UNC SCHOOL OF LAW

NORTH CAROLINA BANKING INSTITUTE

Volume 26 | Issue 1 Article 6

3-1-2022

Regulatory Loan Forbearance in the Banking Industry

Reginald T. O'Shields

William C. Handorf

Regulatory Loan Forbearance in the Banking Industry

WILLIAM C. HANDORF & REGINALD T. O'SHIELDS*

The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") signed into law in 2020 responded to the loss of personal income and business sales due to the COVID-19 pandemic. The CARES Act not only provided massive federal support to businesses and individuals affected by the devastating pandemic, it also allowed affected borrowers with federally-backed mortgages to request forbearance related to paying contractual loan obligations. While not covered directly by the CARES Act, many borrowers of non-federally guaranteed mortgages have also been offered comparable forbearance options. By evaluating alternative resolutions of forbearance for residential mortgage loans, we assess the likely success of the CARES Act for the industry's most important asset class. Statutory and regulatory forbearance in the period from 1980–1994 likely exacerbated and prolonged the economic difficulties experienced during that time. Between 1995 and mid-2020, however, the Federal Deposit Insurance Corporation provided regulatory relief over 200 times in Financial Institution Letters when it responded to short-term, non-financially driven events such as natural disasters. The majority of these programs related to regulatory forbearance were temporary in nature and achieved their objective of supporting communities in a time of need. This article analyzes the CARES Act mortgage forbearance for borrowers and concludes that its impact on bank solvency will likely be minimal, except in the case of banks providing forbearance for more than six months to high-interest rate residential mortgagors with an elevated loan-to-value

* William C. Handorf, Ph.D. is a professor of finance, real estate, and banking with the George Washington University's School of Business. In addition to his academic duties, he serves as an independent director with the Federal Home Loan Bank of Atlanta. Reginald T. O'Shields is Executive Vice President and General Counsel of the Federal Home Loan Bank of Atlanta. The authors would like to thank William Shaw and Adrienne Brown for their valuable comments and contributions to this paper. All opinions expressed in this article are solely those of its authors, and do not express the opinions of the Federal Home Loan Bank of Atlanta, or any of its other officers or directors or the Federal Home Loan Bank System.

ratio and a marginal credit history. These mortgage loans are most at risk of incurring losses for banks from troubled debt restructurings and are more similar to the legislative and regulatory actions taken between 1980–1994 that resulted in a substantial number of financial institution failures. In the case of the CARES Act mortgage forbearance, bank losses will be mitigated by nationwide home value appreciation and very low interest rates that facilitate refinancing of loan balances that were inflated by the capitalization of missed payments during the forbearance period.

I. INTRODUCTION

Commercial banks are viewed as a special sector and normally subject to close scrutiny and tight regulation by applicable state and federal regulatory agencies, such as the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC"). The justifications for this wide-ranging federal regulatory authority include limiting the issuance of bank charters, providing access to the Federal Reserve's discount window and FDIC deposit insurance, containing systemic risk, and ensuring that social and community needs are met in a fair and equitable manner.[1] Banks offer financial services and provide a source of credit for consumers, businesses, and municipalities critical to supporting sustainable economic growth. Yet, historically, banks periodically fail in preventable and predictable waves. As a result of these failures, banks often incur substantial public and private costs to protect insured depositors and preclude a widespread collapse of the industry.

Banks fail, by definition, because capital ratios decline well below levels that regulatory authorities deem necessary to support risk and remain a safe and sound institution. Capital ratios are typically depleted when banks pursue a strategy of quick growth funded by short-term, non-core liabilities invested in high-yield, risky loans and

1. William C. Handorf, Reggie O'Shields, & Andrew Richardson, *An Examination of the Factors Influencing the Enactment of Banking Legislation and Regulation: Evidence from Fifty Years of Banking Laws and Twenty-Five Years of Regulation*, 24 N.C. BANKING INST. 93, 94 (2020).

securities.[2] Unexpectedly large losses not earlier projected within a non-diversified portfolio places subsequent pressure on earnings and capital. In this way, quick growth and high-yield are leading indicators of risk. Liquidity problems arise once loan losses are sufficient to deplete capital and often precede a supervisory merger or liquidation.

Operating losses, low capital, substandard asset quality, strained liquidity, and poor risk management all contribute to bank failure. Often, these metrics are triggered by the poor decisions of executive management and inadequate attention to risk by the board of directors.[3] A failing bank invariably has not established an allowance for loan losses or reserves sufficient to cover subsequent loan losses. However, regulators periodically relax strict accounting and regulatory rules to allow banks to offer forbearance and other accommodations to borrowers. On occasion, regulators also limit increases in loan loss reserves to bolster the ability of banks to survive a temporary regional or even national economic downturn, and better meet the financial needs of their communities when devastated by natural disasters or other periodic calamities.

The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"),[4] overwhelmingly passed by Congress and signed into law by President Trump on March 27, 2020, responded to the widespread loss of personal income and business sales due to the COVID-19 pandemic. The CARES Act not only provided $2.2 trillion in federal support to businesses and consumers affected by the devastating pandemic, but it also allowed affected borrowers of federally-guaranteed mortgages to request forbearance related to paying contractual loan

2. *See* Charles W. Calomiris, *Banking Crises Yesterday and Today*, 17 FIN. HIST. REV. 3, 9–11(2010) (exploring the history of bank failures and identifying the factors that contribute to banking crises).

3. *See* Richard J. Parsons, *Banks Should Reject More Board Candidates*, AM. BANKER (Oct. 19, 2012, 1:44 PM), https://www.americanbanker.com/opinion/banks-should-reject-more-board-candidates [https://perma.cc/U8SL-PF7S] ("The director selection model for too many U.S. banks does not reflect the industry's risk profile . . . ."); KIRSTEN GRIND, THE LOST BANK: THE STORY OF WASHINGTON MUTUAL–THE BIGGEST BANK FAILURE IN AMERICAN HISTORY (Simon & Schuster, 2012) (detailing the mismanagement of one of the nation's largest mortgage lenders in the lead up to the Great Recession of 2008).

4. Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), 15 U.S.C.A. §9001 (West 2022).

obligations.[5] Many borrowers of non-federally guaranteed mortgages have also been offered comparable forbearance options. The term "forbearance" specifies patience as lenders refrain from enforcing obligations due.[6] Under the CARES Act, residential mortgagors unable to honor contractual monthly mortgage payments due to financial difficulties caused by the COVID-19 pandemic were able to request and receive relief for up to eighteen months. However, these missed payments must ultimately be repaid. Whether and how these amounts are repaid will determine the long-term effect of forbearance on bank solvency.

When forbearance ends, mortgage loans must be restructured so that the missed payments may be made up. This restructuring may be considered a Troubled Debt Restructuring ("TDR"),[7] which customarily triggers increased capital requirements, operating losses, and could even lead to a bank failure if the bank's loan portfolio is sizable and significantly impaired. Section 4013 of the CARES Act also provides banks temporary relief from certain normal accounting guidance on when

---

5. CARES Act § 4022(a), (b), (c)(1), 15 U.S.C.A. § §9056(a), (b), (c)(1) (2022); *see also* Ashley Carpenter et al., *Highlights of the CARES Act*, 27 HEADS UP (Deloitte & Touche LLP), Sept. 18, 2020, at 1, 37, https://dart.deloitte.com/USDART/home/publications/deloitte/heads-up/2020/highlights-cares-act [https://perma.cc/W3EL-7V79] (explaining the foreclosure moratorium and forbearance offered under the CARES Act); *CARES Act Mortgage Forbearance: What You Need to Know*, CONSUMER FIN. PROT. BUREAU, https://www.consumerfinance.gov/coronavirus/mortgage-and-housing-assistance/cares-act-mortgage-forbearance-what-you-need-know/ [https://perma.cc/GG2M-YXGE] (last visited Feb. 1, 2022) (presenting forbearance as an option for those struggling to make mortgage payments due to the COVID-19 pandemic).

6. *See, e.g.*, *Forbearance*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/forbearance [https://perma.cc/6QT7-HVL8] (last visited Feb. 1, 2022) (defining forbearance as "a refraining from the enforcement of something," such as debt, a right, or obligation that is due).

7. A TDR occurs if a debtor is experiencing financial difficulties and the creditor has granted a concession. *See* FED. DEPOSIT INS. CORP., SUPERVISORY INSIGHTS, ACCOUNTING NEWS: TROUBLED DEBT RESTRUCTURINGS 26–27 (2012), https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum12/sisummer12-article4.pdf [https://perma.cc/P2BJ-XWWD] [hereinafter FDIC: TROUBLED DEBT RESTRUCTURINGS]. The FASB has proposed eliminating TDRs while expanding disclosure requirements for loan modifications during a period in which a borrower is experiencing financial distress. *See COVID-19-related Loan Restructuring by Creditors*, GRANT THORNTON LLP (Jan. 21, 2021), https://www.grantthornton.com [https://perma.cc/UJ72-PLPC].

a restructuring of a loan must be considered a TDR by the lender and accounted for accordingly.[8] Specifically, the CARES Act permits the suspension of the Financial Accounting Standards Board ("FASB") Accounting Standards Codifications ("ASC") 310-40[9] for loan modification so long as the borrower was not more than thirty days past due as of December 31, 2019.[10] In addition, the federal banking regulators issued an interagency statement on April 7, 2020, that provided guidance on when a loan forbearance may be considered a TDR.[11]

The forbearance authorized by the CARES Act is not an isolated or recent event.[12] In this article, two prior periods of statutory or regulatory forbearance are examined to determine the potential effect of the mortgage forbearance provided by the CARES Act on bank solvency. The first period examined is from 1980 to 1994 and encompasses the Savings and Loan Crisis. During this period, Congress and bank regulators authorized certain regulatory accounting practices and capital forbearance that prolonged the crisis and resulted in a large number of bank and savings and loan failures. The second period examined is from 1995 to mid-2020. During this period, Financial Institution Letters suspended certain accounting rules applying to loan modifications for borrowers that otherwise would have been considered TDRs. This forbearance was often time-limited and in response to a natural disaster

8. CARES Act § 4013, 15 U.S.C.A. § 9051

9. The FASB ASC Topic 310 provides the basis for identifying TDRs and treating TDRs as impaired loans when estimating allocations for the allowance for loan and lease losses. *See* FDIC: TROUBLED DEBT RESTRUCTURINGS, *supra* note 7.

10. *See id.*

11. FRB, FDIC, NATIONAL CREDIT UNION ADMINISTRATION, OCC, CFPB, INTERAGENCY STATEMENT ON LOAN MODIFICATION AND REPORTING FOR FINANCIAL INSTITUTIONS WORKING WITH CUSTOMERS AFFECTED BY THE CORONAVIRUS (Apr. 7, 2020), https://www.fdic.gov/news/press-releases/2020/pr20049a.pdf [https://perma.cc/A2WD-G3NC].

12. Cancellation of debts at certain intervals was provided in the Deuteronomic Code. Hammurabi, a well-known ruler of the 1st dynasty of Babylon who reigned 1792-1750 BCE, specified periodic relief for debtors. According to Deuteronomy 15:1-11, "[a]t the end of every seven years, you shall grant a release. Every creditor shall release what he has lent to his neighbor." A later code designates a special year or jubilee to occur every fifty years instead of the seven-year interlude initially recommended. *See* John Bruce Alexander, *A Babylonian Year of Jubilee?* 57 J. BIBLICAL LITERATURE 75, 75–79 (1938).

affecting a particular region. As we discuss, it was largely successful in providing temporary relief to individuals affected by the disaster without endangering bank solvency.

In this article, the forbearance offered under the CARES Act is examined to determine its likelihood of success for the borrower as well as for the bank. The CARES Act does not require bankers to forgive the obligations of debtors, but instead prescribes a moratorium of payments for a limited period if requested. By evaluating the magnitude of obligations resulting from the forbearance in relation to consumer resources, probable losses to banks on the loans receiving forbearance can be assessed. Repayment alternatives available to banks and their customers to resolve non-payment include: (1) repayment of missed payments in one lump sum; (2) capitalization of missed payments into a larger loan to be repaid with a higher monthly obligation; or (3) repayment of the loan over an extended term. Based on our analysis, we ultimately conclude that the likely success of various loan modifications is related to the length of the forbearance period, the contractual rate of interest on the loan, the loan-to-value ("LTV") of the underlying mortgage, and the readily-available financial resources of the debtor. Mortgagors with a high-rate loan, a high LTV, unstable employment, and little in the way of liquid savings will face financial stress for relief extended six months or longer.

This article provides a framework for evaluating the success of the forbearance options offered in response to the disruption caused by COVID-19 pandemic. In Part II, we begin our analysis by examining loan forbearance and the accounting guidance for loan losses under the Generally Accepted Accounting Principles ("GAAP").[13] To provide a basis for assessing the success of the CARES Act forbearance, we review past regulatory forbearance actions. Part III details legislative and regulatory loan relief programs offered from 1980 to 1994[14] and, in Part IV, we turn to the FDIC's regulatory forbearance practice from 1995 to mid-2020.[15] In this part we review the frequency, rationale, and geographic dispersion of regulatory forbearance guidance extended by

13. *See infra* Part II.
14. *See infra* Part III.
15. *See infra* Part IV.

the FDIC over this quarter-century. Part V refocuses on the present by examining the financial consequence of forbearance for the banking industry's most important class of assets prior to the onset of the COVID-19 pandemic: residential mortgage loans.[16] Specifically, we consider the alternative repayment plans available to borrowers at the end of the forbearance period and evaluate the likelihood that these loans will be repaid in full. Finally, Part VI concludes this article by summarizing its key findings.[17]

II. LOAN FORBEARANCE AND THE ACCOUNTING GUIDANCE FOR LOAN LOSSES UNDER GAAP

The Interagency Policy Statement on the Allowance for Loan and Lease Losses (the "Policy") promulgated by the Federal Financial Institution Examination Council ("FFIEC") in 1993, and later amended in 2001, provides comprehensive guidance to banks on the maintenance of the allowance for loan losses (sometimes called a reserve) and the implementation of an effective loan review system.[18] The allowance for loan and lease losses is a balance sheet entry. Each quarter, the allowance is assessed and, if necessary, there is a further provision for loan and lease losses that appears as an income statement item.

The allowance declines as loan losses increase during an accounting period, and it increases when loans previously charged off result in recoveries from the favorable sale of collateral seized, the completion of a successful workout or restructured loan, or recognition of a settlement, insurance claim, or positive judicial ruling from a lawsuit against a debtor and/or guarantor. A bank increases the allowance to cover expected loan losses by a provision. A larger provision leads to lesser profits or greater losses during the period in which a provision is taken. The Policy is forward-looking and requires banks to consider all significant factors that affect the collectability of a loan. Important considerations often include a debtor's operating cash flow, non-

16. *See infra* Part V.
17. *See infra* Part VI.
18. Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions, 66 Fed. Reg. 35629 (July 6, 2001).

operating cash flow, collateral and/or guarantors. It is important to note, however, that accounting guidance changes over time.

Since 2016, the FASB has required the allowance for loan losses to be sufficient to cover all losses projected over the *estimated life* of loans and leases originated or purchased. This standard is known as the Current Expected Credit Loss ("CECL") model.[19] Prior to the revision, banks established a provision once there was evidence of a credit problem sufficient to incur a loss, and the allowance was required to be judged ample to cover losses over the *subsequent year* for unimpaired loans.

The FASB had earlier issued three Financial Accounting Standards ("FAS") related to problem loans: FAS No. 5, *Accounting for Contingencies*,[20] FAS No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*,[21] and FAS No. 114, *Accounting by Creditors for Impairment of a Loan*.[22] FAS No. 5 and 114 are particularly relevant to our analysis. FAS No. 5 indicated that loan losses should be recognized when a loss had been incurred, and the loss could reasonably be estimated by comparing the current loan balance to the fair value of the collateral or to the present value of a workout discounted at the effective initial interest rate of the loan now modified due to problems of the debtor.[23] FAS No. 5 accentuated incurred, or *ex post*, losses on groups

---

19. William C. Handorf, *Implications of the* Current Expected Credit Loss *Accounting Model*, 19 J. BANKING REG., 211 (2018) ("The Financial Accounting Standards Board approved a controversial accounting change in 2016 that impacts how and when U.S. banks account for loan losses. The accounting modification will require the allowance for loan losses to be sufficient to cover all losses projected over the life of loans and leases originated or purchased. The standard is known as the 'Current Expected Credit Loss' model.").

20. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5, ACCOUNTING FOR CONTINGENCIES (1975), https://www.fasb.org/pdf/fas5.pdf [https://perma.cc/FV8W-8SWS] [hereinafter FAS NO. 5].

21. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 15, ACCOUNTING BY DEBTORS AND CREDITORS FOR TROUBLED DEBT RESTRUCTURINGS (1977), https://www.fasb.org/pdf/aop_FAS15.pdf [https://perma.cc/NJ8K-66EN] [hereinafter FAS NO. 15].

22. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 114, ACCOUNTING BY CREDITORS FOR IMPAIRMENT OF A LOAN (1993), https://perma.cc/K6R6-FM88 [https://perma.cc/24SS-SY2M] [hereinafter FAS NO. 114]. These statements of financial accounting standards have since been superseded by FASB Accounting Standards Codification Topic 105, Generally Accepted Accounting Principles, but they continue to provide useful background on this topic. *See* FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE, TOPIC 105–GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (2009), https://www.fasb.org [https://perma.cc/RXC4-5CK4].

23. FAS NO. 5, *supra* note 20.

of similar loans.[24] FAS No. 114, by contrast, measured impairment of individual loans based on the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral securing the loan.[25] In this way, FAS No. 114 focused on expected, or *ex ante*, losses on loans evaluated discretely or individually.[26] Under the current CECL accounting rules, banks are required to estimate and record an allowance for all expected credit losses over the estimated life of the loan, so that current accounting rules in this area are less driven by specific changes regarding a loan and more by the expected performance over time.

In some cases, the FDIC has allowed banks to suspend GAAP for certain loan modifications that would otherwise be categorized as a TDR if the adjustment resulted from a specified hardship, such as a natural disaster, severe economic contraction, or a pandemic. The more favorable accounting treatment typically recognizes a repayment plan that defers payment of interest and principal on a timely basis relative to the contractual obligations of the debtor. As the COVID-19 pandemic progressed, the OCC, the regulator of national banks, recognized increasing credit risk in commercial, retail, and mortgage lending even as actual losses "have yet to fully materialize across many segments of the banking industry."[27] The OCC also noted that the combination of consumer relief programs and "unprecedented stimulus efforts" is "likely masking potential losses within the financial services industry."[28] Loan losses are expected as consumers and businesses, in some instances, will likely be unable to meet repayment schedules that were modified due to a period of forbearance as discussed in more detail in Part V.[29] Conservative banks have increased the provision for loan losses to ensure their allowance is sufficient when the forbearance periods end.

---

24. *Id.*
25. FAS No. 114, *supra* note 22.
26. *Id.*
27. *See* Brendan Pedersen, *Loss Provisions, Low Interest Rates Could Threaten Profits, OCC Says,* AM. BANKER (Nov. 9, 2020, 4:16 PM), https://www.americanbanker.com/news/loss-provisions-low-interest-rates-could-threaten-profits-occ-says [https://perma.cc/S93Y-CNLB] (quoting the OCC).
28. *Id.*
29. *See infra* Part V.

III. LEGISLATIVE AND REGULATORY LOAN RELIEF PROGRAMS FROM 1980–1994

Between 1980 and 1994, approximately 1,600 banks failed or required assistance from the FDIC.[30] At least in part, these failures can be traced to regional economic downturns preceded by booming economic conditions. Banks committed to the agricultural, energy, and commercial real estate sectors suffered disproportionately leading to the Savings and Loan Crisis. This Part examines the legislative and regulatory forbearance responses. Given the number of bank failures, the responses during this period may have exacerbated and prolonged economic difficulties from high-risk lending by weak financial institutions.

As shown in Table 1, West Texas crude oil prices declined an average of 3.5% per year from 1981 to 1994.[31] Petroleum prices declined in eleven of the fourteen years sampled. Corn prices stayed relatively flat, increasing only an average of 0.2% per year over the fourteen-year period and declining in price in eight of the fourteen years. Operating cash flows of oil producers and farmers plummeted, as did the value of their respective properties. Almost 60% of the banks that failed during this period were located in California, Kansas, Louisiana, Oklahoma, and Texas. Many more banks in the Northeast failed due to excessive exposure to commercial real estate loans that experienced a "boom to bust" scenario as the Economic Recovery Act of 1981 provided tax provisions favorable to enhancing real estate returns only to be reversed by the Tax Reform Act of 1986.[32] Speculative development and construction loan losses increased and reduced bank capital ratios.[33]

---

30. FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE: VOL. I: AN EXAMINATION OF BANKING CRISES OF THE 1980S AND EARLY 1990S 3 (2021), https://www.fdic.gov/bank/historical/history/vol1.html [https://perma.cc/BQF5-A23Y] [hereinafter HISTORY OF THE EIGHTIES].

31. ECONOMIC RESEARCH, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/ [https://perma.cc/X8EF-WC4S] (last visited Jan. 25, 2022).

32. Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.); Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.); John V. Duca et al., *How Taxes and Required Returns Drove Commercial Real Estate Valuations Over the Past Four Decades*, 70 NAT'L TAX J., 549, 549–84 (2017).

33. HISTORY OF THE EIGHTIES, *supra* note 30, at 24–26.

Although real estate returns from the Real Estate Investment Trust ("REIT") Index increased by a robust 12.7% annually between 1981 and 1994, the returns were single-digit or negative in half of the years sampled.[34] The average real estate return is of little consolation to a bank located in a region with a supply/demand imbalance that leads to declining rentals and prices.

Table 1
Annual Bank Failure and Economic Cause (1981 to 1994)

Factor	**Bank Failure**	**Oil Prices**	**Corn Prices**	**REIT Index**
Average	168	-3.5%	0.2%	12.7%
Correlation with Bank Failure				
Same Year		+.487	+.039	**-.539***
One-year Lag		+.161	+.369	**-.404****
Two-year Lag		+.311	+.030	-.188
Three-year Lag		-.265	-.217	+.088

*Significant at 5% Confidence Level ** Significant at 10% Confidence Level
Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

We employed statistical correlation analysis between annual bank failures and the percentage change in the price of West Texas crude,

34. ECONOMIC RESEARCH, FED. RSRV. BANK OF ST. LOUIS, *supra* note 31.

corn prices, and REIT returns. Correlation analysis provides a measure of the relative, not absolute, relationship between variables and does not suggest causality or economic consequence. Correlation can range from + 1.00, or perfect positive correlation, to – 1.00, a perfect inverse correlation. Some of the relationships are significant at the 5% and 10% confidence level with a one-tail test applicable to the directional hypothesis specified. The confidence level represents the probability that a relationship exists when otherwise untrue. We expect more failures of banks when any of the three explanatory variables post smaller gains or larger losses. Table 1 shows bank failures on a coincident basis to the applicable index and with one, two, and three-year bank failure lags.

As expected, in years when real estate returns exhibit smaller gains or losses, more banks fail that year and the following year. The result was negative (i.e., more banks fail when REIT prices decline) and significant at the 5% level for the coincident year and at the 10% level for the subsequent year given a one-tail hypothesis. Surprisingly, this was not the case with agricultural or oil prices. More banks did fail *three years* later, after energy and corn prices fell, but the relationship was not significant. The reason for the anomalous outcome is regulatory capital and loan loss forbearance policies. In this case, forbearance was not given to the borrowers. If the borrowers were unable to repay their loans, subjecting the bank to a loss, forbearance was granted to the bank with respect to its capital requirements, as losses on loans reduced income and ate into bank capital. As indicated by the FDIC:

> The second instance of class-of-forbearance was the 1986 temporary capital forbearance program for banks that were weakened as a result of lending to the troubled agricultural and energy sectors; this program was later expanded to all banks that were experiencing difficulties because of economic factors beyond their control. Bank regulators developed this program at a time when support for forbearance was building in Congress. Bank regulators sought to include a strong

> safety-and-soundness focus. A large majority of the institutions in the program were able to recover.[35]

Congress did not believe regulators were providing sufficient relief for farm banks and enacted the Competitive Equality Banking Act of 1987 ("CEBA"), one section of which allowed agricultural banks that were operating with an accepted capital restoration plan to amortize agricultural loan losses over *a seven-year* period of time,[36] so that bankers could stretch out loan losses, providing temporary relief for earnings and capital. More banks failed several years *after* declining commodity prices given the ability to write-off losses over a long period.

To ensure bank regulators did not apply capital or loan forbearance programs in an imprudent fashion, Congress enacted the Federal Deposit Insurance Corporation Improvement Act of 1991.[37] The law required regulators to take Prompt Corrective Action ("PCA") against undercapitalized, significantly-undercapitalized, and especially critically-undercapitalized banks with a tangible equity to total assets ratio of less than 2%.[38] Banks falling in any capital-deficient PCA class incurred restrictions related to dividends, management fees, and brokered deposits. These banks were also required to file an acceptable capital restoration plan. Regulators were required, with few exceptions, to appoint a receiver within ninety days of a bank being classified as critically-undercapitalized. PCA limited the capital forbearance periods that had been disastrously applied to savings and loan associations by the Federal Home Loan Bank Board ("FHLBB") in managing the woefully inadequate Federal Savings and Loan Insurance Corporation ("FSLIC") deposit insurance fund.

The FHLBB practiced regulatory forbearance to delay the liquidation of insolvent savings and loan institutions that the FSLIC was unable to resolve. The General Accounting Office responded to a request

---

35. HISTORY OF THE EIGHTIES, *supra* note 30, at 49.

36. Competitive Equality Banking Act of 1987, 12 U.S.C. § 1823 (2018).

37. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. 102–242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.).

38. Julie L. Stackhouse, *Prompt Corrective Action: What Does It Mean for A Bank's Liquidity*, VIEWS: FED. RSRV. BANK OF ST. LOUIS 1–2 (Oct. 1, 2008), https://fraser.stlouisfed.org/title/central-banker-6284/fall-2008-603097/views-586499 [https://perma.cc/C97Q-Z7NR].

regarding the policies of the thrift regulator by the Senate Committee on Banking, Housing, and Urban Affairs:

> The FHLBB has offered this delay either because it believed the thrift to be capable of recovery or because the regulator desired to postpone using insurance fund reserves to absorb the losses of failing thrifts. The principal form of forbearance practiced by the Bank Board in 1982 could be described as capital augmentation. The Bank Board changed its preferred form of forbearance between 1982 and 1986. Current policy is to exempt thrifts from minimum [capital] standards.[39]

The thrift regulator sanctioned deceptive Regulatory Accounting Practices ("RAP") that inflated the earnings and capital of the beleaguered institutions. As noted by then-chair of the Securities and Exchange Commission, Richard Breeden, "[b]y creating the appearance that troubled thrift institutions were in compliance with capital requirements, the accounting standards concealed the magnitude of problems."[40] Managerial fraud contributed yet another problem on top of interest rate risk, excessive growth, the origination of excessively risky loans, the purchase of dubious loan participations, strained liquidity, and low or negative capital.[41] "Revelations of large-scale fraud at a number of financial troubled thrifts that had been kept open through regulatory forbearance created pressure to enact a larger recapitalization [FSLIC]

39. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-87-78BR, FORBEARANCE FOR TROUBLED INSTITUTIONS 1982–1986 1–2 (1987), https://www.gao.gov/assets/ggd-87-78br.pdf [https://perma.cc/3LMG-L65K].

40. Richard C. Breeden, *Thumbs on the Scale: The Role That Accounting Practices Played in the Savings and Loan Crisis*, 59 FORDHAM L. REV. 71, 71–91 (1991), https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=2922&context=flr [https://perma.cc/3B78-B4VE].

41. Michael Dotsey & Anatoli Kuprianov, *Reforming Deposit Insurance: Lessons from the Savings and Loan Crisis*, 76 ECON. REV.: FED. RSRV. BANK OF RICHMOND 3, 3–28 (1990), https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/economic_review/1990/pdf/er760201.pdf [https://perma.cc/UR7N-6JT9].

measure."[42] Forbearance as practiced by the FHLBB and the FLSIC in the 1980s was a disaster leading to massive public costs and the restructuring of the supervision of the industry and its ultimate demise.

IV. FDIC REGULATORY FORBEARANCE PRACTICE FROM 1995 TO MID-2020

In order to assess the implications of the most recent regulatory forbearance initiatives, we look at past action by the FDIC and resultant outcomes. Between 1995 and mid-2020, the FDIC issued over 230 Financial Institution Letters ("FILs") in response to legislation, severe economic contractions, man-made calamities, terrorism, or natural disasters. FILs are addressed to the Chief Executive Officers of financial institutions supervised by the FDIC (state banks that are not members of the Federal Reserve System and state chartered savings associations) on a distribution list relevant to the underlying problem that the FIL aims to address.[43] FILs announce new regulations and policies, revised publications, and a variety of other matters of interest to those responsible for operating a bank.[44] On average, the FDIC issued approximately nine letters per year to all institutions or banks in select states between 1995 and 2020. However, averages can be deceptive. No guidance was provided in the year 2000 when attention was directed to operational risk and the ability of bank computer systems to accommodate the millennium change known as *Y2K*.[45] By contrast, the agency released thirty or more letters in 2010 and 2011, as severe weather ravaged diverse parts of the country. The supervisory guidance provided by the FILs is often temporary in nature, as more than two-thirds of the FILs issued during the past twenty-five years are now inactive, having either expired or been rescinded. Table 2 describes the rationale for the issuance of these FILs.

---

42. *Id.*

43. *See generally Financial Institution Letters*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/news/financial-institution-letters/index.html [https://perma.cc/J93L-4G5K] (last visited Feb. 5, 2022) (describing the purpose of FILs).

44. *Id.*

45. Y2K is a shorthand term for the Year 2000, in the lead up to which a widespread computer programming shortcut was expected to cause extensive havoc in the financial sector and beyond.

Table 2
A Quarter Century (1995 to mid-2020) of Regulatory Forbearance

Primary Reason for Financial Institution Letter and Forbearance

Rationale for FIL	Percent
Natural Disaster	96.6%
Economic Downturn	1.7%
Pandemic	0.9%
Oil Spill	0.4%
September 11 Terrorism	0.4%

Source: Federal Deposit Insurance Corporation, https://www.fdic.gov/news/financial-institution-letters/.

Natural disasters represent the most frequent reason the FDIC encourages or allows bankers to facilitate recovery and meet the needs of the communities they serve, accounting for approximately 96% of the FILs.[46] However, the most frequent justification should not be interpreted to indicate the most pervasive or disruptive reason for an FIL. For example, the COVID-19 pandemic accounts for less than 1% of the supervisory actions released, even though the deadly virus contributed to a devastating loss of employment within months of contagion, a sharp contraction of gross domestic product, a surge in the fiscal deficit, and accumulated federal debt. Similarly, the Great Recession between late-2007 and mid-2009 comprises less than 2% of the letters, despite the fact that this event adversely affected millions of homeowners and thousands of land developers and builders. The losses bankers incurred on home loans and acquisition, development and construction real estate loans subsequently precipitated almost 500 bank failures.[47]

Given the overwhelming number of the FILs released due to natural disasters, Table 3 depicts the class of catastrophe, with storms, flooding, wind, and tornados accounting for approximately two-thirds of

46. *See National Disaster Impact: Guidance for Bankers*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/news/disaster/bankers.html [https://perma.cc/LAT6-WG6B] [hereinafter *National Disaster Impact Guidance*] (last updated Sept. 1, 2021) (providing a comprehensive set of FILs related to national disasters).

47. William C. Handorf, *The Panic of 2008: Bank Failure and Commercial Real Estate*, 38 REAL ESTATE REV. 27, 27–37 (2009).

the natural disasters, followed by hurricanes, typhoons, and tropical storms making up almost one-quarter of the adversities. Fires, often fueled by wind, spawned more than 5% of the problems. Volcanoes and earthquakes precipitated 2.2% of the natural disasters leading to regulatory relief. However, less than 1% of the natural calamities were related to drought.

Table 3
Primary Source of Natural Disaster

Justification for FIL	**Percent**
Storm, Wind, and Tornado	67.9%
Hurricane, Typhoon, and Tropical Storm	23.2%
Fire	5.8%
Volcano and Earthquake	2.2%
Drought	0.9%

Source: Federal Deposit Insurance Corporation, https://www.fdic.gov/news/financial-institution-letters/.

Some regions and states suffer relatively more recurring natural catastrophes than others, with slightly more than 20% of the FILs applying to banks in all states and regions of the country.[48]
Regardless of cause or location, however, FILs invariably allow affected financial institutions to suspend the requirements of GAAP to permit loan modifications for borrowers that otherwise would be considered a TDR requiring increased capital.

48. When an advisory letter focuses on a given state, territory, or commonwealth, the most frequently cited include Texas, Oklahoma and other southern and plain states, as well as California and Florida. States susceptible to hurricanes, tornadoes, wildfires, and earthquakes are more frequently delineated. U.S. Territories and Commonwealths are the subject of FILs too and include Puerto Rico, Guam, the Virgin Islands, Northern Mariana Islands, and American Samoa. Some states, such as Alaska, Connecticut, Delaware, Maryland, Montana, Nevada, and Wyoming, have largely been spared natural disasters of sufficient scope to warrant a FIL during the period sampled.

V. ALTERNATIVE LOAN REPAYMENT PLANS AS A RESULT OF THE PANDEMIC FOLLOWING THE END OF FORBEARANCE

How will loan modification strategies for residential mortgage loans impact both banks and borrowers? Given that residential mortgage loans comprised approximately 28% of the banking industry's assets at year-end 2019 (the industry's dominant assets class as of 2020 when the CARES Act was signed into law) forbearance and mortgage modification will have a significant effect on bank assets and earnings.[49] We modeled alternative loan repayment plans following different period of forbearance. The CARES Act originally provided for two successive six-month forbearance periods that were later extended to eighteen months by regulatory actions. We also considered an additional potential extension to twenty-four months due to the extended duration of the COVID-19 pandemic and its impact on the economy. We used the average yield on residential mortgage loans as of the enactment of the law of 5.28%, which resulted in an implied monthly payment for interest and principal of $601.02 per $100,000 outstanding for an assumed remaining 25-year period of amortization.

Table 4 illustrates several alternatives for the mortgagor to cure various forbearance periods for an average or typical mortgage loan on the books of banks. First, the debtor could repay the delinquent payments in a lump sum. Second, the missed payments could be capitalized into a larger loan with a new, higher payment paid over the remaining contractual term. Third, the contractual monthly payment could be maintained, and the revised loan balance amortized over a longer period of time.

Table 4
Financial Options Applicable to Regulatory Forbearance

Consequence of Repayment Options for a $100,000, 25-year Mortgage Loan at 50th Percentile (5.28%) with Loan Payment of $601.02 and Different Forbearance Periods

49. Other important asset classes include commercial real estate loans, and commercial and industrial business loans. *See The Uniform Bank Performance Report*, FED. FIN. INST. EXAMINATION COUNCIL, https://www.ffiec.gov/ubpr.htm [https://perma.cc/HL4B-5HDN] (last visited Feb. 5, 2022).

Period	**Lump Sum Due**	**Interest Capitalization: Higher Payment**	**Interest Capitalization: Longer Term**
6-months	$2,640	$622.97 (+3.7%)	+24 Months (+8.2%)
12-months	$5,280	$645.53 (+7.4%)	+48 Months (+16.7%)
18-months	$7,920	$668.74 (+11.3%)	+74 Months (+26.2%)
24-months	$10,560	$692.65 (+15.3%)	+102 Months (+37.0%)

Bankers have been criticized by their handling of mortgage loan relief, particularly for requiring lump sum payments when the forbearance period ends, rather than extending the term.

> Big banks are facing criticism over rules they are enforcing when borrowers are supposed to resume making their payments. A report from The Committee for Better Banks includes the recommendation that banks should offer all affected customers the option of extending the term on the loan instead of making a balloon payment at the end of the forbearance period.[50]

Borrowers with mortgages backed by the Federal National Mortgage Association ("Fannie Mae"), Federal Home Loan Mortgage Corporation ("Freddie Mac"), or other governmental agencies, on the other hand, cannot be required to demand lump-sum payments at the end of the relief period.

To evaluate the success or failure of the CARES Act mortgage forbearance, we calculated the magnitude of the obligation resulting from

50. Kevin Wack, *Banks Criticized for Requiring Balloon Payments on Loans in Forbearance*, AM. BANKER (Sept. 22, 2020, 9:00 PM), https://www.americanbanker.com/news/banks-criticized-for-requiring-balloon-payments-on-loans-in-forbearance [https://perma.cc/GW4N-GD7A].

different forbearance periods in relation to resources of borrowers. Conceptualizing the potential lump sum due, or the increase in required payment, is critical to establishing the loan losses, if any, on TDRs when the deferment period ends. As Table 4 demonstrates, the adverse consequence of deferring monthly payments increases as the forbearance period extends.

- **6-month Forbearance Period:** First, the delinquency can be cured with a lump sum payment of $2,640 per $100,000 outstanding. The payment due represents interest not paid. Alternately, the lump sum could include interest and principal that would lead to a lesser loan balance due. Second, the payment could be increased from $601.02 to $622.97 on a $102,640 loan balance, which represents a 3.7% increase in monthly obligations. Third, the term of the loan could be extended by twenty-four months, but the payment would remain unchanged on the recast larger loan balance. It is important to note that missing payments for six months translates into two years of additional contractual commitments.

- **12-month Forbearance Period:** The mortgagor can (1) pay a lump sum of $5,280l; (2) face a large increase in monthly payment to $645.53 on a $105,280 loan (a 7.4% monthly increase); or (3) extend the loan by forty-eight months (four years) on the larger loan balance to pay off the one-year moratorium.

- **18-month Forbearance Period:** Although not initially authorized by the CARES Act, but later implemented by regulatory action, the mortgagor can (1) pay a lump sum of $7,920; (2) face a significant increase in monthly payment to $668.74 (an 11.3% increase) on a loan of $107,920; or (3) extend the loan by seventy-four months (more than six years) to pay off the eighteen month deferment period.

- **24-month Forbearance Period:** Even though few banks would ordinarily consider a two-year moratorium unless specified by law or encouraged by regulation, the mortgagor in this case would (1) pay a lump sum of $10,560; (2) face an exorbitant increase in monthly payment to $692.65 (a 15.3% rise) on a loan balance of $110,560; or (3) extend the loan by 102 months (eight and one-half years) to pay off the twenty-four month grace period.

If a repayment plan is not practical because of the length of the forbearance period, bankers could also consider loan forgiveness or a reduction in the contractual rate of interest where such actions are preferable for the consumer *and* better than foreclosure and seizure of the dwelling by the financial institution.

The rate of interest on the original mortgage loan is also an important factor in evaluating the effect of the CARES Act forbearance on the borrower and the bank. Table 5 shows how mortgagors with contractual rates of interest at the 5th, 95th, and 99th percentiles are affected by different forbearance periods.

Table 5

Consequence of Repayment Options for a $=100,000, 25-year Mortgage Loan at Various Interest Rates and Authorized Forbearance Periods

5th at 3.87% Rate and Payment at $520.69	**Lump Sum Due**	**Interest Capitalization: Higher Payment**	**Interest Capitalization: Longer Term**
6-months	$1,935	$537.20 (+3.2%)	+16 Months (+5.4%)
12-months	$3,870	$554.25 (+6.4%)	+33 Months (+11.5%)
95th at 7.42% and Payment at $733.80			
6-months	$3,710	$766.41 (+4.4%)	+42 Months (+14.3%)
12-months	$7,420	$799.71 (+9.0%)	+ 95 Months (+33.0%)

99th at 9.38% and Payment at $865.37			
6-months	$4,690	$910.62 (+5.2%)	+80 Months (+27.2%)
12-months	$9,380	$956.57 (+10.5%)	+281 Months (+97.6%)

It is instructive to focus on high-rate loans at the 99th percentile, as these loans retain a higher LTV ratio, a worse debt service coverage ratio, and/or a debtor with a poor credit history. The average yield on residential mortgage loans at the 99th percentile—as of the enactment of the CARES Act—was 9.38%. The implied monthly payment is $865.37 per $100,000 outstanding for a residual twenty-five year period of amortization. We considered the two forbearance periods initially authorized by the CARES Act.

- **6-month Forbearance Period:** First, the delinquency can be cured with a lump sum payment of $4,690 per $100,000 outstanding. Second, the payment could be increased from $865.37 to $910.62 on a $104,690 loan balance, which represents a very large 5.2% increase in monthly obligations that will exceed wage growth if the mortgagor is fortunate enough to remain employed. Third, the term of the loan could be extended by eighty months, but the payment would remain unchanged on the larger loan balance. Forbearance of mortgage payments for just six months translates into almost seven years of additional payments on a high-rate loan.

- **12-month Forbearance Period:** The mortgagor can (1) pay a steep lump sum of $9,380; (2) face a significant increase in monthly payment to $956.57 on a $109,380 loan (a 10.5% monthly increase); or (3) extend the loan by 281 months on the larger loan (more than twenty-three additional years) to pay off a one-year moratorium on mortgage payments. If the payment forbearance lasts more than one year, the loan balance increases so much for high-rate loans that extending the maturity is not financially feasible.

Mortgagors with high-rate loans have little latitude to afford longer terms given the consequence of compounding interest. Resolving loan forbearance lasting twelve months or longer offers sharply fewer options than forbearance limited to six months. In this complex environment, bankers will be challenged to set a repayment plan suitable for a cash-strapped homeowner. The contractual rate of interest and the deferment period are important determinants of the likely success of a loan modification program for a TDR.

Another key variable in evaluation the effect of the CARES Act forbearance program is the LTV ratio. The LTV of new loans originated in 2019 averaged 87% with a median value of 95%.[51] If a more severe 95% LTV at the time of the origination of the loan is assumed, this key credit risk metric would change for various contractual interest rates; and deferment periods with LTV ratios in excess of 100% indicate that a bank would suffer losses in the case of foreclosure on the mortgage.

- **Loans at the 5th Percentile Interest Rate (3.87%):** The implied LTV ratio would only exceed 100% with an eighteen-month or twenty-four-month period of grace, neither of which was initially contemplated in the CARES Act.

- **Loans at the 95th Percentile Interest Rate (7.42%) and at the 99th Percentile Interest Rate (9.38%):** Higher-rate loans exceed a 100% LTV with a one-year or longer deferment period.

The potential loan repayment plans must be compared to home value trends, wage growth, and the mortgagor's likely financial resources. According to the S&P/Case Shiller Home Price Index released in early 2021, home prices for the 20-City Composite appreciated by 11.1% in the United States for the year ended in January 2021.[52] In

51. Tendayi Kapfidze, *U.S. Mortgage Market Statistics: 2019*, LENDING TREE (Feb. 18, 2020), https://www.lendingtree.com/home/mortgage/u-s-mortgage-market-statistics-2019/ [https://perma.cc/7WYX-6RLK].

52. *S&P Corelogic Case-Shiller Index Reports 11.2% Annual Home Price Gain to Start 2021*, S&P DOW JONES INDICES (Mar. 30, 2021), https://www.spglobal.com/spdji/en/documents/indexnews/announcements/20210330-1347565/1347565_cshomeprice-release-0330.pdf [https://perma.cc/WK9Z-Q6R9] ("The 20-City Composite posted an 11.1% year-over-year gain, up from 10.2% in the previous month.").

contrast to the Great Recession, when home prices declined nationally by over 30%, very low interest rates and telecommuting have encouraged home buying.

Together, the very low interest rates engineered by the Federal Reserve to combat the economic consequence of the COVID-19 pandemic and higher home prices have allowed many qualified mortgagors to refinance into a new larger loan, thus avoiding the hardship of paying a lump sum or the stress of a higher loan payment at the expiration of forbearance. For a time, Fannie Mae and Freddie Mac imposed an "Adverse Market Fee" of 0.5% on most refinanced mortgages.[53] The announcement drew an immediate backlash from the mortgage industry and was repealed promptly after a new acting director of the Federal Housing Finance Agency was appointed by President Biden in June of 2021.[54]

Many mortgagors will be unable to afford higher loan payments to pay off loan balances capitalizing missed payments, despite the fact that average hourly earnings of all U.S. workers increased 4.7% in 2020 according to the Bureau of Labor Statistics.[55] This wage growth is

---

53. *See* News Release, Adverse Market Refinance Fee Implementation Now December 1 (Aug. 25, 2020), https://www.fhfa.gov/Media/PublicAffairs/Pages/Adverse-Market-Refinance-Fee-Implementation-Now-December-1.aspx [https://perma.cc/49NY-865W] (describing the Federal Housing Finance Agency's plan to implement the Adverse Market Refinance Fee).

54. *See* News Release, Fed. Hous. Fin. Agency, FHFA Eliminates Adverse Market Refinance Fee (July 16, 2021), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Eliminates-Adverse-Market-Refinance-Fee.aspx [https://perma.cc/TH4G-JYN2] (announcing that, effective August 1, 2021, the Federal Housing Finance Agency will eliminate the Adverse Market Refinance Fee); *see also FHFA Eliminates Controversial 'Adverse Market Refinance Fee'*, ABA BANKING J. (July 16, 2021), https://bankingjournal.aba.com/2021/07/fhfa-eliminates-controversial-adverse-market-refinance-fee/ [https://perma.cc/UM3L-UQZK] (reporting the Federal Housing Finance Agency's plan to scrap the "controversial" and "widely criticized" Adverse Market Refinance Fee); Press Release, White House Briefing Room, President Biden Announces Nominee for Director of the Federal Housing Finance Agency (Oct. 14, 2012), https://www.whitehouse.gov/briefing-room/statements-releases/2021/12/14/president-biden-announces-nominee-for-director-of-the-federal-housing-finance-agency/ [https://perma.cc/3HMD-W3JK] (publicizing President Joe Biden's nomination of Sandra L. Thompson to serve as Director of the Federal Housing Finance Agency).

55. *Real Average Weekly Earnings up 4.7 Percent from November 2019 to November 2020*, U.S. BUREAU OF LABOR STAT. *(Dec. 17, 2020),* https://www.bls.gov/opub/ted/2020/real-average-weekly-earnings-up-4-7-percent-from-november-2019-to-november-2020.htm [https://perma.cc/49NY-865W] ("Real average

sufficient to meet a higher payment from a loan recast for a six-month deferment period, but it is likely inadequate to service higher rate loans or longer deferment terms. Moreover, solid wage growth is not shared by all Americans, such as service workers in the travel and entertainment industries that were battered by the COVID-19 pandemic.

Refinancing into a lower interest rate loan brings little comfort to bankers and mortgagors located in geographic regions experiencing little demand for housing and much lower levels, if any, of home price appreciation. Mortgagors unable to meet contractual loan payments, whether deferred or not, also have less of an ability to sustain normal and recurring maintenance on residences. Properties with substantial deferred maintenance will not appreciate at the same level, if at all, as other homes in the region.

The most recent Survey of Consumer Finances compiled by the Federal Reserve prior to the onset of the COVID-19 pandemic provides a framework by which to estimate how consumers might deal with curing a period of payment relief mandated by the CARES Act.[56]

- 15% of families report spending more than received in income. These families resolved the shortfall by relying on savings and using credit cards.

- The median residential loan size outstanding is $111,000 (50% of families have a larger mortgage loan).

- The median debt-to-income ratio for debtors is 95.1%.

hourly earnings increased 3.2 percent from November 2019 to November 2020. The change in real average hourly earnings combined with an increase of 1.5 percent in the average workweek resulted in a 4.7-percent increase in real average weekly earnings over this period.").

56. *See* Jesse Bricker et al., *Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances* 103 FED. RES. BULL., (2017), https://www.federalreserve.gov/publications/2017-september-changes-in-us-family-finances-from-2013-to-2016.htm [https://perma.cc/NBP7-8PP6] (providing data about family income, net worth, credit use and other financial metrics that can be used as a reference point in understanding the impact of COVID-19 on family finances).

- The median amount of readily-available transaction account balances is $4,500.

Adjusting for the larger median size mortgage loan ($111,000) relative to the $100,000 illustrated in Table 5, households with a loan bearing an interest rate in the 5th, 50th, or 95th percentile might have sufficient cash to cure a six-month payment moratorium with a lump sum payment unless that cash has been depleted for normal living expenses. Mortgagors with a higher interest rate loan will likely have insufficient ready cash for even a half-year of payment relief. While most debtors do have other sources of cash, accessing those sources may trigger tax issues or early withdrawal fees. Loans with interest rates set at the 50th percentile or higher will likely need to be modified with a higher payment or a longer term unless the mortgagor qualifies for a new, lower rate loan by refinancing.

Some consumer advocates argue that debt forgiveness—not forbearance—would promote fairness for the weakest debtors. Economists within the Federal Reserve System have acknowledged this possibility and its important benefits but have also noted that such a policy shift would come with substantial costs:

> [D]ebt forgiveness . . . [would] remove excessive debt burdens that block the path to future growth . . . . To be sure, such a policy would place the burden of the crisis on another group, namely creditors . . . . The initial responses to the crises by fiscal and monetary policymakers and bank regulators have been massive in scope. Together, they have provided safety net assistance, supported aggregate demand, and helped many households and businesses preserve their financial health and avoid default. Despite these efforts, many lower-wage workers and small businesses continue to struggle financially. . . .[57]

57. JOHN MULLIN, FED. RES. BANK OF RICHMOND, THE CORONAVIRUS CRISIS AND DEBT RELIEF 7 (2020), https://www.richmondfed.org/-/media/RichmondFedOrg/publications/research/econ_focus/2020/q2-3/feature1.pdf [https://perma.cc/WS3K-WCSZ].

The federal government recently has embarked on an ambitious policy of providing direct financial assistance to consumers and borrowers, such as the stimulus payments authorized under the CARES Act, the Consolidated Appropriations Act of 2021, and most recently, the American Rescue Plan Act of 2021.[58] The impact of these legislative initiatives has not yet been fully realized. Direct stimulus payments to consumers with moderate- to low-incomes provides, in some respects, a source of debt forgiveness. Our empirical analysis confirms the regulatory insight that higher risk debtors borrowing funds at a high-rate, and with limited other resources, are most at risk of being unable to benefit from any period of relief provided by regulatory forbearance. Moreover, these debtors are most in need of debt forgiveness or stimulus payments.

This analysis suggests that bank will be spared losses in the areas where home prices have generally appreciated by 10% or more. Generally, home values have kept pace with larger loan balances incurred by borrowers accepting a six-month moratorium for a loan at any rate of interest. If mortgagor's request, and banks subsequently provide, a one-year moratorium for borrowers with loan rates at or above the 50th percentile, there is likely to be more risk to banks. Such mortgagors have fewer sources of cash and savings available and are already indebted heavily. Thus, banks that focused on mortgagors with low credit scores and high LTV ratios to earn high rates of interest will be susceptible to incurring the largest losses. Historically, banks fail given the origination of high-yield, risky loans.

VI. CONCLUSION

Commercial banks are subject to regulation, examination, and supervision designed to foster a safe and sound industry given the economic importance of the sector and the public costs incurred when institutions fail. The CARES Act, signed into law in 2020, responded to

58. The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"), Pub. L. No. 116-136, 134 Stat. 231 (2020); Consolidated Appropriations Act, 2021, Pub. L. 116-260, 134 Stat. 1182 (2020); American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat. 4.

the loss of personal income and business sales due to the COVID-19 pandemic. While the CARES Act allowed affected borrowers to request forbearance related to paying contractual loan obligations, it did not forgive the payments altogether.

For loans not refinanced or modified with higher payments or longer terms after the deferment period terminates, banks will need to apply GAAP for any TDR. CECL, adopted by the FASB in the years following the Great Recession, requires the allowance for loan losses to be sufficient to cover all losses projected over the *estimated life* of loans and leases originated or purchased.

Banks that originated or purchased high-rate residential mortgage loans to mortgagors with a high loan-to-value ratio or an uneven credit history, and that deferred payment for longer than six months, are most at risk of incurring losses. This is because such borrowers will unlikely be able to pay a lump sum to cure the payments skipped or afford a higher monthly payment. Bankers who originated low-rate loans to customers with lower LTV ratios and strong credit histories, and who limited deferment periods to six months or less, will fare relatively well. This is especially likely given the fact that home prices have increased by more than 10% nationwide since the onset of the COVID-19 pandemic. Very low interest rates achieved by the Federal Reserve System to resuscitate the moribund economy allowed qualified mortgagors to refinance. Well-managed banks well equipped to withstand economic shocks or natural disasters. Losses should prove manageable given that only 5.5% of homeowners were in forbearance as of late-2020.[59]

Financial institutions that adopted business plans based on high-yield mortgage loans incur the most exposure to losses. Forbearance merely extends the period until loan losses, if any, are recorded and allows adversely affected debtors time to restore diminished financial resources. Loss exposure for banks increases the longer the period of forbearance, the higher the LTV ratio, and for mortgagors maintaining irregular credit histories, little available cash, and homes located in

59. *See* Orla McCaffrey, *Covid-19's Financial Toll Mounts as Homeowners Keep Postponing Mortgage Payments*, WALL ST. J. (Jan. 24, 2021, 8:00 AM), https://www.wsj.com/articles/covids-financial-toll-mounts-as-homeowners-keep-postponing-mortgage-payments-11611493201 [https://perma.cc/QU2A-S3MC].

economically depressed regions. The Federal Housing Finance Agency extended forbearance relief to eighteen months for federally-insured loans.[60] Banks with a non-diversified portfolio of high-rate mortgages are most at risk. There are many other asset classes not considered in this analysis, such as commercial real estate, construction and development, and business and credit card loans that require further examination to estimate total industry losses. High-rate loans remain a signal of risk that temporary regulatory forbearance is unable to mask.[61]

In summary, as demonstrated by past experience with relief, regulatory forbearance is most effective when related to short duration, non-financially driven events such as the COVID-19 pandemic.[62] Regulatory forbearance is also more effective when it is implemented by healthy financial institutions with substantial governmental fiscal support, such as during natural disasters. On the other hand, forbearance can exacerbate and prolong economic difficulties driven by high-risk lending by weak financial institutions. At this point, it appears that the most recent relief related to the COVID-19 pandemic will fall into the former category, particularly when implemented by the strongest banks and financial institutions along with massive fiscal stimulus and prolonged monetary accommodation.[63]

---

60. *See* Press Release, Federal Finance Housing Agency, FHFA Extends COVID-19 Forbearance Period and Foreclosure and REO Eviction Moratoriums (Feb. 25, 2021), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Extends-COVID-19-Forbearance-Period-and-Foreclosure-and-REO-Eviction-Moratoriums.aspx [https://perma.cc/M4XA-NJ6K] ("The policy hurts non-bank mortgage servicers since they must continue making payments for a longer period of time."); *see also* Kate Berry, *The Mounting Costs of Protracted Mortgage Forbearance*, AM. BANKER, (Mar. 26, 2021), https://www.americanbanker.com/news/the-mounting-costs-of-protracted-mortgage-forbearance [https://perma.cc/AU89-7PRU].

61. *See supra* Part V.

62. *See supra* Parts III and IV.

63. *See supra* Part V.