Payment Shock

Understanding Payment Shocks

Payment shock is an unexpected, large increase in debts/liabilities for a borrower, from what they were previously paying. This increase can happen gradually over time or suddenly due to changes in interest rates, loan terms, or possibly taxes during a refinance review.

Payment shock can potentially lead to financial distress, default, and even foreclosure for borrowers.

It is crucial for mortgage lenders to understand and address payment shock to prevent these negative outcomes.

GSE Guidelines on Payment Shock

While Freddie Mac's guidelines do not specifically reference payment shock, Fannie Mae does, particularly concerning potential payment shock when an ARM loan's initial fixed period ends.

→ Fannie Mae Selling Guide B2-1.4-02, Adjustable-Rate Mortgages (ARMs)

- According to Fannie Mae, ARMs that offer low initial payments based on fixed introductory rates that expire after a short period and then adjust to a variable rate for the remaining term have the potential for payment shock.
- No specific rules are outlined, but it is considered when assessing a loan's risk.
- The 2014 "Ability-to-Repay" rules also addressed many payment shock concerns by ensuring lenders and bankers closely review a borrower's ability to make new payments.
- When reviewing a loan file, it's important to review the automated underwriting system (AUS) findings as it will analyze factors like payment shock to determine eligibility.

Mitigating Payment Shock for Borrowers

Mortgage lenders can help mitigate payment shock by:

- Educating borrowers on loan terms and possible changes in payments.
- Offering mortgage products with fixed rates and longer loan terms to reduce the impact of payment shock.
- Encouraging borrowers with ample liquid assets to place larger down payments on purchases which effectively lowers monthly payments.

Payment Shock Scenarios

Example 1:

A borrower currently paying $1000/month in rent is looking to purchase a home that will result in a $2000/month PITIA (principal, interest, taxes and insurance + any potential association dues) payment.

This results in a 100% increase in their housing costs which could increase payment shock risks despite their debt-to-income ratio still qualifying them.

Example 2:

A borrower with an adjustable-rate mortgage has their current rate of 4% about to adjust to current market rates at 6.5%.

Their monthly payment will jump from $1200/month to $1500/month which reflects gradual payment shock that needs consideration during risk review and under Fannie Mae's guidelines.

Key Takeaways

- Payment shock can have a significant negative impact on borrowers when they experience a sudden or gradual increase in their mortgage payment.
- Mortgage lenders can help mitigate payment shock by providing education and offering mortgage products with fixed rates and longer terms.
- Lenders need to be proactive in addressing payment shock to help borrowers achieve homeownership while maintaining financial stability.

Additional Resources

→ Fannie Mae Selling Guide B2-1.4-02, Adjustable-Rate Mortgages (ARMs)

→ Fannie Mae Selling Guide B3-6-04, Qualifying Payment Requirements

→ CFPB: Ability-to-Repay/Qualified Mortgage Rule

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