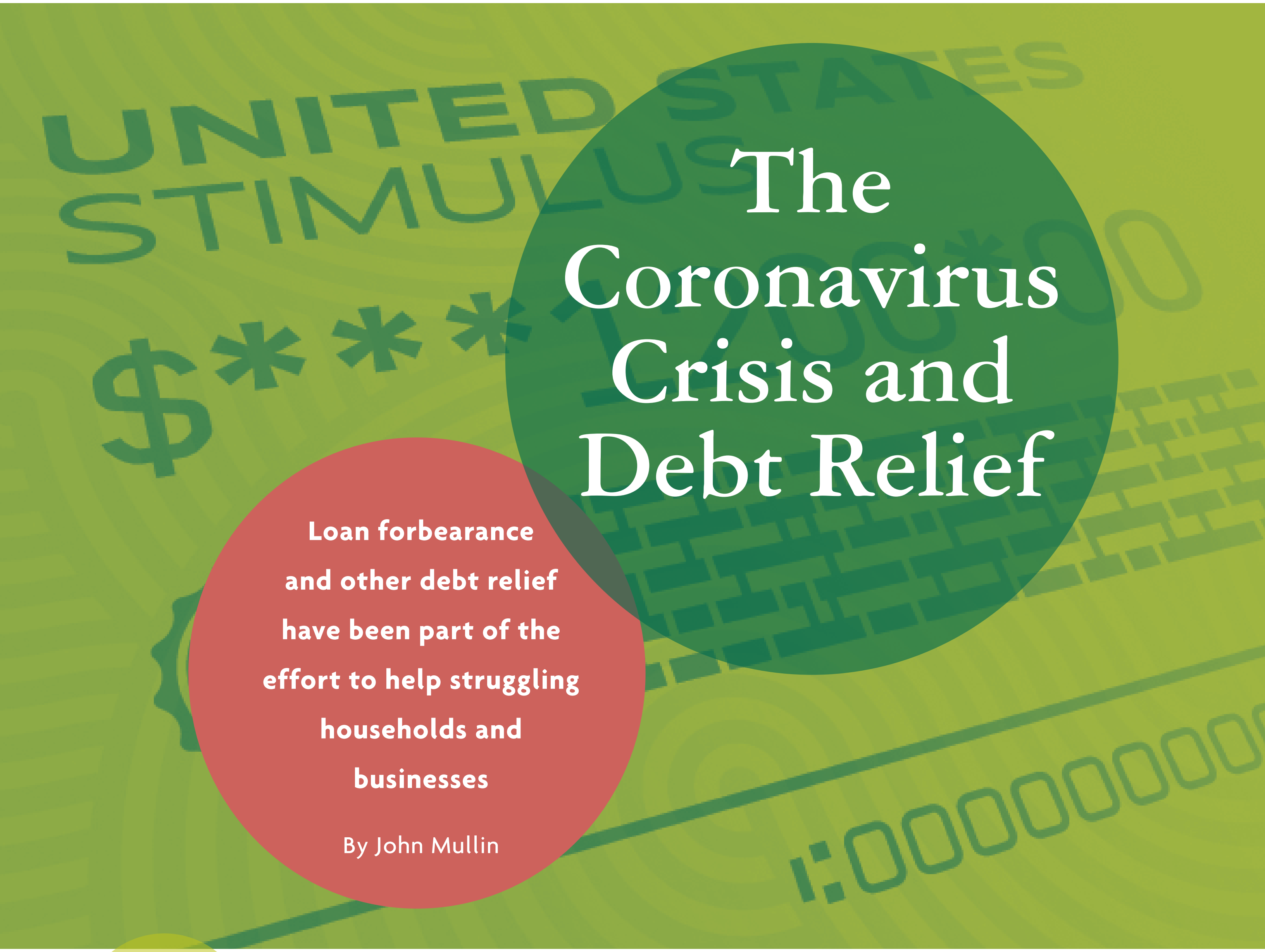

The Coronavirus Crisis and Debt Relief

Loan forbearance and other debt relief have been part of the effort to help struggling households and businesses

By John Mullin

The pandemic's harmful financial effects have been distributed unevenly — so much so that the headline macroeconomic numbers generally have not captured the experiences of those who have been hardest hit financially. Between February and April, for example, the U.S. personal savings rate actually increased by 25 percentage points. This macro statistic reflected the reality that the majority of U.S. workers remained employed, received tax rebates, and reduced their consumption. But the savings data did not reflect the experiences of many newly unemployed service sector workers.

And there are additional puzzles in the data. The U.S. economy is now in the midst of the worst economic downturn since World War II, yet the headline stock market indexes — such as the Dow Jones Industrial Average and the S&P 500 — are near record highs, and housing prices have generally remained firm. How can this be? Many observers agree that the Fed's expansionary monetary policy is playing a substantial role in supporting asset prices, but another part of the explanation may be that the pandemic's economic damage has been concentrated among firms that are too small to be included in the headline stock indexes and among low-wage workers, who are not a major factor in the U.S. housing market.

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Policymakers have taken aggressive steps to mitigate the pandemic's financial fallout. Among the most prominent have been IRS tax rebates, the expansion of unemployment insurance benefits, and forgivable Payroll Protection Plan (PPP) loans for businesses. But these fiscal steps have been complemented by an array of policies specifically designed to ease private sector debt burdens. The CARES Act, for instance, mandated debt forbearance on federally backed mortgages and student loans. And the Fed — in addition to launching several new lending facilities — has coordinated with other federal bank regulators to encourage banks to work constructively with their clients in need of loan restructurings. (See "The Fed's Emergency Lending Evolves," p. 14.) While less well-publicized than the fiscal steps, these debt relief measures are arguably no less consequential.

A Role for Debt Relief

The economic policies that have been adopted in response to the crisis were designed to meet multiple goals. The most immediate concerns were to provide safety net aid to those in need and to stimulate aggregate demand. But there was also a longer-term objective: to improve the foundation for future growth by helping households and firms maintain their financial health. This goal is being addressed partly by fiscal transfers to households and firms to help them avoid depleting their assets and increasing their debts. But crucially, the goal is also being advanced by policies designed to keep the supply of bank credit flowing and to prevent unnecessary loan defaults and business failures.

The CARES Act contains several important debt relief provisions. In addition to allowing for the deferment of student loan debt repayments and providing debt service forbearance and foreclosure protection for borrowers with federally backed mortgages, the legislation also mandated the relaxation of certain accounting standards — making it more attractive for banks to offer debt forbearance to households and firms affected by the pandemic. In support of the legislation's intent, federal bank regulators at the Fed and other agencies issued an interagency statement on March 22 confirming that financial institutions could make pandemic-related loan modifications without having to downgrade the loans to the category of Troubled Debt Restructurings (or TDRs). Since it is costly for banks to recategorize loans as TDRs, this interpretation helped to remove an impediment to loan restructurings.

Bank regulators followed this up by issuing a statement in June that outlined supervisory principles for assessing the safety and soundness of financial institutions during the pandemic. According to the statement, regulators "have encouraged institutions to use their capital buffers to promote lending activities." Moreover, the regulators emphasized that they "view loan modification programs as positive actions that can mitigate adverse effects on borrowers due to the pandemic." They sought to assure bankers that bank examiners "will not criticize institutions for working with borrowers as part of a risk mitigation strategy intended to improve existing loans, even if the restructured loans have or develop weaknesses that ultimately result in adverse credit classification."

This guidance has been implemented by the Fed's regional bank supervisors, including those in the Fifth District. "We want the banks to be part of the solution and to continue to lend," says Lisa White, executive vice president of the Supervision, Regulation, and Credit department at the Richmond Fed. "Overall, the banks were more resilient from a capital perspective heading into the current crisis compared to the last," she says. "The philosophy behind the interagency guidance was to convey our planned supervisory approach and clearly communicate what we will be most focused on as we assess how banks are handling the challenges associated with the pandemic."

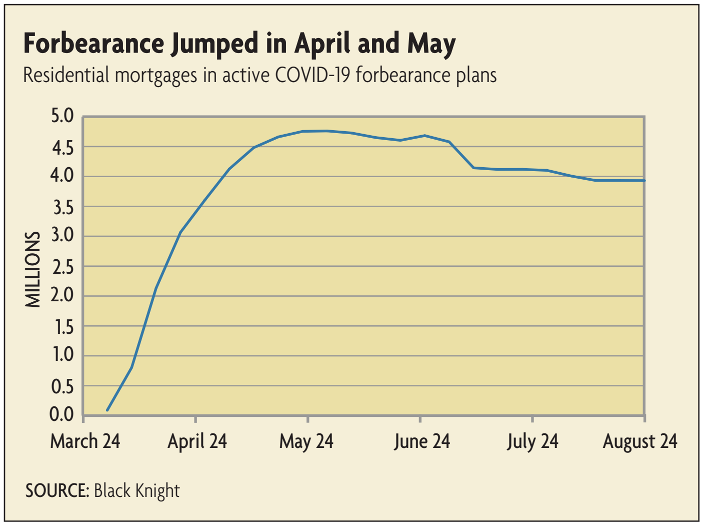
When supervisors evaluate how well banks have performed during the crisis, she explains, "we are going to assess how well they have managed their deferral and forbearance programs, and we will put more emphasis — even more than we've had in the past — on their underwriting and risk management practices versus just the results or how they translate into a particular loan's performance."

Loan Forbearance and Households

Prior to the pandemic, the household sector's credit metrics appeared to be in good shape. In 2019, the overall delinquency rate for consumer credit stood at a post-financial-crisis low of roughly 5 percent, as declining mortgage delinquencies in recent years had roughly offset increased auto loan and credit card delinquencies. Moreover, the aggregate data showed no noticeable upward trend in personal foreclosures and bankruptcies. These signs of health may have partly reflected the conservative underwriting practices that creditors had adopted after the 2007-2008 financial crisis, when they shifted toward making loans to borrowers with higher credit scores.

But these numbers may not adequately reflect the financial vulnerability of many low-income households. According to the research and consulting firm Financial Health Network, as many as 33.9 percent of those surveyed in 2019 stated that they were "unable to pay all bills on time." The same survey found that, among those who make less than $30,000, only 34.7 percent stated that they have a "manageable amount of debt." These numbers are consistent with the notion that there is a significant part of the U.S. population that lives paycheck to paycheck and is quite vulnerable to interruptions in income.

These vulnerable low-income households bore the brunt of the economy's job losses at the onset of the pandemic. Based on an analysis of ADP data presented



at a recent Brookings Papers on Economic Activity conference, employment losses were disproportionately high among the quintile of employees with the lowest pre-pandemic wages. That quintile had a greater than 35 percent decline in employment by April, which contrasts sharply with the less than 10 percent decline in employment for those in the highest-wage quintile.

The notion that many households stand on shaky financial ground finds support in the rapidity with which borrowers have sought out debt forbearance. According to Black Knight, a provider of mortgage data, the number of mortgages in forbearance increased from close to zero in March to over 4 million in May. That figure represented roughly 8 percent of active mortgages. (See chart.)

It appears that banks have generally been receptive to forbearance requests by their consumer credit clients. "We've been very public with statements on the consumer side, letting clients know that if you are in trouble, contact us," says John Asbury, CEO of Atlantic Union Bank. "What's happened is the borrowers have contacted us and said, 'I'm having financial challenges.' For borrowers with no previous payment problems, we have typically granted 90-day deferrals for the consumer, no questions asked."

Forbearance programs are likely to help mitigate defaults and foreclosures, at least in the short run. In a recent Richmond Fed working paper, Grey Gordon and John Bailey Jones concluded that mortgage forbearance, student loan forbearance, and fiscal transfers will keep delinquency rates from increasing much in the near future. According to their analysis, the forbearance programs are likely to have the greatest effect, with fiscal transfers playing a smaller role.

But consumer loan forbearance is no panacea. It does not eliminate debt but merely provides borrowers with time to improve their repayment capacity. If U.S. unemployment remains substantially above pre-pandemic levels, the economy may see a substantial increase in defaults as forbearance arrangements expire.

Loan Forbearance and Businesses

The negative effects of social distancing have been most strongly felt among relatively small businesses. In part, this is because small businesses are disproportionately represented in many of the hardest-hit industries, such as hotels, restaurants, and retail trade. But it also reflects the relative financial vulnerability of small firms. This point was highlighted in a September 2019 study by JPMorgan, which found that, in the typical community, 47 percent of small businesses had two weeks or less of cash liquidity.

In more normal times, insufficient revenue and inadequate access to capital are among the most frequent reasons for small business failures. During the current crisis, of course, these problems have become particularly widespread. According to a recent survey by MetLife and the U.S. Chamber of Commerce, 70 percent of small businesses "are concerned about financial hardship due to prolonged closures" and 58 percent "worry about having to permanently close." Two-thirds of survey participants agreed that minority-owned businesses "have been disproportionately impacted by COVID-19."

The risk of permanent closure was underscored in a recent report by the business review website Yelp. Yelp found that 132,500 of the firms that it tracks were closed for business on July 10 and that a little more than half of the closures were permanent.

As with consumer credit, many banks have been offering forbearance plans to their business clients who have been negatively affected by the pandemic. Atlantic Union Bank, for example, has already modified over 700 business loans in segments it has identified as "COVID-19 sensitive." By the third week of April, Atlantic Union had already made roughly 4,000 pandemic-related loan modifications, accounting for 14.8 percent of the bank's overall loan portfolio. These modifications have been particularly concentrated among its loans to hotels, restaurants, health care, and retail.

"We have offered payment deferrals in cases where we fundamentally believe there will be an operating company to work with on the other side," says John Asbury of Atlantic Union. "Then we can work with them and monitor their operations. However, if we ultimately lose confidence in the company's viability, then we have to treat it differently and downgrade the loan's risk rating. We don't want to push problems down the road."

In some cases, forbearance programs for real estate developers have had favorable knock-on effects. Such was the case with Lion's Paw Development, a Richmond firm that has built many restaurants for "mom and pop" operators. When Lion's Paw was offered a real estate loan deferment by its bank, it gave the firm the flexibility to offer rent forbearance to its retail tenants. "I've worked out rent forbearance deals with many of my tenants," says Charlie Diradour, president of Lion's Paw. "I'm going to send the tenants addendums to their leases that acknowledge that rent payments have not been paid for April, May, June, and maybe July. We're going to add those months on the back end of their current terms."

Yet many small businesses remain vulnerable to being shut down. This risk presents a major concern for policymakers, because small-business closures not only eliminate job opportunities, they also deplete the assets of business owners — thus damaging their ability to make future investments.

The Forgiveness Frontier

Some observers have advocated debt forgiveness for the most vulnerable — not only for reasons of fairness, but also to remove excessive debt burdens that block the path to future growth.

For Michael Hudson of University of Missouri, Kansas City, author of the 2018 book *...and forgive them their debts: Lending, Foreclosure and Redemption from Bronze Age Finance to the Jubilee Year*, solutions for the current pandemic and its related debt burdens should draw on history. For example, in ancient Mesopotamia, under the Laws of Hammurabi, periods of debt forgiveness called "jubilees" were periodically invoked after a famine or other natural disaster created levels of debt that could not be addressed by regular means. "But Hammurabi was not a Utopian idealist when he forgave the debts," says Hudson. "He recognized that it's not worth slowing down the whole economy and putting it into recession just so creditors can get paid."

To be sure, such a policy would place the burden of the crisis on another group, namely creditors. The long-term effects on the availability and pricing of credit are hard to predict. But in Hudson's view, bankers, creditors, and landlords have done well enough over the past 10 years to warrant a similar policy today. "They can afford to take a hit — a write-down — the rest of the economy cannot."

Other observers have called for more modest debt relief measures. For example, Joseph Stiglitz offered some ideas on the topic of debt relief in a recent interview, including a proposal to lower what he called the "usurious interest rates" on credit card debt. Observing the unequal impact of the crisis, Stiglitz added, "And for those businesses that are getting so much help from the government, part of that should be used to help the debtors, who otherwise will sink under a mountain of debt."

A proposal to address the debt burdens of small businesses was recently published in the *Brookings Papers on Economic Activity* by Markus Brunnermeier of Princeton University and Arvind Krishnamurthy of Stanford University. They posited that increased debt loads lead firms to focus on meeting debt obligations rather than keeping workers employed or pursuing new investment projects. In their view, rather than stimulating demand, the government policy's main aim should be to provide insurance to firms and workers by injecting "liquidity into small and medium sized firms that are liquidity constrained."

Debt forgiveness was practiced in ancient Mesopotamia. The Laws of Hammurabi, seen here, laid out situations in which debt slates could be wiped clean, such as if "a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain."

The initial responses to the crisis 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, and economists and policymakers continue to consider the best policy responses. **EF**

Readings

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