Consumer Metrics Institute Members News

June 21, 2011: Updating the Impact of Strategic Defaults

We have previously tried to quantify how much consumer spending was being boosted by the "rent free" living created by mortgage delinquencies. Since those posts an additional two quarters of data has become available, and we can now update our calculations to include the newer delinquency rates -- which are moderating slightly from the historically high levels seen earlier.

Scope of Defaults and Delinquencies

The source data that we have been using for delinquency rates is published quarterly by the Mortgage Bankers Association (MBA). Their latest news release was published on May 19, 2011 and covers the first quarter of 2011. In that data release the headline (seasonally adjusted) delinquency rate for owner occupied one-to-four-unit residential properties was reported to be 8.32%. This rate was up slightly from the 8.22% reported for 4Q-2010, but significantly lower than the 9.13% reported for 3Q-2010 -- and down nearly 1.75% year-over-year.

According to their press release that delinquency rate "includes loans that are at least one payment past due but does not include loans in the process of foreclosure." If you include their separately provided figures for the properties in the process of foreclosure (4.52%) the rate rises to a seasonally adjusted 12.84% -- essentially unchanged from the seasonally adjusted 12.85% recorded in 4Q-2010 but down from the 13.52% registered in 3Q-2010.

However encouraging the somewhat lower rates may be, more than 1 in 8 owner-occupied mortgaged residential properties are still providing "rent free" living for their owners.

Economic Impact of Defaults and Delinquencies

To estimate the economic impact of the "free rent," we did some back-of-the-envelope calculations using data from the U.S. Census Bureau. In their latest publication of the "American Housing Survey" (covering the fall of 2009, now approaching 2 years old), there were about 76.4 million owner-occupied housing units, of which 50.3 million had at least one mortgage still active. If the latest 12.84% total delinquency rate is applied to the number of currently active mortgages, roughly 6.46 million homeowners have missed at least one mortgage payment. Since some of these instances might not be in irretrievable default (or involve multiple mortgages on the same property), we'll use only 75% of them (roughly 4.8 million) for the purposes of our calculations.

From another Census Bureau table we can estimate the total cash-flow represented by the 4.8 million delinquencies. From the table showing the distribution of mortgages by payment value, we have extrapolated the likely average monthly principal, interest and escrow (taxes and insurance) (PITI) payments for the delinquent mortgages. To do this we have made a two key assumptions: 1) that the owner/occupants have continued to pay utilities during their "rent free" stage; and 2) that the greater portion of defaulters had originated their loans in the past decade (and therefore had the highest payment schedules and the greatest likelihood of being upside-down).

Using these assumptions, we have concluded that the the average cash-flow freed up by defaulters is about $1,500 per month. Assuming 4.8 million defaulters missing $1,500 per month in mortgage PITI payments, the total annualized free cash-flow is something like $87 billion -- about 7.5% of total annual consumer spending on discretionary durable goods.

Behavioral Patterns

Clearly not all of the $87 billion will end up as consumer spending. Presumably many defaulters have maxed-out their credit cards before starting the default process -- although there is some evidence that at least some have treated credit cards as the more senior (or at least less hopeless) obligation. If the average household credit card debt is in the $16,000 range, for our back-of-the-envelope calculation we might assume that those in default average about twice that total -- which with the recently increased minimum payment levels will eat up about half of the freed-up cash-flow.

We also understand that the defaulters will go through several stages (psychological as well as legal and financial) during the entire process. At first they may be in denial and think that they will be able to clear things up in a month or two. During that time we expect no changes in spending behavior, with any free cash ending up in a cookie jar with the intent of eventually correcting the arrears. After several months, the hopelessness of the situation may become more evident, and with that resignation there may be a real sense of liberation. Between then and the point of imminent eviction we might expect the free-cash to start to come out of the cookie jar as a self-medicated analgesic for their financial ills.

We believe that the majority of the increased spending will occur at brick-and-mortar retail establishments. Once the default process begins most of the defaulters will see their other sources of credit impaired, resulting in an increase in transactions that are conducted in cash, checks or equivalents -- reducing the share of their purchases that are made on-line and simultaneously benefiting more traditional retailers located in the defaulter's home community.

The Bottom Line

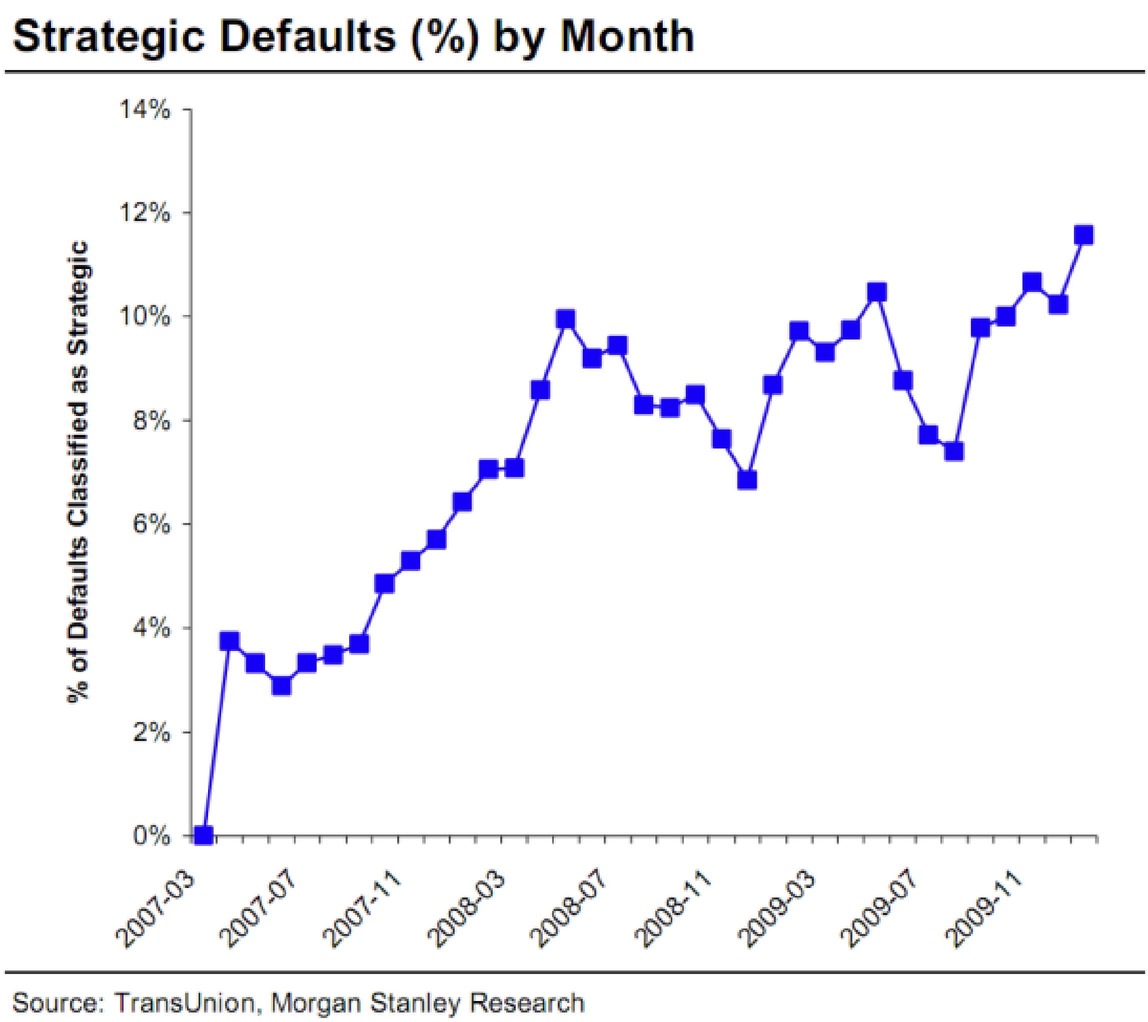
If we assume that our defaulters were able to cover most other non-discretionary budget items before the default process began, we can then also assume that most of the cash leaving the cookie jar will end up as discretionary durable goods. If we further assume that somewhere between one-quarter to one-half of the $87 billion actually ends up in discretionary consumer spending, we might expect to see durable goods gaining at an excess 2% to 4% annualized rate -- even as real incomes remained nearly stagnant.

The Strategic View

The data cited above does not distinguish between "traditional" defaults caused by financial hardships and "strategic" defaults where the ability to continue payments is not an issue (i.e., the default is a conscious personal decision to walk away from a hopelessly "upside down" investment). Although the total percentage of defaults has recently stabilized, the mix between these two categories of defaults is likely evolving**:**

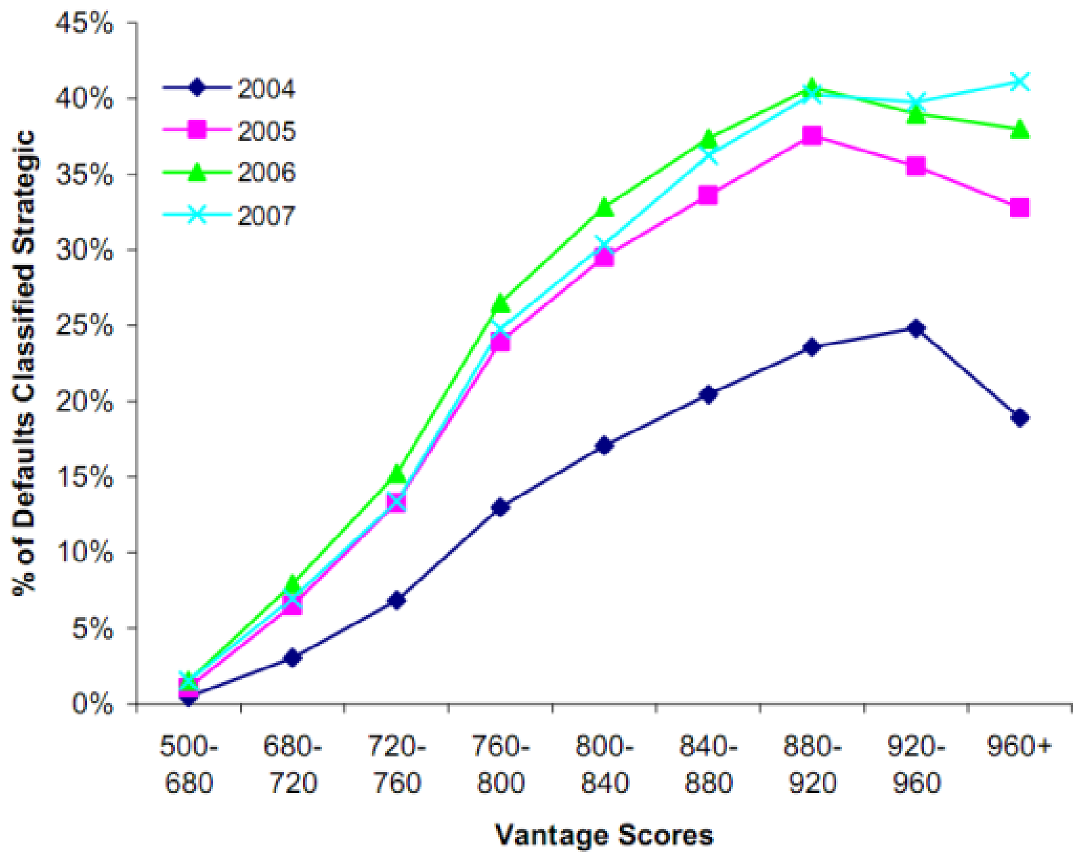
-- The wave of so-called "financial hardship" defaults was driven to a large extent by the poor loan underwriting standards from 2004 through 2007, resetting ARMs, and job losses between 2008 and 2010. Many of those loans should not have been issued in the first place, and many of the defaults are less a case of "financial hardship" than "financial reality happens." This wave has probably already peaked, and the year-over-year drops in the delinquency rates may be reflecting those loans working their way through the foreclosure process.

-- The portion of all defaults that can be characterized as "strategic" has historically grown over time. Last year a report by Morgan Stanley and TransUnion found that for mortgages issued between 2004 and 2007 the rate of strategic defaults had generally increased over time**:**



-- Additionally, the strategic portion of the defaults has been a function of current mortgage loan-to-market-value ratios. That same Morgan Stanley and TransUnion report found that for the 2004 through 2007 annual cohorts of new loans the rate of strategic defaults had generally increased year-over-year**:**

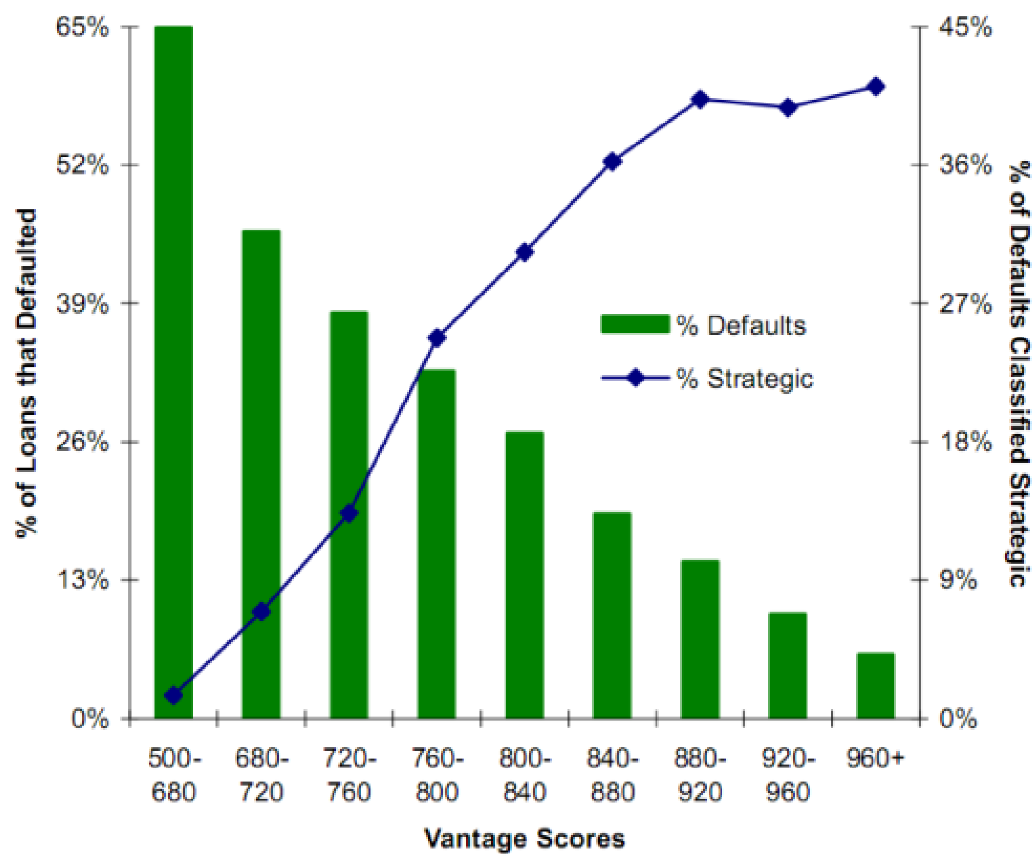
Strategic Defaults Across Vintages:
Higher Strategic Defaults at Higher Vantage Scores



Source: TransUnion, Morgan Stanley Research

There are two pieces of critical information in the above chart. First, the percentages of strategic defaults has generally increased from loan vintage to loan vintage, as a consequence of higher originating ("bubble") prices putting the later loans now progressively further "under water." Secondly, the rates of strategic defaults are *inversely related to the credit risk associated with the borrower*, per their Vantage scores (conceptually similar to FICO scoring)**:**

Total Defaults and Strategic Defaults: 2007 Vintage



Source: TransUnion, Morgan Stanley Research

Based on these two pieces of information we could conclude that even as "traditional" defaults may be stabilizing (as the less-credit-worthy borrowers flush through the foreclosure process), additional more-credit-worthy borrowers may be electing to strategically default as home prices continue to decline. And the most credit-worthy of those borrowers appear to be making "more sophisticated" financial decisions to walk away from non-recourse loans, even as their less credit-worthy brethren appear more inclined to honor their contractual commitments.

It is important to remember that the health or weakness of the local real estate market varies greatly from region to region. According to the MBA report previously mentioned**:**

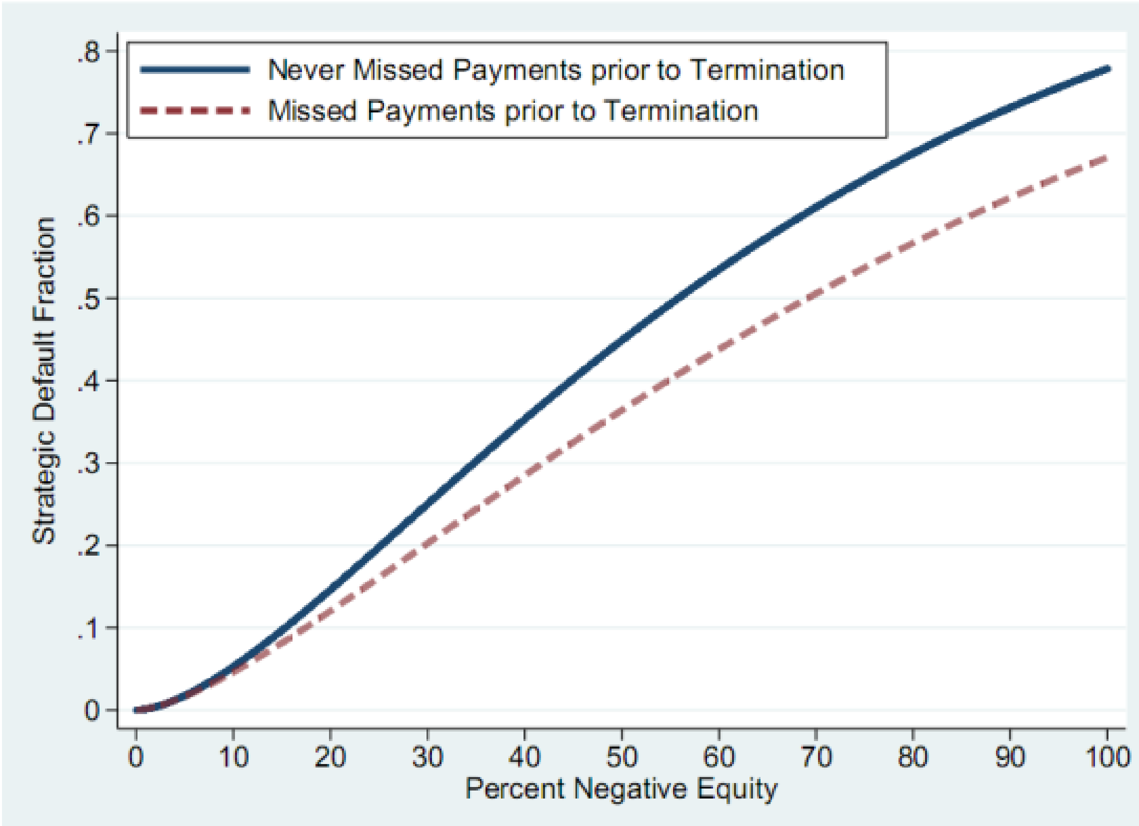
"National statistics, however, are somewhat meaningless in real estate because local market conditions determine values and peoples' perception of values of conditions. Florida remains a problem. Twenty-four percent of all mortgages in the country that are in foreclosure are in Florida and 23 percent of the loans in Florida are anywhere from one payment past due to in foreclosure. In Nevada, foreclosure actions are still being initiated at an annualized rate of over 9 percent. In Arizona the annualized rate of foreclosures started is over seven percent and more than half of all of the loans in foreclosure in this country are in just five states."

Recognizing the uneven nature of the real estate environment, some academic data has been developed that can help us understand how the strategic default rate will respond to localized declines in residential real estate valuations. A study by Guiso, Sapienza and Zingales found that in 2009 strategic defaults represented about 26% of all defaults. But the truly interesting finding was that:

"the most important variables in predicting strategic default are moral and social considerations ... people who consider it immoral to default are 77% less likely to declare their intention to do so, while people who know someone who defaulted are 82% more likely to declare their intention to do so. The willingness to default increases nonlinearly with the proportion of foreclosures in the same ZIP code."

The contagion effect of knowing someone who has "strategically" defaulted can be seen in one of their charts that captures the density of foreclosures in the sampled zip codes:

Yet another May 2010 report by the Federal Reserve Board found that the median strategic defaulter will walk away from a mortgage when the market value has dropped to about 62% of the loan value**:**

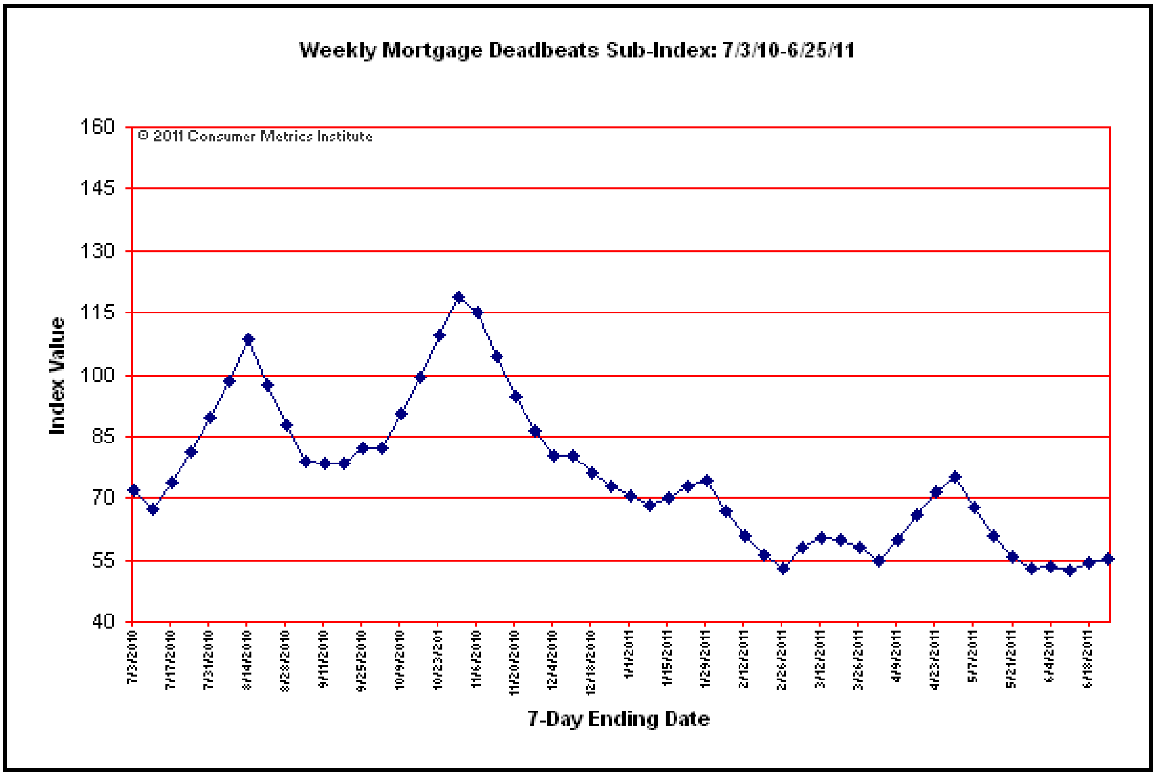


This chart distinguishes between defaulters who have missed occasional payments before "giving up" and those who have had immaculate payment histories before suddenly stopping the remittances. The latter (the solid line) are more likely to be defaulting by choice, as opposed to the former (the dotted line) who have previously shown signs of financial stress. These findings are consistent with the Guiso, Sapienza and Zingales report cited above, which found that *17% of all households would default* if their negative equity reaches 50% of the current value of the property (e.g., 33% market value decline for an original 100% loan-to-value 2006 mortgage -- *frighteningly close to the 32.3% actual to-date decline in the national Case Shiller index since 2Q-2006*).

Even if the initial wave of "financial reality" defaults is waning, there is a significant potential for a new wave of socially contagious "strategic" defaults that could keep the "rent free" phenomena alive and well -- especially if the long awaited bottom to residential real estate market continues to prove elusive.

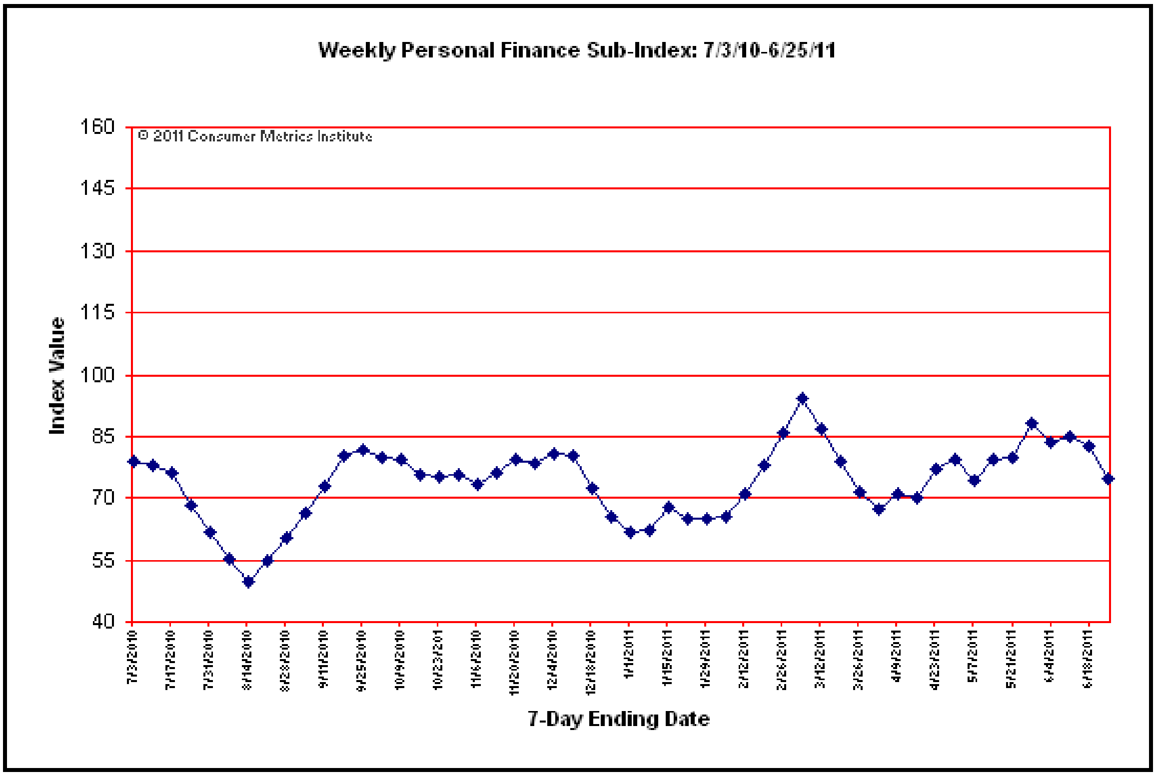
Chart Update

Our data shows broad swings over the past year in the level of consumers contemplating "strategic defaults", and the most recent data shows that the levels have fallen off sharply from peaks reached early in 4Q-2010:



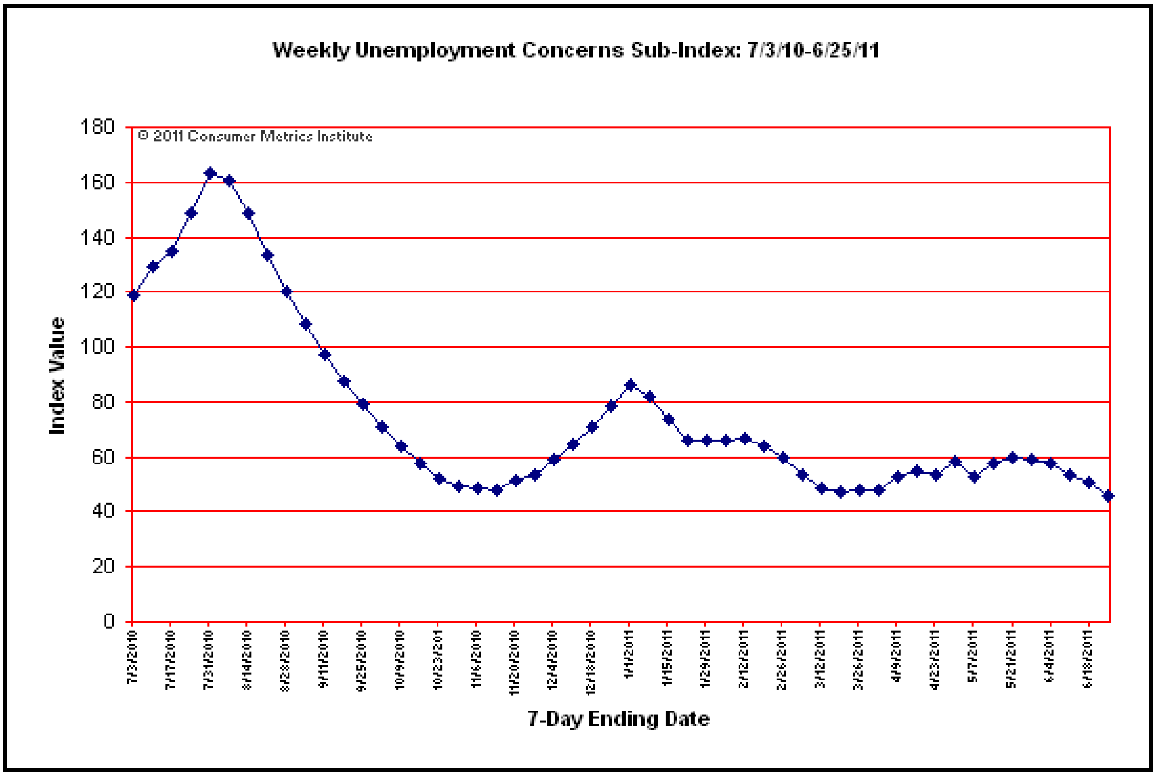
Over the past month we have seen year-over-year contractions in consumer demand for mortgage delinquency products and services averaging about 45%. This contrasts with numbers at the end of last October that were running 20% higher than a year earlier. If this correlates well to actual levels of new delinquencies, we should be seeing similar variations in the level of "free rent" induced spending over the next six months or so.

We also publish a chart that we think tells us a lot about the self-perceived financial condition of our on-line consumers -- one that we call the "Personal Finance Sub-Index":



This chart tracks consumer comfort with the state of their personal finances. Among other things it tracks the (inverted) consumer demand for credit counseling services, foreclosure advisors and bankruptcy attorneys. Because we invert the measures of demand for products or services required by financial stress, the line in the above chart goes up as people feel better about their financial situation and down as their circumstances get worse. Despite the reduction in contemplated "strategic defaults," the consumers that we track are still not feeling great about their finances at the present time.

To some extent our data also indicates that unemployment is not currently the most pressing issue, certainly not compared to late last summer:



The index shows a nearly 50% year-over-year contraction in those engaging job counseling or employment services. The decline is significant, and to some extent it reflects the occasional conflict between "new claims" data and aggregate unemployment rates. Nevertheless, heightened job worries are clearly not the primary source of the broader weak financial self-esteem shown in the previous chart. The most plausible explanation for the cross-currents in the above charts is simply job-search fatigue, coupled with a passage of time that has simply dimmed our consumer's prospects for any imminent relief.