POLICY BRIEF | APRIL, 2021

Stanford | Institute for Economic Policy Research (SIEPR)

On Target: Debt forbearance policies help curb pandemic financial woes

By Amit Seru

KEY TAKEAWAYS

- The financial fallout on households and the U.S. economy as a whole was dampened by the federal CARES Act debt forbearance program as well as bank debt-suspension efforts.
- The forbearance programs resulted in a better-targeted relief policy because they were voluntary, allowing borrowers to decide when and how much, if any, debt suspension to request.
- By the first quarter of 2021, estimates are that more than 60 million consumers have missed about $70 billion in debt repayments in the $14 trillion U.S. consumer credit market.
- The problem of paying back the debt that was temporarily suspended, remains. How it is resolved could have major consequences for individuals and the economy.

The coronavirus pandemic caused a sudden and sharp recession in the United States and around the world. But my research with Susan Cherry, Erica Jiang, Gregor Matvos, and Tomasz Piskorski found that the financial distress that hit U.S. households — and the economy at large — was significantly blunted by federal and private debt forbearance programs.

We studied how debt forbearance provisions of private lender programs and the federal Coronavirus Aid, Relief, and Economic Security (CARES) Act affected the entire U.S. population of borrowers between March and October 2020.

Our study[1] found that the extraordinary size and speed of the federal debt forbearance program, coupled with private debt forbearance, brought significant financial relief to borrowers. In all, loans worth more than $2 trillion out of the $14 trillion U.S. consumer credit market entered into forbearance. These were mostly mortgages and student loans, but forbearance was also offered on revolving debt and auto loans. We estimated that by the first quarter of 2021, debt forbearance allowed more than 60 million people to miss about $70 billion in debt repayments.

Moreover, the programs resulted in a potentially better-targeted relief policy because they were voluntary, allowing borrowers to decide when and how much debt suspension to request. We find that forbearance rates are higher in regions with the highest COVID-19 infection rates and the greatest deterioration in local economic activity as exemplified by high levels of unemployment insurance claims. Individuals with lower credit scores, lower incomes, and higher debt balances and regions with a higher share of minority residents received forbearance at higher rates.

1 Susan F. Cherry, Erica Xuewei Jiang, Gregor Matvos, Tomasz Piskorski, and Amit Seru. "Government and Private Household Debt Relief During COVID-19." NBER Working Paper 28357, 2021 (*https://www.nber.org/papers/w28357*).

Our results suggest that debt forbearance significantly muted the household debt distress channel that played a prominent role in slowing recovery in the aftermath of the Great Recession. But there remains the problem of "forbearance overhang" — paying back the debt that was temporarily suspended. How repayment is achieved, whether by a one-time balloon payment or amortizations over the remaining life of the loans, could have major financial consequences for individuals and affect the economy as a whole.

The crisis in perspective

Major economic crises, such as the Great Depression and the Great Recession, often cause significant household debt problems — including defaults, foreclosures, and bankruptcies — which can spill over into the rest of the economy. Governments have regularly intervened in household credit markets during such times, but the CARES Act was unusual in method, scope, and speed. It mandated debt forbearance — a temporary suspension of debt repayments rather than a complete forgiveness of loans — on a large share of mortgages and almost all student debt.

In addition to government programs, private-sector lenders also provided debt forbearance. It is a policy that is often used to restructure debt payments of households in more normal economic times to avoid foreclosure. Typically, although the payments are delayed, interest does not stop accruing.

We documented the extraordinary size and speed of debt forbearance in response to the COVID-19 pandemic as well as the resulting low levels of household debt distress, which likely significantly dampened the potential adverse spillovers to the rest of the economy. We also measured the amount and rate of the relief across population strata, including age, race, income level, and region of the country. In addition, we examined the roles that borrower self-selection and government subsidies had in determining the amount and incidence of the relief.

Our study used a representative credit bureau panel of 10 percent of U.S. consumers amounting to more than 20 million U.S. consumers. The data allowed us to study which households in the U.S. chose to miss payments. Some households, for example, decided to make full payments despite being in forbearance. We used the data to measure the extent of forbearance, as well as its distribution across households of varying credit scores, income, exposure to COVID-19, and economic shocks. Finally, the data allowed us to classify which loans received debt relief under the CARES Act and which relief was provided by the private sector.

Extent of forbearance

The extent of forbearance varied by category of debt. Between March and October 2020 a total of $2 trillion in loans were in forbearance, affecting 60 million individuals. As a result, forbearance rates rose substantially in all categories of household debt, with share of loans in forbearance ranging from a low of 4.6 percent for revolving debt to a high of 92 percent for student debt.

The lion's share of new forbearance initiated during the COVID-19 crisis was for mortgages, affecting about $1.1 trillion outstanding debt. It was highest because of the large balances involved in mortgages. Student debt was second at $580 billion.

While in forbearance, individuals had the option to pause payments on their loans for six months with an option to extend for another six months (this was extended to 18 months subsequently). We found that around a third of borrowers in forbearance did not do that but rather continued making full loan repayments. Thus, forbearance partially acted as a credit line, allowing borrowers to "draw" on forbearance if needed.

Impact and consequences

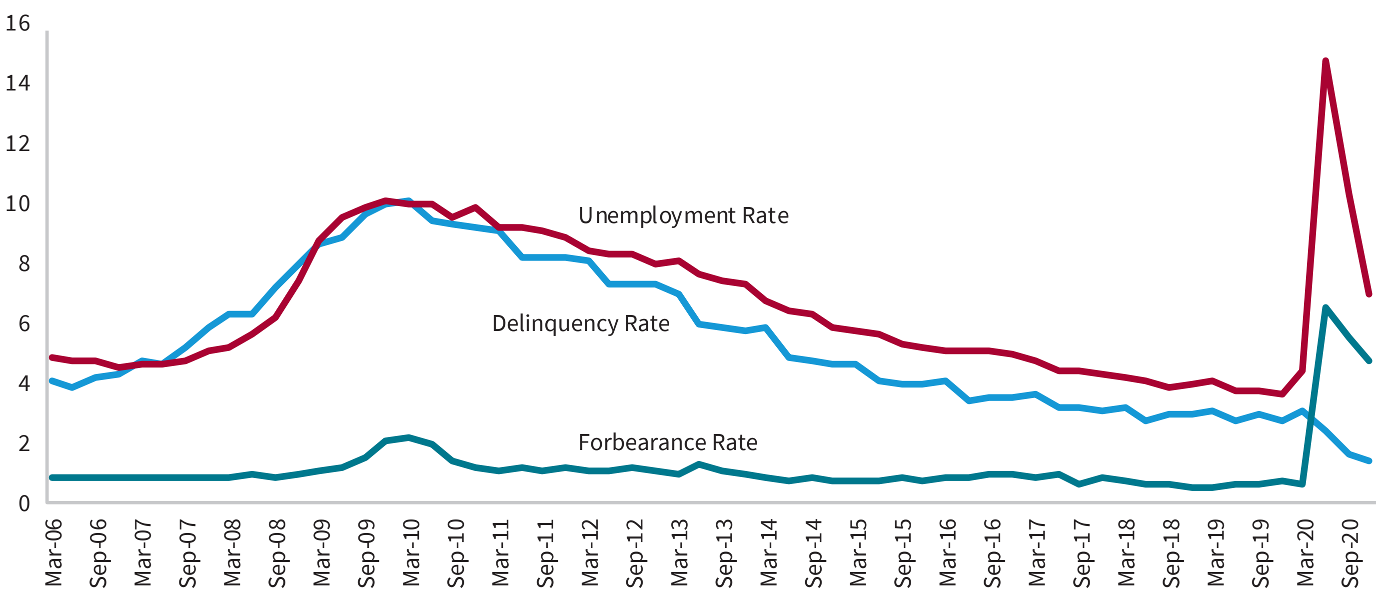
Forbearance programs resulted in substantial financial relief for households. Cumulative payments missed by individuals in forbearance during the March-October 2020 period were on average largest for mortgage debt ($3,200) and auto debt ($430). By October 2020, debt forbearance allowed U.S. consumers to miss about $43 billion in payments. At this rate, more than 60 million consumers would miss about $70 billion in payments by the end of the first quarter of 2021.

The extent of forbearance had significant aggregate consequences, by substantially dampening household debt distress. In the Great Recession, for example, mortgage delinquencies rose from a low of 2 percent to more than 8 percent. The effects spilled over into the rest of the economy, resulting in a decline in house prices, as well as a fall in aggregate demand. However, during the COVID-19 pandemic, delinquency rates declined from 3 percent to 1.8 percent, presumably as a result of forbearance.

This decline came despite an unprecedented increase in the unemployment rate, which reached almost 15 percent in the second quarter of 2020. Usually, there is a strong historical association between the unemployment rate and mortgage defaults.

Figure 1 strongly suggests that most potential delinquencies in the mortgage market were averted because of forbearance. We speculate, and back-of-the-envelope calculations confirm, that the low delinquencies explain at least in part why the pandemic has not resulted in house price declines.

Figure 1. Delinquency, Forbearance, and Unemployment Rates



This figure plots the U.S. residential mortgage delinquency rates, mortgage forbearance rates, and unemployment rates over time. The dashed vertical line shows the declaration of the national emergency due to COVID-19 and the passage of the CARES Act in March 2020. Forbearance rates are calculated according to Equifax standard procedure for identifying loans in forbearance. The quarterly unemployment rates are from the U.S. Bureau of Labor Statistics and are peak values in respective quarters. Sources: Equifax 10% representative sample of the U.S. credit population.

Reaching the targets

The incidence of household debt forbearance differed substantially from other relief programs directed at households. About 60 percent of the total dollar amount of relief was received by borrowers with above median pre-pandemic incomes, in other words, individuals earning $52,000 or more. This indicates forbearance provided relief to higher-income individuals than other CARES Act policies, such as stimulus checks.

But this does not imply that forbearance is unrelated to pandemic-induced economic shocks. Lower-income households were more likely to obtain forbearance relief. However, because they have lower debt balances, the dollar value of debt relief was smaller.

The rate of forbearance also related to credit ratings. Consumers who ended up in forbearance during the pandemic had on average much lower credit scores, lower incomes, and higher debt balances before the onset of COVID-19 than those who did not end up in debt forbearance.

This observation highlights an important feature of forbearance. Incidence is related to borrower credit quality, while other programs, such as stimulus check programs, often target individuals based solely on their prior income. Debt forbearance may have complemented other stabilization programs by providing significant relief to financially vulnerable individuals with higher pre-pandemic incomes — i.e., individuals ineligible for policies like the stimulus check program.

Forbearance potentially provided targeted relief to borrowers who felt they were subject to financial shocks because it is up to the borrower to request it and is subject to lender approval in the case of private forbearance. Either borrower self-selection or lender scrutiny could result in focusing relief on households that require it.

We found that households with a higher likelihood of COVID-19 related shocks were more likely to obtain debt relief. For example, forbearance rates were significantly higher in regions that experienced the highest COVID-19 infection rates and the greatest deterioration in their local economies. Figure 2 plots average state forbearance rates against average COVID case rates, average changes in unemployment insurance claim rates, changes in time spent at workplaces, and changes in the number of open small businesses. The figure shows that states with higher COVID case rates and higher unemployment insurance claim rates had higher forbearance rates, as did states with larger decreases in the time spent at workplaces and the number of open businesses.

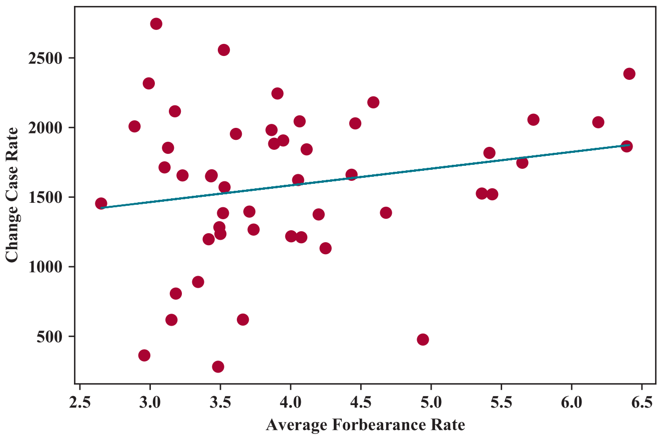
The economic and health consequences of the pandemic have disproportionately impacted minorities, especially Black Americans. Our research showed that regions with higher shares of minorities and Blacks received higher rates of debt forbearance. This was especially important for borrowers living in areas with higher house prices, where affordability and debt payment constraints are likely to be more binding. Figure 3 plots state forbearance rates against these characteristics and shows a strong correlation between forbearance rate and the percent of a region's population that is Black or non-white.

Thus, forbearance may have reached its intended targets, including minorities and higher-income households that were affected but might otherwise not be eligible for income-based programs.

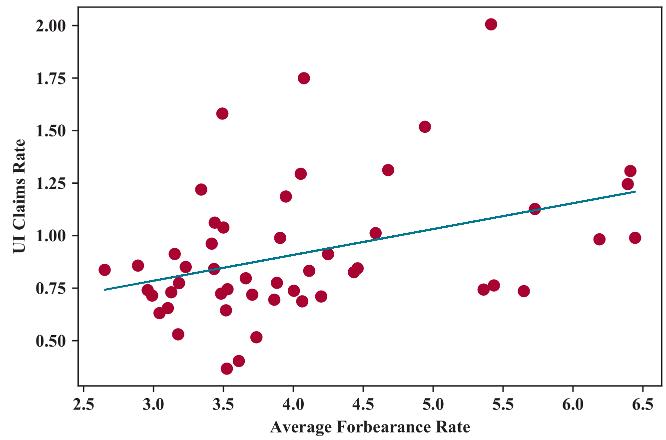
Roles of the private sector and self-selection

The CARES Act mandated forbearance of federally insured mortgages and student loans. We also found substantial increases in forbearance in auto and credit card loans from the private sector, as well as so-called jumbo mortgage loans, none of which were eligible under the CARES Act. Overall, more than a quarter of all debt relief — government and private — was provided by the private sector, and this was for debt not eligible under CARES rules.

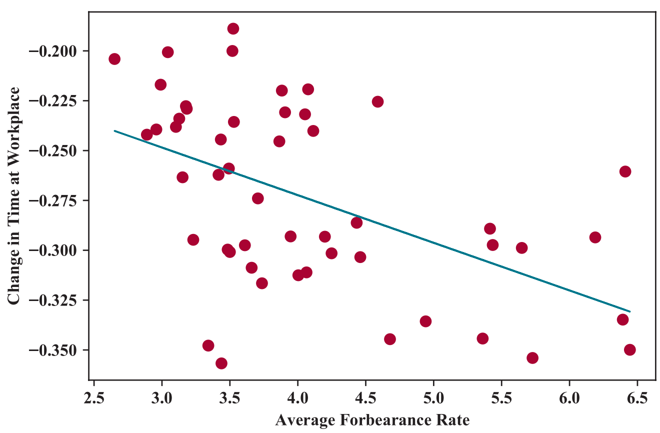
Figure 2. Correlation between State Forbearance Rates and COVID related Shocks



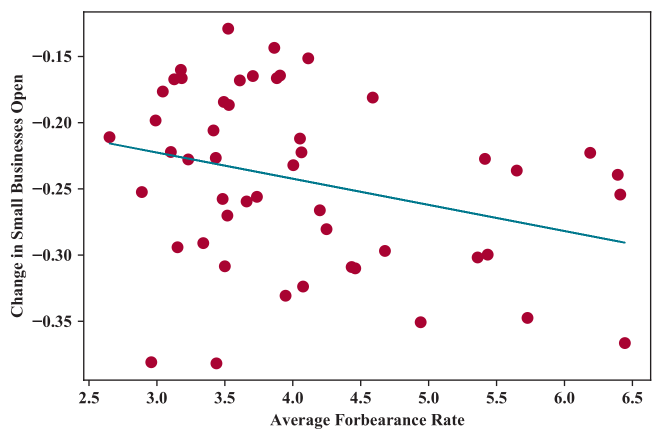
Panel (a): Covid Case Rates



Panel (b): UI Claims



Panel (c): Time Spent at Workplace

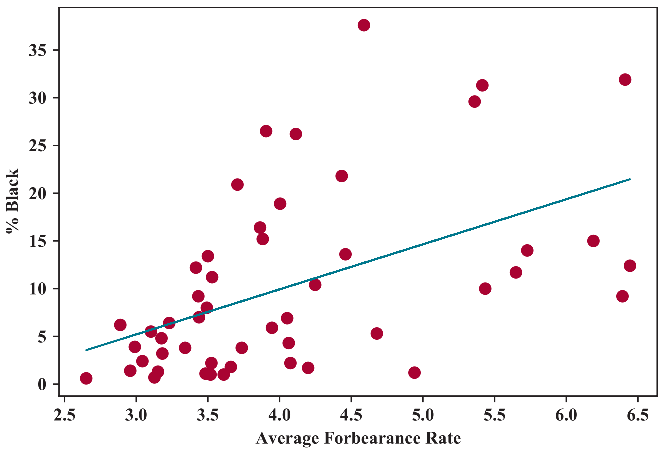


Panel (d): Number of Small Businesses Open

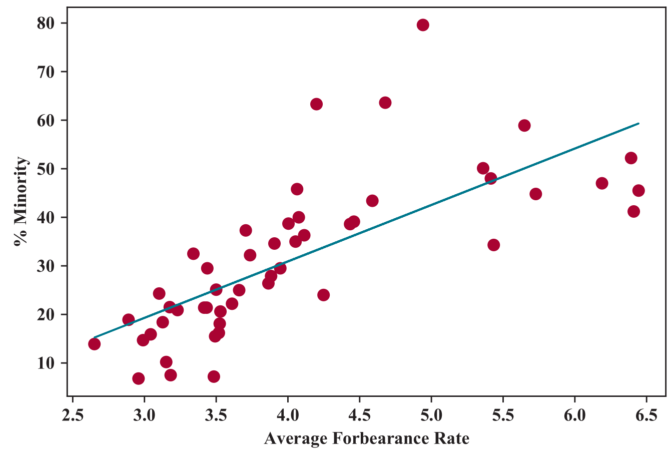
This figure plots average state level forbearance rates against state level COVID shocks. Forbearance rates are the mean monthly mortgage forbearance rate in state taken over the period from March 2020 through October 2020. Panel (a) plots forbearance against average COVID case rates, panel (b) shows average weekly initial unemployment insurance claims rate, panel (c) shows the average daily change in time spent at workplaces relative to January 2020, and panel (d) shows the average weekly change in the number of small businesses open relative to January 2020. Averages are taken from March to October 2020. The black line indicates the line of best fit.

Sources: COVID cases, credit/debit card spending, and time spent at workplace come from Opportunity Insights Tracker. Forbearance rates come from Equifax.

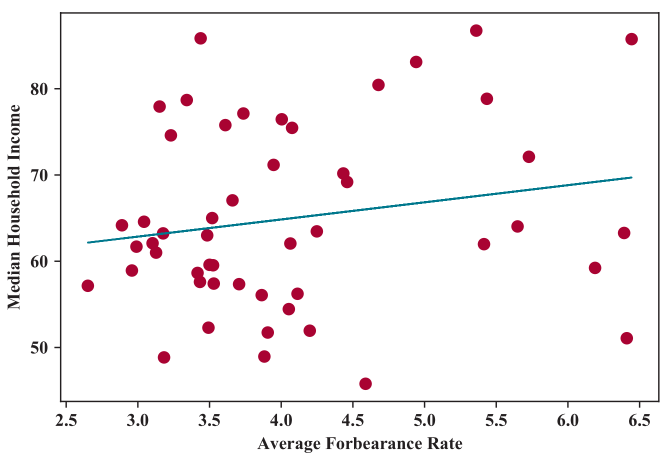
Figure 3. Correlation between State Forbearance Rates and Socioeconomic Characteristics



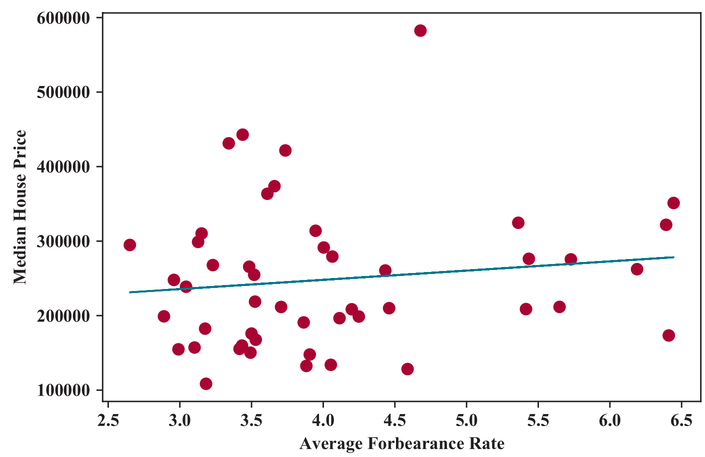
Panel (a): % Black



Panel (b): % Minority



Panel (c): Median Household Income



Panel (d): Median House Price

This figure plots average state level forbearance rates against state level socioeconomic characteristics. Forbearance rates are the mean monthly mortgage forbearance rate in state taken over the period from March 2020 through October 2020. Panel (a) plots forbearance against % of the population that is Black, panel (b) shows the % of the population that is minority (non-white), panel (c) shows the median household income, and panel (d) shows the median house price. Average forbearance rates are taken from March to October 2020. The black line indicates the line of best fit.

Sources: Race and income come from the Census Bureau and are taken as of 2019. House prices come from Zillow and are taken as of January 2020. Forbearance rates come from Equifax.

We studied the data on mandated CARES Act forbearance for eligible mortgages in order to understand the role of borrower self-selection in determining the incidence of debt relief. There are generally two steps in determining which borrowers obtain debt relief.

First, the borrower must request relief from the lender. That's self-selection. Second, the lender must agree to provide relief, though this was mandated for government-insured loans. More than 90 percent of borrowers decided not to apply debt relief to eligible mortgages, suggesting that borrower self-selection is a powerful force in determining forbearance rates.

We also wanted to understand the degree to which self-selection is responsible for the distribution of debt relief across different types of households. To obtain mortgage forbearance under the CARES Act, eligible mortgage borrowers had to apply for forbearance, but forbearance approval was mandated whether or not it was used.

We found that forbearance rates were higher among lower-income and less-creditworthy borrowers than they were for high-income individuals. However, the dollar amounts were larger among higher-income individuals. This showed that borrower self-selection drives forbearance rates for these loans. Forbearance of non-eligible loans, on the other hand, must be approved by the lender. Therefore, private debt relief is the outcome of a mutually beneficial renegotiation.

We documented that forbearance rates declined as income and creditworthiness rose for private and government loans across loan categories. These results suggest that borrower self-selection is important in determining how relief is allocated. As a consequence, unlike more blanket CARES Act subsidies, such as stimulus checks, mortgage debt relief flows to more vulnerable households precisely because these types of households apply for it.

This stands in stark contrast to federally insured student loans. Those were automatically placed in forbearance by the CARES Act, resulting in more blanket relief that was not necessarily correlated with borrower need.

We documented that more than a quarter of relief is private, suggesting that not all government relief is subsidized. On the other hand, CARES Act eligible debt differs from private debt both in type and the types of borrowers, making it difficult to evaluate the magnitude of subsidies.

To evaluate the importance of the implicit government subsidies involved in mandatory forbearance, we looked at both mortgages that were and were not eligible for relief under the CARES Act. Government-insured loans below the conforming loan limit — $510,400 in 2020 and $822,375 in high-cost areas — qualified for government mandated forbearance, but loans above the limits, so-called jumbo loans, were not eligible.

We compared forbearance rates on conforming loans — which were mandated — against jumbo loans, for which there was no mandated forbearance. We found forbearance rates were about 25 percent higher for the conforming loans. Without government mandated forbearance policies, the forbearance rates for conforming and jumbo loans are roughly the same. Thus, we concluded that the additional 25 percent difference was the result of the mandated forbearance policy. Our back- of-the-envelope estimates suggest that about 20 percent of forbearance of the conforming loan amounts was a result of mandated forbearance.

Unwinding forbearance, a policy challenge

An important policy question is how forbearance will be unwound after it expires. As of October 2020, more than half of the 60 million Americans who entered forbearance during the pandemic were missing more than $43 billion on their debt repayments. At this rate, by the first quarter of 2021, when forbearance mandates are set to expire, we estimate that these borrowers will be left with a "forbearance overhang" of more than $60 billion in accumulated postponed repayments. That amounts to about $1,800 per individual, which is more than half of their average monthly income, and more than 80 percent for lower-income borrowers. Moreover, for mortgage borrowers, the amount of accumulated missed payments is more than $6,000 per borrower.

If deferred payments are structured as a one-time balloon payment due immediately after forbearance ends, then a significant share of low-income borrowers will likely be distressed, even if this payment is anticipated. Alternatively, deferred payments could be amortized over the remaining life of the loan or added as a one-time balloon payment at the end of the loan.

Structuring forbearance by delaying payments would alleviate potentially serious household budget problems. Some of this might also be at a potential cost to the lender or to taxpayers. Given the associated negative externalities due to household distress, policymakers might want to seriously consider such options.

Depending on the degree of consumer foresight and ability to reduce their consumption expenses, these two unwinding scenarios could have significantly different consequences for consumers. Either way, the extent of forbearance overhang suggests that the unwinding of forbearance could have major consequences for household debt distress and, through it, for the aggregate economy.

Conclusion

Our analyses suggest that debt forbearance reached its intended target: financially vulnerable borrowers living in regions that experienced the highest COVID-19 infection rates and the greatest economic collapse.

This may explain why forbearance had such a large impact on distressed households despite costing less than other federal relief programs, such as stimulus checks or unemployment insurance.

One possible reason for the quick implementation of debt relief action during COVID-19 is that policymakers and the private sector may have learned from the Great Recession that there were significant costs associated with widespread defaults and foreclosures and were more willing to provide quick debt relief. We estimate that if those households in forbearance had not had debt relief and instead missed payments, then by October 2020 we would have about 2 million more mortgage borrowers in default.

Another reason for quick debt relief could be that the COVID-19 shock was perceived as more transitory than previous crises, which could have promoted a more widespread use of temporary debt relief measures by the private sector.

The COVID-19 shock is a textbook example of a rare aggregate "exogenous" shock that is largely outside of people's control. This should alleviate concerns about the moral hazard effects of debt relief, leading to a more widespread loan renegotiation effort during such times.

Amit Seru is a SIEPR senior fellow and The Steven and Roberta Denning Professor of Finance at the Stanford Graduate School of Business. He is interested in issues related to financial intermediation and regulation, interaction of internal organization of firms with financing and investment, and incentive provision in firms.

Ken Howe contributed editorial assistance to this Policy Brief.