



Is the Disease Being Treated or Just the Symptoms?

While much has been written and said about the unprecedented U.S. mortgage market decline and its impact on home values, homeowners, and mortgage servicers, we feel there is room for improvement in the way mortgage performance metrics are interpreted and applied across the full loan life cycle.

This column is the first in a new series that will present ideas and findings tying together mortgage-related data—from origination through real estate-owned (REO) sale. The goal is to present a comprehensive interpretation of where problems lie, and to unearth the much-hoped-for “green shoots” that provide early indicators of improvement in the mortgage industry.

In this month’s analysis, we focus on delinquency roll rates that differentiate between incremental stages of severe delinquency to demonstrate a swelling inventory of increasingly delinquent loans that are not yet in foreclosure.

Future columns will address topics such as early payment defaults, newly delinquent loan trends and characteristics, market replenishment and secondary market liquidity, foreclosure life cycle, REO activity relative to overall real estate sales, and pervasiveness of hard and soft fraud.

The importance of deep and broad data

Analytics that span the mortgage life cycle need to be formulated on a data set that covers the entire credit spectrum. That is to say, both breadth and depth to data are critical to establishing a firm analytic foundation.

To illustrate the importance of studying the full credit spectrum, consider that while subprime loans get the majority of the blame as the source of our meltdown, clear signals indicated that deterioration first occurred in alternative-A, pay-option adjustable-rate mortgages (ARMs) and nonconforming prime loans. Deterioration on an absolute basis still points to subprime, but problems were brewing in other bands of the credit spectrum as well, and it tends to be the surprise factor (the tails) that inflicts the most pain.

The lessons from this are clear: Avoiding specific zones of the credit spectrum such as subprime and exotic products won’t serve as an insulating strategy against future risk. Market participants blind to issues arising outside of their credit-spectrum bands of focus have increased risk of unexpected problems in their own portfolios. Understanding mortgage performance across the full credit spectrum is a key to long-term survival.

The importance of mortgage metrics across the loan life cycle

Broad-scale deterioration has resulted in herculean efforts from the public and private sectors. Efforts are aimed at getting ahead of the problems that now plague the industry—problems that, unfortunately, are continuing to mutate as well-intentioned initiatives move from concept to implementation.

For example, increasing rates of foreclosure were initially addressed by foreclosure moratoria and increased loss-mitigation efforts; these efforts are now contributing to large numbers of severely delinquent loans, many of which will prove to be tomorrow’s foreclosures and REO properties.

This very fact points to the industry’s need for a broader range of vision to strengthen and enhance its understanding of emerging trends. With broad and deep data, we will be better positioned to understand the issues we face, identify critical turning points in the health of the markets both earlier and more accurately, and translate that knowledge into actions that can help address the problems that are still coming.

We need to be cautious in making historical comparisons in today’s environment. Material volumes of “unnatural” market impacts that drive payment behavior such as moratoria, repayment plans and loan modifications complicate benchmarking, analytics and modeling.

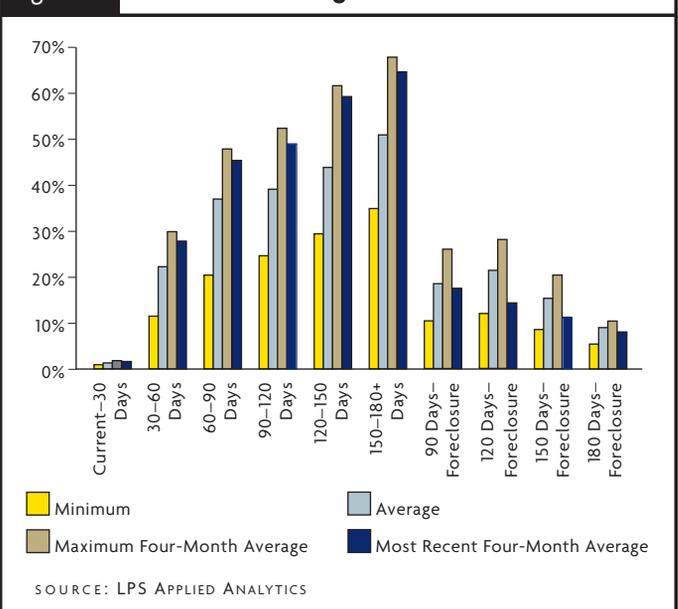
With that said, thoughtful analysis is even more critical and there is much to be gleaned from studying key indicators such as delinquency roll rates, particularly when it comes to understanding current market conditions so that new measures can be developed or programs can be modified to better attain their goals.

This month’s focus: severe delinquency roll rates

A tremendous amount of attention has been paid to levels of foreclosure activity as defined by notices of default or foreclosure starts. The mantra of many experts has been: “Stop the foreclosures, and the market will have time to correct.”

Of course, foreclosure activity should be a cornerstone and

Figure 1 Roll Rate Averages



the focus of aggressive mitigation and preventative measures. But rather than dealing with just the symptom of our crisis, there needs to be increased efforts to identify where tomorrow's foreclosures are coming from and what this volume will be.

A detailed late-stage delinquency roll-rate analysis is tremendously valuable here (see Figure 1). Roll rates are a form of static pool analysis that tell us, for example, that over each of the most recent four months, an average of 45 percent of 60-days-late loans rolled into 90-days-late loans.

While our analysis shows that loans' roll rates from severe stages of delinquency to foreclosure for the last four months are at or below the average roll rates since 2005, these data belie the true magnitude of the problem. Figure 1 offers insight into recent roll-rate trends for severely delinquent loans that are not entering foreclosure, therefore giving an indication of the magnitude of pending foreclosure volumes.

We demonstrate here that while servicers continue to make strenuous efforts focused on foreclosure prevention, the roll rates of loans that are deteriorating into further stages of delinquency continue at rates approaching the highest since 2005, and are approximately 25 percent higher than the average over this time.

An additional example of the problems facing servicers is seen in the continually evolving universe of problem loans. The Lender Processing Services (LPS) loan-level database of mort-

gage loans had 34,906,487 current loans as of Dec. 31, 2008. As of July 31, 2009, 750,702 (or 2.2 percent of current loans as of Dec. 31, 2008) of the borrowers from that universe of performing loans had migrated to at least two payments behind.

At least a portion of this newly defaulted loan universe will contribute further to the ever-growing universe of troubled borrowers who require personal interaction from servicers to determine eligibility for loss mitigation.

Views into these expanded roll-rate metrics illustrate a growing problem that is not sufficiently being addressed by today's foreclosure moratoria and loss-mitigation efforts, in spite of their prevalence and the best efforts of mortgage servicers. It appears that while the symptoms of the disease are being treated, the disease itself is mutating, spreading and, in fact worsening—at least in part due to continued house-price instability and high levels of unemployment.

Market interventions indeed appear to be effective in spreading the time horizon over which the housing market pain will be felt, but they do not appear to be meaningfully lessening the overall volume of borrower defaults or providing a long-term borrower solution as of today.

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