KEYBRIDGE RESEARCH

KEY INSIGHTS

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The Foreclosure Pipeline: Looking for a Turning Point

Key Insights

- In recent weeks, several major mortgage lending institutions have indefinitely suspended mortgage foreclosure activities amid concerns regarding documentation review and approval practices.
- The moratorium announcements are symptomatic of a mortgage foreclosure "pipeline" that has grown well beyond the bounds of both historical experience and institutional capacity.
- Although the foreclosure rate peaked in early 2009, analysis of the foreclosure pipeline indicates that the crisis has not yet reached a clear turning point. Rather, it has simply reached terminal velocity.
- The evolution of the foreclosure crises in the near term will be driven by a handful of factors, some of which will place additional pressure on the pipeline and some of which will relieve that pressure.
- In the absence of meaningful mortgage modifications that provide distressed families with enough breathing room for the housing market and broader economy to recover, foreclosure rates are likely to remain elevated in the near term — generating significant headwinds for the U.S. economy in 2011.

Several major lending institutions have imposed moratoria on foreclosures.

In recent weeks, several major lending institutions have imposed moratoria on foreclosure activities amid concerns regarding documentation review and approval practices. At the center of this controversy is the use of so-called "robo signers" — bank employees who approved hundreds of foreclosure documents a day with little scrutiny. Ironically, these developments suggest that the U.S. housing crisis has come full circle, as lenders manage the foreclosure crisis with a "quantity over quality" approach that is reminiscent of the underwriting practices that fueled the housing market bubble and set the stage for the subprime mortgage crisis in the first place.

The foreclosure "pipeline" has grown well beyond the bounds of both historical experience and institutional capacity.

The recent wave of moratorium announcements is symptomatic of a mortgage foreclosure "pipeline" that has grown well beyond the bounds of both historical experience and institutional capacity. Approximately one in every ten mortgages in the U.S. is either in severe delinquency or foreclosure. In addition to the significant financial and psychological impact on directly affected families, this unprecedented backlog generates significant headwinds for the U.S. economy. Specifically, by increasing the stock of cheap excess housing and depressing home values, foreclosures:

- Decrease the demand for new home construction and impair job growth;
- Increase levels of negative equity, making it difficult for homeowners to leave their homes and reducing the mobility of the nation's workforce;
- Reduce personal wealth, negatively impacting consumer confidence and upending the outlook of those nearing retirement; and
- Weaken the tax base, squeezing local government budgets and leading to cuts in services and payrolls.

Given these potential impacts, analysis of the foreclosure pipeline can provide valuable insights into the likely evolution of the pipeline and, thus, prospects for the broader macro economy.

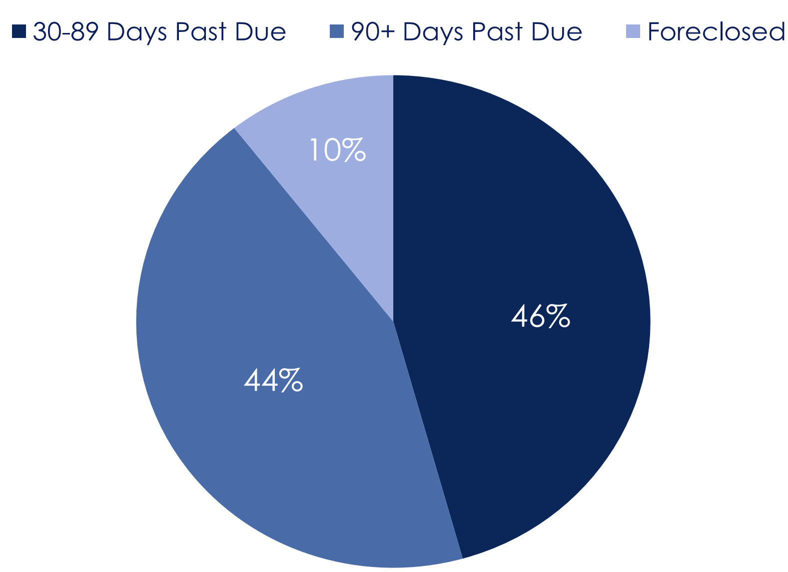
The Foreclosure Pipeline: Properties & Process

The foreclosure pipeline provides a snapshot of the volume and timing of mortgages likely to go into foreclosure.

The foreclosure pipeline consists of the flow of mortgages that are delinquent or in the foreclosure process. Accordingly, the pipeline provides a snapshot of the volume and timing of mortgages likely to go into foreclosure. For this analysis, loans are categorized into three groups:

- Initial Delinquencies = 30 to 89 days past due
- Severe Delinquencies = 90 days or more past due
- Foreclosures = 90 days or more past due plus initiation of foreclosure process

Figure 1. The Current Foreclosure Pipeline



Source: Mortgage Bankers Association.

The foreclosure process typically begins after a borrower fails to make mortgage payments for 90 days. Once a lender determines that foreclosure provides the best means to mitigate potential losses, it notifies the borrower that their home will be put up for auction. Once the homes is sold at auction, the foreclosure process is complete. The entire process can take anywhere from six months to three years from the date of the first missed payment, with the actual timeframe depending on both the particulars of state law and the backlog of foreclosures in a given geographic region.

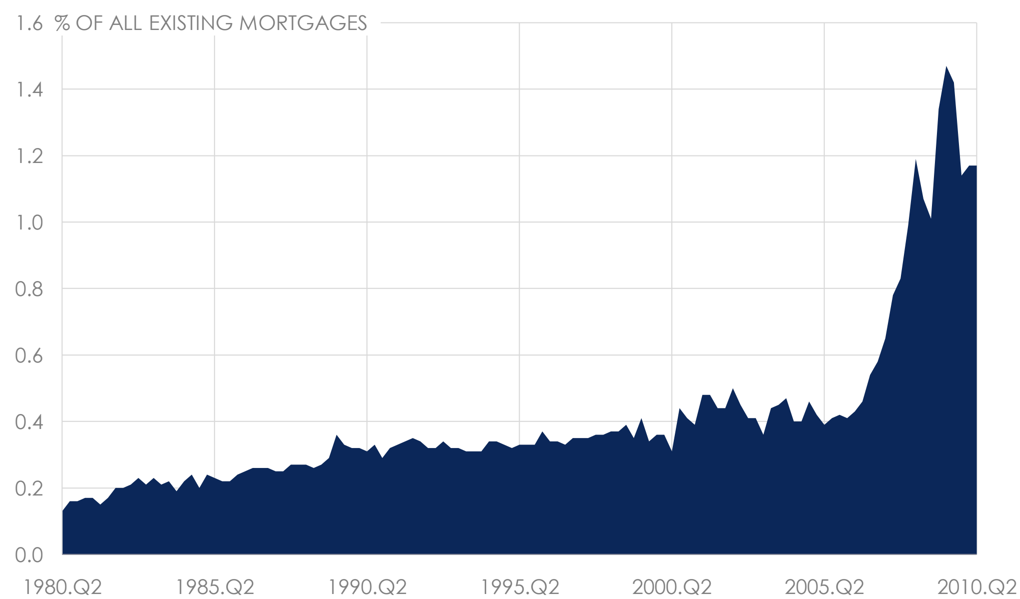
The Foreclosure Pipeline: Turning Point or Terminal Velocity?

The foreclosure rate tripled between 2006-2009.

The current flow of mortgages through the foreclosure pipeline is, by any measure, well beyond the bounds of historical experience. Although the foreclosure rate rose steadily from 1980 to 2006, including relatively modest increases during recessions, it never exceeded 0.5% of mortgages outstanding. Between 2006 and 2009, however, the foreclosure rate surged — eventually tripling to 1.5% in 2009. Although a brief decline in the foreclosure rate to less than 1.2% in the latter half of 2009 provided hope that the crisis had reached a turning point, analysis of the broader foreclosure pipeline offers a different interpretation.

In late 2009, a decline in the foreclosure rate provided hope that the crisis had reached a turning point, but analysis of the foreclosure pipeline offers a different interpretation.

Figure 2. U.S. Mortgage Foreclosure Rate

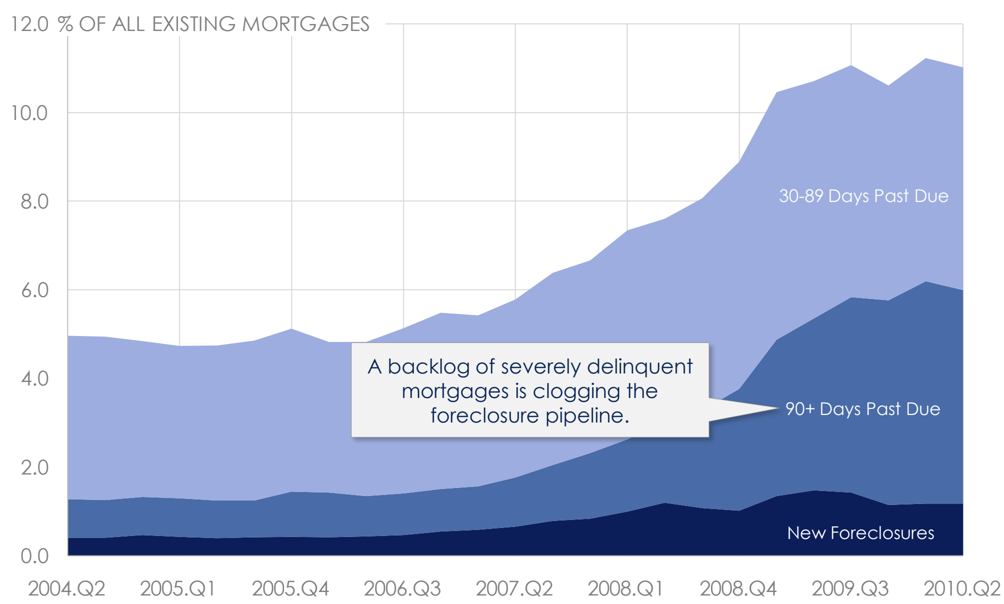


Source: Mortgage Bankers Association – National Delinquency Survey.

More than one in 20 mortgages are severely delinquent, and initial delinquencies remain at elevated levels.

While the foreclosure rate has increased by a factor of three since the onset of the crisis, the severe delinquency rate has increased by a factor of five. This widening spread indicates that the pipeline is clogged by a growing pool of severely delinquent mortgages. Indeed, more than one in 20 mortgages in the U.S. are severely delinquent, and initial delinquencies (i.e., 30-89 days past due) remain at elevated levels — suggesting that the pressure in the pipeline is unlikely to subside in the near term. Even at pre-moratorium foreclosure rates, it would likely take lenders more than a year to process the existing stock of severely delinquent mortgages.

Figure 3. The Foreclosure Pipeline: 2004 -2010



Source: Mortgage Bankers Association – National Delinquency Survey.

The widening spread between severe delinquencies and foreclosures suggests that the pipeline is clogged by a growing pool of severely delinquent mortgages.

It is difficult to conclude that the foreclosure crisis has reached a turning point. Rather, it is more likely that it has simply reached terminal velocity.

Although a moratorium on foreclosures may provide a brief respite for families unable to pay their mortgage, a significant portion of those in severe delinquency are unlikely to avoid foreclosure, especially in the absence of vigorous job growth. In the meantime, the rate of flow through the pipeline will be constrained by the processing capacity of lending institutions and state judicial systems, and a moratorium may simply compound the situation. For this reason, it is difficult to conclude that the foreclosure crisis has reached a turning point. Rather, it is more likely that it has simply reached terminal velocity.

The Foreclosure Pipeline: Key Drivers of Future Performance

Seven key factors – four that may increase pressure on foreclosures and three that may mitigate it – will affect the trajectory of the foreclosure pipeline in the next 6 -18 months.

Factors that Increase Pressure on Foreclosures

Alt-A loans and option ARMs are likely to place additional pressure on foreclosure rates through 2011.

- **Poor Quality of Outstanding Mortgages:** Although the subprime crisis has mostly passed, risky mortgage products originated between 2004 and 2007 will place additional pressure on foreclosure rates through 2011. In particular, a proliferation of lax standards and teaser rates on Alt-A loans and option ARMs significantly raises the probability of foreclosure. As of 2010 Q2, the Office of Thrift Supervision (OTS) reported that 17.5% of Alt-A loans are delinquent or in foreclosure. And according to RealtyTrac, $134 Billion in option ARMs will reset in 2010 and 2011. Despite historically low interest rates today, the monthly burden for a typical household with an option ARM loan is estimated to increase by roughly 65%. As a result, OTS recently reported that, as of the end of 2010 Q1, more than one third of the more than 774,000 option ARMs outstanding were delinquent or in foreclosure.

One of the fastest growing groups of foreclosures is homeowners with good credit and conventional loans, but are either unemployed or have reduced income.

- **High Unemployment:** While mortgage foreclosures helped to precipitate the 2008-09 recession and subsequent high unemployment, persistent joblessness is now almost certainly a contributing factor to sustained delinquencies and foreclosures. The recession was marked by a self-reinforcing downward spiral of rising foreclosures, collapsing housing markets, tightening of credit, and rising unemployment. The slowness of the recovery is due, in part, to gridlock in this chain. Now, one of the fastest growing groups of foreclosures is homeowners with good credit histories and conventional loans, but who are either unemployed or have newly reduced income. With persistently weak job growth, economic woes could precipitate further foreclosures over the next 6-18 months.

It is estimated that strategic defaults constitute 12-35% of all foreclosures in 2010.

- **Negative Equity:** Negative equity increases new foreclosure rates by encouraging strategic defaults and also by precluding refinancing. As a result, it is estimated that mortgages that are 10-15% "under water" are almost twice as likely to foreclose compared to a fully collateralized mortgage. According to First American CoreLogic Negative Equity, 11 million homes, or 23% of all residential mortgages, were under water in 2010 Q2. And of the aggregate $801 billion in negative equity, 82% is from mortgages that are 25% or more under water. Experian claims that "strategic defaults" (i.e., walking away from an underwater mortgage despite being able to make the monthly payments) more than doubled from 2007 to 2008 to 588,000, and make up an estimated 12-35% of all foreclosures in 2010. Short of a dramatic turnaround in home values over the next 12 months, it is unlikely that this trend will reverse.

Tight credit is increasing the probability of default for the unemployed, those with high levels of negative equity, and borrowers facing option ARM resets.

- **Tight Credit:** Compounding these problems has been a tightening of credit on the part of lenders. The Federal Reserve's Senior Loan Officer Survey reported historic levels of credit tightening in every quarter from the beginning of 2007 through April 2010. The most recent Fed Survey in July 2010 showed a potential cresting of lending standards for mortgages, although it is too early to say that there is any movement toward credit easing. In any case, tight current credit conditions increase the chance of default for the unemployed, people with high levels of negative equity, and borrowers facing option ARM resets. Tighter lending standards are a necessary adjustment after the profligate ways that led to the housing bubble. However, this does not negate the fact that many borrowers who need to refinance to stay in their homes are unable to do so.

Factors that Decrease Pressure on Foreclosures

Nascent government programs aimed at addressing the foreclosure crisis may help reduce foreclosures.

- **Government Programs:** Nascent government programs aimed at addressing the foreclosure crisis may be having a significant impact on the current foreclosure pipeline. The Making Homes Affordable Program includes two avenues for refinancing or modifying loans — the Home Affordable Modification Program (HAMP), and the Home Affordable Refinance Program (HARP). For example, there have been 1.3 million trial HAMP modification starts between April and June of this year. This is significant because servicers and lenders are not allowed to initiate foreclosures on mortgages that have been flagged for eligibility in HAMP. This tranche of mortgages that is ineligible for foreclosure helps to explain part of the spread between severe delinquencies and new foreclosures. However, the long-term effect of these programs is likely minimal, as a relatively small percentage of HAMP and HARP applications result in a permanent and positive resolution.

Growing political pressure may provide banks with the pretext needed to implement more aggressive loan modification measures.

- **Banks' Legal Obstacles:** Banks have primarily responded to the foreclosure crisis with mortgage modifications that offer interest rates reductions and term extensions, rather than principal write downs that might expose them to lawsuits from investors. Ironically, the political fallout regarding the improper documentation of foreclosures, including growing pressure from Congress and state attorneys, might provide banks with the pretext needed to implement principal forgiveness programs or other more aggressive measures that might stem the flow of mortgages in the foreclosure pipeline.

Bank strategies are creating a massive "shadow inventory" of homes, which merely delays the bottoming out of the market.

- **Bank Financial Strategies:** Notwithstanding legal problems, there is evidence that banks are spreading out their mortgage losses. By allowing occupants to stay in their homes without paying their mortgage, banks incur a modest short-term hit to cash flow, but avoid taking larger losses, eating into balance sheets (they may not have enough reserves under new federal mandates). These actions may also work to maintain market confidence and prevent a flooding of the market with even more excess housing stock, which would further depress prices and exacerbate the problem. While this is a short-term solution for the banks, it creates a massive "shadow inventory" of homes and merely delays the bottoming out of the market, a mistake that Japan perpetuated for more than a decade.

Conclusion

A moratorium on foreclosures is the policy equivalent of treating the symptom, not the disease.

Recent housing and economic data suggest that the rate of new foreclosures peaked in the summer of 2009. Nevertheless, it is difficult to conclude that the U.S. has turned the corner in the foreclosure crisis. Rather, an unprecedented backlog of severely delinquent mortgages offers a different interpretation: the crisis has simply reached terminal velocity.

The rising spread between severe delinquencies and foreclosures is unsustainable. Although a moratorium will reduce the short-run pace of foreclosures, it will do little to reduce the backlog of severely delinquent mortgages. In this sense, a moratorium on foreclosures is the policy equivalent of treating the symptom, not the disease. Unless coupled with actions to reduce the pool of severely delinquent mortgages, a moratorium will only serve to temporarily place an artificial floor under housing prices and delay the adjustment process in distressed areas. Such an outcome offers little solace for those waiting for a housing recovery, as a bad situation that is not deteriorating is still a bad situation.

Unless the pipeline is unclogged, foreclosures are likely to generate headwinds for the U.S. economy in 2011.

The key question is whether institutional forces, including government programs and banking strategies, can unclog the foreclosure pipeline through mortgage modifications that provide distressed families with enough breathing room for the housing market and broader economy to recover. In the absence of such actions, foreclosures are likely to remain elevated — generating significant headwinds for the U.S. economy in 2011.