FHFA SUPPLEMENTAL PARTIAL CLAIM: THE NEXT ITERATION

Taking a deep dive into Supplemental Partial Claims, the benefits and drawbacks they present in today's mortgage landscape, and other considerations.

By **JOSEPH SMITH**

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From policies implemented following the 2008 financial crisis to mortgage relief programs put in place during the COVID-19 pandemic, the mortgage industry has seen many innovations in how distressed mortgages are resolved. As distressed homeowners today are facing new challenges associated with a high-rate, high-value real estate market, the Supplemental Partial Claim is one tool that may help mortgage professionals and homeowners manage through these difficult times.

As a standalone tool that has been around for many years, it is functional in certain circumstances and can address a number of defaulted loans. While it has some limitations, it can serve as a pathway to new workout solutions. Mortgage professionals and homeowners can benefit from a deeper understanding of how Supplemental Partial Claims work, the benefits and drawbacks they present in today's mortgage landscape, and other considerations.

How Supplemental Partial Claims Work

The basic premise for Supplemental Partial Claims is that 30% of the unpaid principal balance (UPB) of the mortgage will become the source of funds to offset the arrears and create a balloon balance due at the end of the loan. Any funds left over after the arrears will be used to calculate the amount and period of time—up to 60 months—that the principal portion of the monthly payment will be reduced at a 25% rate. At a minimum, there will be a 5% reduction in payment.

A series of calculations is conducted to determine if the partial claim principal reduction lasts for up to 60 months (if less than 36 months, there is a 5% payment reduction) and to determine "excess" equity after the arrears to be used to calculate a reduced principal payment. The goal is to reduce the principal portion by up to 25% maximum monthly principal reduction (Max MoPR) for up to 60 months, based on the difference between the arrears and the MaxMoPR.

The Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD) have provided a worksheet that can be automated either in Excel or in an application to run loan scenarios to evaluate loans for eligibility. Based on most calculations, it appears that the Supplemental Partial Claim will create lower payments in response to a number of defaulted loans and provide some hope in this high-rate environment.

Potential Drawbacks

While there are many advantages to Supplemental Partial Claims, there are drawbacks to consider as well. Not all loans will qualify for the payment reduction, even at 5%. Furthermore, variable rate loans and prior bankrupt loans that did not reaffirm are ineligible. More mature loans will have a lower maximum partial claim due to the pay-down of the principal balance. Additionally, there are multiple calculation points for potential errors. What is clear is that the greater the UPB versus the arrears, the greater and longer the savings.

The Supplemental Partial Claim appears to only work with agency and government loans, as it's unclear whether the same interest rate can be maintained with nonagency or nongovernment loans. Furthermore, it's not widely understood by the general population and is not offered nationally.

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Within bankruptcy, it is unclear how the Supplemental Partial Claim will be accounted for by the trustee or mortgagor. There is also a question of extension of new credit instead of a modification of existing credit for the bankruptcy court.

The Issue of Increased Payment in Today's High-Rate, High-Value Environment

Created in the wake of the financial crisis, the Home Affordable Modification Program (HAMP) was a revolutionary change to save the mortgage industry from losing all of its value through distressed sales. These mortgage modifications were based on rate and term changes to re-amortize the arrears with the principal. This led to "proprietary" modifications for nongovernment/agency mortgages and streamlined modifications for Fannie Mae and Freddie Mac mortgages.

These modifications had several characteristics in common. The new rate environment was lower than when the mortgages were originated, with modifications as low as 2%. Furthermore, the arrears were re-amortized using a reduced interest rate and extended terms. The result was a lower payment than before and a current loan balance.

Today, the issue stems from the inability to achieve the lower payment that one would typically see from HAMP in a lower interest environment. The increase in interest rates to over 7%, when mortgage rates are in the 3% range, makes it almost impossible to modify a loan to a decreased payment. It would be necessary to extend the term considerably. The supplemental partial claim suggests extending the term to 480 months, or 40 years. Unfortunately, that only addresses a small percentage of interest rate change and certainly not the 3-4% rate change over the past three years. As a result, FHFA and Freddie have been working on the Supplemental Partial Claim to address the loan resolution with a lower payment.

The high-rate, high-value mortgage environment is a two-edged sword. Many say those who have defaulted on their loans can sell at the elevated rate but are stopped because they cannot afford to rent after selling. We see this issue in the Bankruptcy Mortgage Loss Mitigation Program. People who are back to work and can afford to pay more are denied a modification because the payment went up a few dollars. Most people expect to pay something more when they get behind and need to catch up. In bankruptcy, you pay the regular payment plus one-sixtieth (1/60) of the arrears each month—or in other words, an increase for a normal repay plan.

For some reason, the mortgage industry has decided that all workouts must be at a reduced payment, ignoring the details of it making sense. It certainly is easier to explain and get borrower support when you lower the payment, that holds doubly true when rates are artificially low. But with rates up and workouts down, values will start to drop. Once that happens, the 30% UPB maximum partial claim starts to become a 40-50% partial claim. At what point does it become an unrealized loss when marked to market?

Conclusion

The Supplemental Partial Claim can be beneficial in certain circumstances and will address a number of defaulted loans. It will not cover the spectrum like HAMP, and in the event of a major housing reset, it will not stop the downward slide in market value. However, allowing some workouts with Supplemental Partial Claims is good for the market and will help with losses. There are also advantages to working out a few loans with increased payments. Together, they form the first review for defaulted loans. The strength in working out loans is based in the underlying knowledge of the basics of the loan and in evaluating the ability to repay. To repeat, it is based on re-underwriting the loan and its affordability, not just saying the payment must be reduced. We have seen too many borrowers with new jobs and increased pay rejected because the payment did not go down far enough. We need to keep that in focus as we determine possible workout solutions. MP