | 90%          | 10% | 93%       | 3%  | 3%  | 92%           | 3%     | 24%       | 739       | 54%          | 18%       | 27%             | 18% |

Source: FHN Financial Capital Assets Corp. Forbearance Risk Analysis - 2020 Study Data

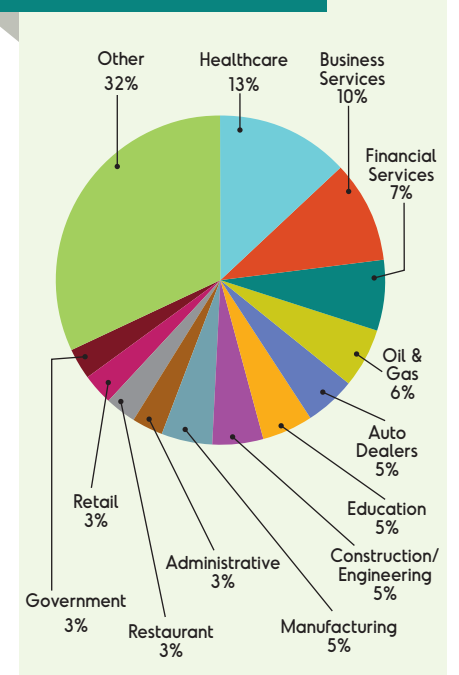
### BORROWER DEMOGRAPHICS

Capital Assets collected borrower data on a sample subset from 14,000 imaged loan files to examine information not typically on a loan-servicing database.

In particular, we reviewed borrower age, W2 vs. self-employed, first-time homebuyer and the industry in which the borrower worked. What we found was not what we initially expected. Borrower age appears to have little to do with a member requesting relief. W2 borrowers were 82% and first-time homebuyers 24%.

The table below illustrates study findings for borrower employment industry. Our initial expectation was that the travel/leisure sector would be one of the top three industries, but health care was number one overall, and was in the top three categories for every individual case.

### BORROWER EMPLOYMENT INDUSTRY GROUP



### CREDIT LAYERING

Capital Assets subjected the loan data to a Credit Risk Layering Analysis (CRLA), which is a qualitative method of assessing credit from a layered risk standpoint.

Loans with historical delinquency, high LTV, high DTI and NOO are assigned a high-risk weighting. The aver-

age number of high risks are calculated and converted to a score. A mortgage portfolio with a CRLA score of about 0.50% or lower is considered A-grade prime. Deferred payments are not considered a high risk in the analysis because the borrower was given permission. As such, we are effectively measuring credit layering pre-shelter-in-place.

The following chart compares the CRLA score of deferral loans to the remaining loans. The loans in payment

relief had a slighter higher CRLA score compared to the remaining loans before the shelter-in-place stressor.

### LIQUIDITY GRADING

Another method of assessing quality is to segment the loans by liquidity. Credit unions do an excellent job in documenting their mortgages. As such, the vast majority of loans made to hold in portfolio are investment grade, meaning they are highly liquid and price efficient.

Capital Assets subjected the data to a Waterfall Liquidity Analysis that segments the loans into six liquidity grades, A through F. Grades A, B and C are investment grade. These loans are the most liquid and have a mark-to-market value that is equal to, or higher than, their economic value.

The chart below illustrates the liquidity grade of the owned portfolio loans and sold loans, comparing those in payment relief to the others.

## CREDIT RISK LAYERING ANALYSIS

|  | OWNED          |               | SOLD          |             | TOTAL          |
|--|----------------|---------------|---------------|-------------|----------------|
|  | NON-FORB       | FORB          | NON-FORB      | FORB        |                |
| CRLA Score :                                       | 0.52           | 0.69          | 0.30          | 0.65        | 0.50           |
| Percent of Loans Without Layering :                | 88.23%         | 83.48%        | 96.59%        | 79.28%      | 88.91%         |
| Number of Loans                                    | 127,448        | 6,365         | 26,701        | 1,041       | 161,555        |
| Total Balance (\$)                                 | 28,663,933,048 | 2,096,895,275 | 4,242,865,630 | 175,583,929 | 35,179,277,882 |
| Percent of 1-4 Portfolio Balance                   | 81%            | 6%            | 12%           | 0%          | 100%           |
| <b>Percent of Each Pool With A Given High Risk</b> |                |               |               |             |                |
| % Currently Delinquent                             | 1%             | 6%            | 0%            | 17%         | 1%             |
| % With Credit Score Below 620                      | 1%             | 3%            | 0%            | 2%          | 1%             |
| % With Excess Amortized LTV (1)                    | 11%            | 9%            | 0%            | 2%          | 9%             |
| % With Excess Updated LTV (1)                      | 7%             | 7%            | 0%            | 1%          | 7%             |
| % Non-Owner Occupied                               | 4%             | 3%            | 0%            | 6%          | 3%             |
| % With Alternative Product Risk                    | 1%             | 1%            | 0%            | 0%          | 1%             |
| % With Rate Increase Over 2.00%                    | 0%             | 0%            | 0%            | 0%          | 0%             |
| % With Balance Over \$1,500,000                    | 5%             | 11%           | 0%            | 0%          | 5%             |
| % With Seasoning Under 12 Months                   | 26%            | 23%           | 0%            | 26%         | 22%            |
| % Non-Performing (Bkrpt, Forc, Non-Acc.)           | 1%             | 7%            | 0%            | 17%         | 1%             |
| % With DTI Ratio Over 50%                          | 1%             | 1%            | 0%            | 1%          | 1%             |
| <b>Pool Description</b>                            |                |               |               |             |                |
| Current Delinquency Rate                           | 1%             | 6%            | 0%            | 17%         | 1%             |
| Weighted Avg. Score                                | 759            | 739           | 0             | 735         | 666            |
| Weighted Avg. Amortized LTV                        | 67%            | 69%           | 0%            | 66%         | 59%            |
| Weighted Avg. Updated LTV                          | 61%            | 63%           | 0%            | 58%         | 54%            |
| Average Balance                                    | 225,170        | 329,442       | 0             | 168,669     | 203,946        |
| Weighted Avg. Coupon                               | 3.74%          | 3.77%         | 0.00%         | 4.09%       | 3.30%          |
| Weighted Avg. Seasoning                            | 38             | 40            | 0             | 43          | 33             |
| Weighted Avg. DTI Ratio                            | 34%            | 36%           | 0%            | 35%         | 30%            |

Source : FHN Financial Capital Assets Corp. Forbearance Risk Analysis - 2020 Study Data

## LIQUIDITY GRADING AND LOSSES

| Liquidity Grade | OWNED                 |             |                      |             | SOLD                 |             |                    |             | % of TOTAL  |
|-----------------|-----------------------|-------------|----------------------|-------------|----------------------|-------------|--------------------|-------------|-------------|
|                 | Non-Forbearance       |             | Forbearance          |             | Non-Forbearance      |             | Forbearance        |             |             |
|                 | Balance               | % of Total  | Balance              | % of Total  | Balance              | % of Total  | Balance            | % of Total  |             |
| A               | 11,629,492,024        | 41%         | 561,533,848          | 27%         | 2,112,349,112        | 50%         | 57,741,920         | 33%         | 41%         |
| B               | 11,823,292,972        | 41%         | 995,046,166          | 47%         | 1,834,152,586        | 43%         | 70,883,327         | 40%         | 42%         |
| C               | 4,802,670,097         | 17%         | 364,028,435          | 17%         | 244,103,955          | 6%          | 15,618,636         | 9%          | 15%         |
| D               | 54,945,735            | 0%          | 4,137,296            | 0%          | 1,922,173            | 0%          | 86,764             | 0%          | 0%          |
| E               | 269,844,008           | 1%          | 121,685,687          | 6%          | 35,852,174           | 1%          | 28,239,788         | 16%         | 1%          |
| F               | 83,688,211            | 0%          | 50,463,842           | 2%          | 14,485,631           | 0%          | 3,013,495          | 2%          | 0%          |
| <b>Total</b>    | <b>28,663,933,048</b> | <b>100%</b> | <b>2,096,895,275</b> | <b>100%</b> | <b>4,242,865,630</b> | <b>100%</b> | <b>175,583,929</b> | <b>100%</b> | <b>100%</b> |

Source : FHN Financial Capital Assets Corp. Forbearance Risk Analysis - 2020 Study Data

Once again, we see that loans in payment deferral had a slightly lower liquidity grade before shelter-in-place.

## POTENTIAL FOR LOSSES

Capital Assets has decades of experience conducting loan analysis, but we've never had to conduct a predictive analysis because of a pandemic. In projecting potential credit losses, we are using what we believe to be conservative assumptions.

Over the next three months, information will become available as to how many members return to normal amortization or request an extension

in payment relief. Also, as the study progresses and more institutions participate, we will have an even larger and more diverse dataset. Both of these factors will also allow us to tighten up assumptions accordingly.

The following chart illustrates one possible outcome. For the purpose of the study, we are estimating losses by liquidity grade. The default assumption is the percentage that we assume will eventually become a foreclosure.

In a normal world, the default assumption for the investment grade loans would typically be much lower.

The default rate is the loss on defaulted loans and increases as the liquidity grade goes down. For estimated losses, we calculate indexed LTVs using the Case-Shiller™ (CS) Index and apply any additional discount on foreclosure using data from RealtyTrac®.

Based on these assumptions, 9.04% of the \$2 billion of loans in our Owned sample will go into foreclosure. Further, that 9.04% would have -11.87% losses. Spread that loss assumption over the entire population of payment deferrals, and lifetime losses are a modest -1.74%.

## LIQUIDITY GRADING AND LOSSES

|                                     | A             | B             | C             | D              | E             | F             | TOTAL         |
|-------------------------------------|---------------|---------------|---------------|----------------|---------------|---------------|---------------|
| <b>OWNED</b>                        |               |               |               |                |               |               |               |
| Current Balance                     | 561,533,848   | 995,046,166   | 364,028,435   | 4,137,296      | 121,685,687   | 50,463,842    | 2,096,895,275 |
| Default Assumption                  | 5.00%         | 5.00%         | 5.00%         | 15.00%         | 35.00%        | 100.00%       | 9.04%         |
| Owned FB Loss Severity              | -7.43%        | -11.99%       | -17.75%       | -54.28%        | -11.70%       | -13.24%       | -11.87%       |
| <b>Owned FB Lifetime Net Losses</b> | <b>-0.78%</b> | <b>-0.91%</b> | <b>-2.26%</b> | <b>-15.73%</b> | <b>-7.59%</b> | <b>-9.60%</b> | <b>-1.74%</b> |
| <b>SOLD</b>                         |               |               |               |                |               |               |               |
| Current Balance                     | 57,741,920    | 70,883,327    | 15,618,636    | 86,764         | 28,239,788    | 3,013,495     | 175,583,929   |
| Default Assumption                  | 5.00%         | 5.00%         | 5.00%         | 15.00%         | 35.00%        | 100.00%       | 11.46%        |
| Sold FB Loss Severity               | -5.80%        | -22.30%       | -14.02%       | -85.31%        | -11.07%       | -11.77%       | -14.19%       |
| <b>Sold FB Lifetime Net Losses</b>  | <b>-0.76%</b> | <b>-2.25%</b> | <b>-1.57%</b> | <b>-28.23%</b> | <b>-7.75%</b> | <b>-7.68%</b> | <b>-2.69%</b> |
| <b>TOTAL</b>                        |               |               |               |                |               |               |               |
| Current Balance                     | 619,275,768   | 1,065,929,493 | 379,647,072   | 4,224,059      | 149,925,474   | 53,477,337    | 2,272,479,204 |
| Default Assumption                  | 5.00%         | 5.00%         | 5.00%         | 15.00%         | 35.00%        | 100.00%       | 9.23%         |
| Total FB Loss Severity              | -7.28%        | -12.67%       | -17.60%       | -54.92%        | -11.58%       | -13.16%       | -12.04%       |
| <b>Total FB Lifetime Net Losses</b> | <b>-0.77%</b> | <b>-1.00%</b> | <b>-2.24%</b> | <b>-15.98%</b> | <b>-7.62%</b> | <b>-9.49%</b> | <b>-1.81%</b> |

Source : FHN Financial. Capital Assets Corp. Forbearance Risk Analysis - 2020 Study Data

Note: The servicer has no direct credit risk on sold loans; however, we evaluate forbearance data whenever possible for two reasons. First, if a member has entered into forbearance, that implies they could be struggling with other obligations such as their auto, HELOC or consumer loan. Secondly, the data clearly indicates credit unions are experiencing far fewer forbearances than Fannie Mae and Freddie Mac. This data can be leveraged by your lending personnel when dealing with the GSEs.

## PAYMENT DEFERRAL TRENDS: THE SILVER LINING

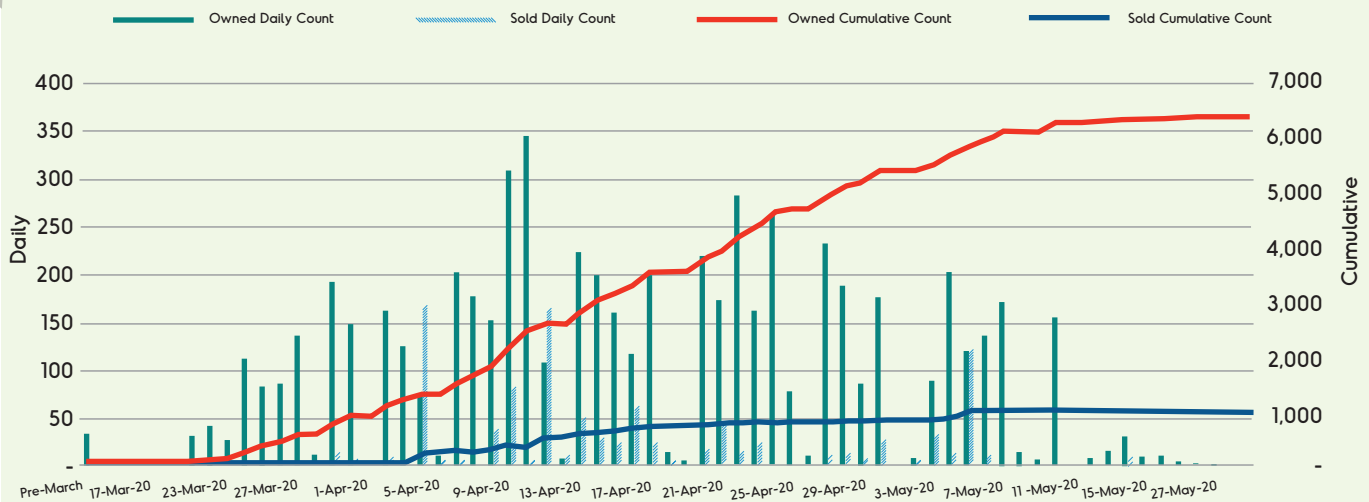
Using the effective date of forbearance or deferral, we prepared the trend chart below. That data shows that payment relief peaked in April, then began to decline through the end of June.

Except for regions of the country with extended shelter-in-place, we anticipate the number of new requests will be fewer and fewer. As new requests decline, the next inflection point will be the end of the deferral period.

Will the deferral loan return to nor-

mal amortization or will the member request an extension? What we hope for is a favorable deferral decay rate indicating fewer deferral requests and a high instance of payment recovery. Only time will tell, but for now, the trends are positive.

## FORBEARANCE RUN RATE



Source: FHN Financial Capital Assets Corp. Forbearance Risk Analysis – 2020 Study Data

### COULD THERE BE A SECOND WAVE?

The uncertainty about how long requests for relief will occur and concerns over a resurgence of additional payment relief requests is on the mind of most risk managers. One of the key reasons the credit exposure is manageable is that we currently do not have an oversupply of housing, as was the case during the credit crisis 12 years ago. If foreclosures were to spike, that could increase loss severity in the event of a default.

For the moment at least, credit exposure in the majority of cases is very manageable. But one thing 2020 has taught us is that anything can happen. A reoccurrence of COVID-19 in the fall could trigger more shelter-in-place mandates around the country.

There is also tremendous concern about the growing number of Commercial Real Estate (CRE) loans in forbearance. Defaults in that sector could have a trickle-down effect on mortgage and consumer loans. Will this happen? No one really knows. Could this happen? This is 2020; anything can happen.

### SUMMARY

At this time, the data points to most credit unions, and the industry as a

whole, having very manageable risk due to payment deferrals. This first wave of payment deferral requests looks to be winding down, but there is plenty of uncertainty associated with how these loans will perform once their deferral periods end.

Best practices would be to remain vigilant. Monitor new deferral requests and extensions of existing payment deferrals closely. Document your findings. Doing so will not only give you the best understanding of your exposure, but will also help when dealing with auditors and the regulators. ▲

As President & CEO of FHN Financial Capital Assets Corp. for more than 30 years, Jerry Hubbard oversees the full spectrum of services offered by the professional staff of CPAs, financial analysts, loan portfolio advisors and operations specialists. Capital Assets' services include loan portfolio risk management, mergers and acquisitions, and the design and implementation of loan-related balance sheet strategies, including participation sales and securitizations.



Jerry Hubbard

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