Should Your Institution be Prepared for Foreclosure Déjà vu?

lending industry update credit risk

Summary: As mortgage foreclosures begin to inch up and federal foreclosure moratoriums draw to a close, financial institutions should prepare themselves for a worst-case scenario. It's unlikely that the bursting of the current real estate bubble will play out the way things did when the last couple of real estate bubbles burst. Should a worst-case scenario emerge, CFIs should be prepared to show regulators they took adequate precautions.

When it comes to ocean waters, sometimes the calmest looking spots can be the most dangerous. When waves are actively breaking on the shore, heading to an area where the water is still and less active seems the most logical choice for surfing and swimming. In reality, a calm section of water between waves can actually be an indicator of a rip current - an incredibly strong, narrow undertow of water that pulls from the shore out to the point just beyond where waves begin breaking. Rip currents lead to an average of 46 drowning deaths every year and are one of the biggest causes for lifeguard rescues.

With the housing market still going gangbusters and demand continuing to exceed supply, real estate still appears strong. But with the Federal Reserve starting to raise rates again, additional hikes expected, and moratoriums on mortgage forbearance winding down across the country, real estate lending has the potential to prove to be somewhat of a riptide for financial institutions, if foreclosure activity begins significantly ramping up.

Early activity. As forbearances across the country have begun to run out, foreclosure activity has started inching up again. In February 2022, foreclosures were up 70% from December 2021 according to ATTOM Data Solutions. Though this was still on the relatively low side, activity has slowly continued rising. In May, though foreclosure starts were down from the previous month, activity was still up 274% from last year. Part of this spike is attributable to lenders finally catching up with the backlog of foreclosures that already existed before the pandemic and were put on hold by the implementation of The Coronavirus Aid, Relief, and Economic Security Act in March 2020.

But now that federal foreclosure moratoriums have expired, there are fears that institutions could experience a bit of déjà vu back to the housing market in 2007 - 2010. So far, it appears that any damage will be minimal, as the number of foreclosures starts have far exceeded the number of completed foreclosures. Given that demand for homes still outweighs supply, most homeowners who are unable to remain current on their mortgages are more likely to be able to sell their homes than default on them. But that doesn't mean that institutions shouldn't prepare themselves for the worst, particularly if rising interest rates bring a quick cooling off to the housing market.

Caution abounds. There is plenty of room for optimism that institutions are likely to evade the massive defaults experienced when the last couple of real estate bubbles burst. Industry experts warn that lenders need to remain cognizant that the current bubble is unsustainable and is likely to burst sometime before the end of the year.

Key steps to prepare for impending foreclosures:

In light of this reality, there are a few steps community financial institutions (CFIs) can take to prepare for the inevitable real estate downturn and an eventual rise in foreclosure activity.

- **Target and address federal loans.** Under the Consumer Financial Protection Bureau's (CFPB) rules, for loans that are in any way connected to the federal government (i.e. insured by the Federal Housing Administration or bought by Freddie Mac or Fannie Mae), lenders need to give homeowners a chance to save their homes before they are foreclosed on. CFIs should actively scour their lending portfolios for federal loans and act quickly when a borrower misses a payment, instead of waiting for trouble to arise. "*Unprepared is unacceptable,*" said CFPB's acting director Dave Uejio in an April 2021 compliance bulletin, warning institutions that the agency will hold lenders accountable if they do not take precautions to help homeowners avoid financial distress.
- **Evaluate level of liability insurance coverage needed.** CFIs should also take a close look at their liability insurance coverage to ensure it's adequate before things go south. Insurance should be significant enough to cover everything from lending errors on your part, to directors and officers who could potentially be dragged into any legal proceedings that emerge out of foreclosure activities.
- **Leverage an extra set of eyes.** Another thing to consider is the importance of an outside perspective when it comes to reviewing your institution's potential involvement in a rise in foreclosure activity. Bringing in an outside perspective can be a good way to make sure your lenders aren't so close to your portfolio that they could overlook risks that might be more apparent to someone outside your institution.

Despite the looming burst of the current housing bubble, there are plenty of warning signs to identify borrowers at risk of foreclosure as well as precautions your institution can take to help your borrowers avoid becoming part of the foreclosure fallout.

PCBB PODCAST: EXCITING, NEW & INFORMATIVE

ECONOMY & RATES

Rates As Of: 07/25/2022 05:35AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	2.49	0.77	2.43
6M	2.97	0.46	2.78
1Y	3.05	0.26	2.66
2Y	3.00	0.05	2.27
5Y	2.89	-0.15	1.63
10Y	2.82	-0.20	1.31
30Y	3.06	-0.13	1.15

FF Market	FF Disc	IORB
1.58	1.75	1.65
SOFR	**Prime**	**OBFR**
1.52	4.75	1.57