A Case Study – The Building Default Rate and Resolution Curve

May 18, 2020

Bradley Staley – Pinnacle Rock Capital, LLC.

The mortgage industry faced a "black swan" event in 2008 and needs to call on the tough lessons learned to execute on a playbook to handle the sharp increase in the mortgage default rate created by the COVID-19 crisis. The challenges that face the mortgage industry in 2020 are not unique to the housing sector but are similar in nature the problems that are pervasive throughout the economy. One of the primary indicators of a stressed mortgage industry is the rising mortgage default rate. In 2008 the mortgage industry experienced a financial crisis that was driven by lax oversight within the subprime lending market. The economic problems that emerged spilled over into the broader economy. The mortgage industry was forced to evolve and operate within an improved regulatory environment and reinvent a mortgage servicing system to handle an increased volume in defaulted mortgages. The crisis we face in 2020 is biological in nature but the negative impacts to the mortgage default rate are similar. The one key difference that we face today is the speed at which the crisis is developing. In the prior crisis, the problems in subprime lending standards took years to develop and came to a head in 2008. The COVID-19 Crisis has developed in just 90 days. The speed of COVID-19 crisis will cause the default rate to seemingly spike overnight. The servicers and investors that will successfully manage through this crisis will be the ones that apply the lessons from the 2008 Subprime Lending Crisis (2008 Crisis). Those lessons learned start with a transparent risk based approach and add the proper oversight in the speed and flexibility in a response to the resolution of delinquent loans.

The macro economic elements that have an impact on the mortgage industry are not completely unsimilar to the 2008 Crisis but it is important to outline both the similarities and differences that exist. The unemployment rate is one of the largest drivers to an increasing mortgage default rate. The unemployment rate today is higher than 2008. 30,000,000 new jobless claims have been made since the economic shut down began and it remains unclear how quickly those jobs will come back. The government reaction has been somewhat similar to 2008 in the structure of the CARES Act, however, the size of the bailout packages is unprecedented. The Federal Reserve also has acted lowering interest rates to historical lows and buying mortgage back securities to help stabilize the overall mortgage market. The next problem that faces the mortgage industry is the liquidity that will be required to manage through the crisis. Bank balance sheets have remained strong and the capital requirements implemented after the 2008 Crisis have worked. However, large portfolios of the mortgage servicing rights that have moved to non-bank servicers that do not have the same capital requirements and face liquidity concerns brought on by an unprecedented spike in loan forbearance. Lastly for the purposes of this paper, the housing values nationwide have remained relatively unchanged. The 2008 Crisis was met with an overbuilt housing market. Today, the supply of housing was relatively low based on the demand of a growing population. The supply coupled with low rates has helped keep housing values from seeing drastic swings like in the 2008 Crisis.

In order to understand the impact of the mortgage delinquency rate ("the rate"), it makes sense to look at the rate in two buckets: 30-89 days delinquent and 90+ days delinquent. The 2008 Crisis saw the 30-89 day bucket reach it's peak in January of 2009 at 4.2% and the 90+ day bucket peaked one year later January 2010 at 4.9%.[1] During the 2008 Crisis the mortgage servicing infrastructure had 4-5 million loans in these buckets. The system was unprepared and did not have the infrastructure to handle the default actions required to properly resolve the problem loans. These actions required the development of the proper loss mitigation procedures, technology platforms to handle the volume of default related actions, and the oversight management and reporting. The problem in 2008 was not created overnight and the actions required to help homeowners took years to complete and stabilize the mortgage market.

[1] https://www.consumerfinance.gov/data-research/mortgage-performance-trends/mortgages-30-89-days-delinquent/
https://www.consumerfinance.gov/data-research/mortgage-performance-trends/mortgages-90-or-more-days-delinquent/#mp-line-chart-container

The COVID-19 Crisis has developed in a matter of months and touched almost every sector of the economy. In the last 90 days, over 4.7 million borrowers have requested mortgage forbearance plans and will need to be resolved.[2] The resolution to the quickly escalating mortgage delinquency rate will require mortgage servicers to tap liquidity reserves in order to hire people, vendors, and handle the advancing requirements of the loan securitizations. The unprecedented speed of the economic collapse and rise in the mortgage default rate will require a transparent risk based approach with oversight training and reporting requirements that will inevitably change as the crisis develops. The speed the delinquency rate increases may be unprecedented but the manner of resolution of at least a portion delinquent loans will likely resolve at the same pace of the 2008 Crisis. Modifications and other frequency related resolutions will be solved much faster while the loss severity options like short sales and foreclosures will likely follow a timeline much more similar to the 2008 Crisis. The simple fact is that courts that handle foreclosure and buyers engaging in short sales will likely not have the same motivation of an expedited resolution.

The loss mitigation outcomes at a macro level will be different. The 2008 Crisis saw resolutions that were roughly equally spread among modifications/repayment plans, short-sale/DIL, and foreclosure/bankruptcy outcomes. These outcomes became the foundation of resolving the mortgage default rate. The likely distribution of resolutions today will be different driven mainly by the volatility of the unemployment rate and the rate of which people returning to work. The loss mitigation efforts will be both traditional outcomes like the ones seen in 2008 and new outcomes like specialized modification programs (i.e. HAMP). The key component to swiftly addresses the mortgage default rate will be the modification program. The modification program will start when the borrower rolls off the forbearance plans but the look will vary from simply repayment of the missed payments, adding the payments on to the end of the mortgage, and forgiveness of the payments. It is important to note that potential "modification" programs announced today are likely to change based on the economic recovery. The loans that do not fit within this likely modification scenario will flow through the disposition channel. The borrowers will need to work through a short sale, DIL, or foreclosure and these will not move with the same speed as modifications and likely follow a timing of resolution that the industry saw in 2008. The plans will vary but the key components to manage the risk within the loan portfolio for investors and servicers will be ensure borrowers fit within their ability to repay or resolve the "delinquency."

The fundamental concept that will successfully address the mortgage default rate is a transparent risk based approach that allows for creative approaches to help homeowners recover. The outcome and the timing of this crisis are unclear as of the time of this publication. However, there are a couple items that worked in 2008 and can be applied in the crisis we face today. It is extremely important to have a robust and flexible default servicing risk surveillance platform to assist homeowners while managing the risk for investors. The short term plan of curing the default on each asset will be key but doing so while treating each homeowner with dignity and respect will be important in a crisis that has not been caused by financial malfeasance. What does the recovery side of that mortgage default curve look like over time? It's reasonable to assume, as the economy recovers, the recovery phase of mortgage default curve will likely see an initial downward trend that has an equally sharp decent in the first few months of a recovery as borrowers return to work and work out modifications. Once these the new modifications are complete the delinquency curve will look more like what the industry saw in 2008. The size and slope of the recovery in the mortgage default curve will depend on the pace at which workers return to their old jobs or find new employment if those jobs no longer exist.

[2] https://www.mba.org/2020-press-releases/may/mortgage-delinquencies-rise-in-first-quarter-of-2020