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The Shadow Inventory Of Troubled Mortgages Could Undo U.S. Housing Price Gains

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In summer 2009, the seasonally adjusted S&P/Case-Shiller Home Price Index rose for the first time in virtually two years. Since May 2009, the index has risen by over 3%, suggesting that the necessary correction to U.S. residential home prices is nearing an end. However, in Standard & Poor's Ratings Services' view, the mortgage crisis may be far from over. The overhang of homes heading toward liquidation suggests more delinquencies and lower home prices are to come.

The current "shadow inventory" (including all delinquent loans, not only those that are real estate owned [REO]) of troubled mortgages will likely take about 33 months—or nearly three years—to clear at the current rate of liquidations. Moreover, we believe this estimate is conservative, as we do not assume any loans that have yet to show any serious signs of distress to date will default in the future and further increase the overhang of homes. Nonetheless, we believe that in reality additional loans will default in the near future due to the weak economic environment, distressed residential home values, and the resulting contraction in the supply of mortgage finance.

We believe that the recent reversal in housing prices is the result of a temporary constriction in the supply of foreclosed homes on the market. This temporary constriction ensued because servicers have completed fewer foreclosures due to court delays, servicing backlogs, and political pressure to keep borrowers in their homes. However, there is a rapidly growing shadow inventory of properties where borrowers are delinquent but foreclosure has not been completed. Overall, it is our opinion that recent positive housing reports should not be construed as a sign that the distress in the residential housing market is abating, but rather should be attributed to the temporarily limited supply of homes on the market.

Methodology

We included in our analysis all first-lien prime, Alternative-A, and subprime mortgages for single-family, two to four family, coops/condos, and manufactured houses that appear in private, nonagency securitized transactions. While the sample was not limited by vintage, we focused our attention on trends occurring since 2005. We did not only consider transactions that Standard & Poor's rates. Rather, we incorporated all the securitized loan-level data available through LoanPerformance, a unit of First American CoreLogic, which provides residential-mortgage backed securities data.

Throughout our analysis, we chose to use the original balance instead of the current balance of each loan because we wanted a consistent balance for comparison over the loan's life. Our analysis does not consider loss severity in the event of default, only the frequency of default.

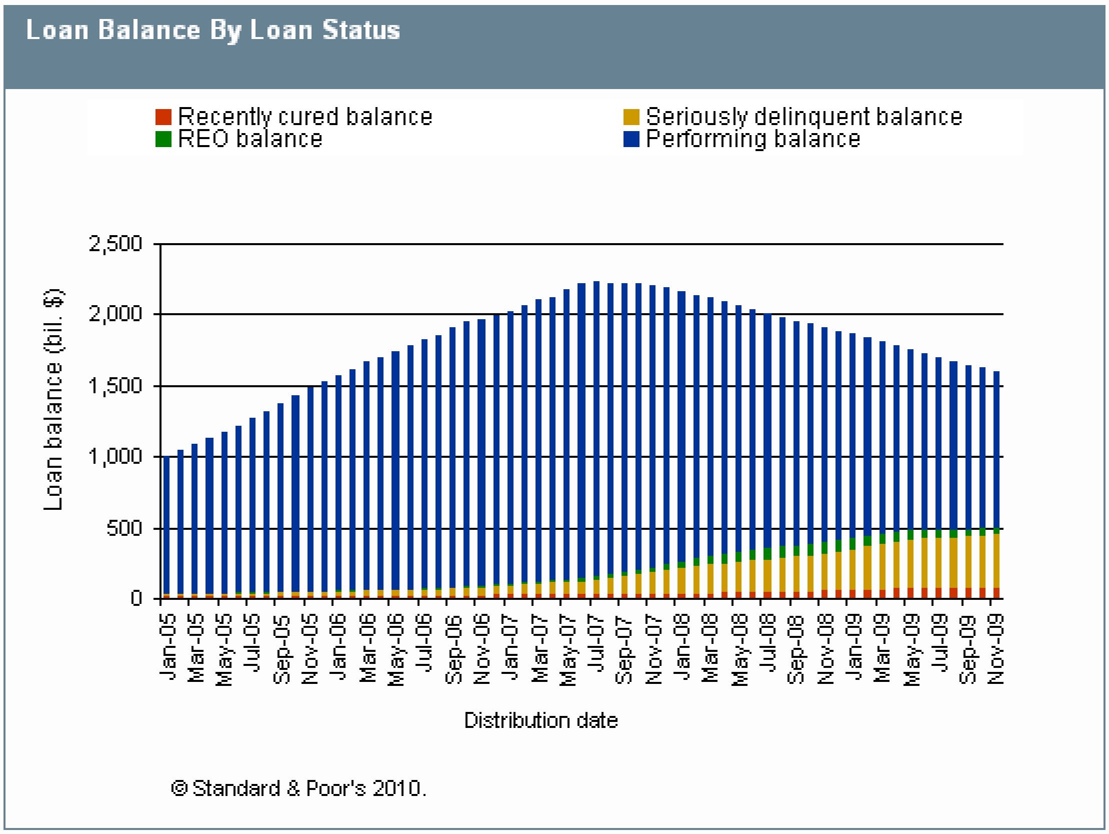
We classified all loans into one of four different categories (see table) in order to assess the relative size of the overhang, or shadow inventory, problem. The four categories were performing, recently cured, seriously delinquent, and REO. We aggregated the data according to these classifications over time to determine the relative size of the trends (see chart 1).

Standard & Poor's Loan Classifications Based On Performance

Category	Current delinquency status	90+ days delinquent within previous 12 months?
Performing	Less than 90 days delinquent	No
Recently Cured	Less than 90 days delinquent	Yes
Seriously Delinquent	90+ days delinquent or in foreclosure	N/A
REO*	Real estate owned	N/A

*REO loans represent homes in foreclosure, with ownership transferred from the borrower to the lender or securitization trust. N/A--Not applicable.

Chart 1

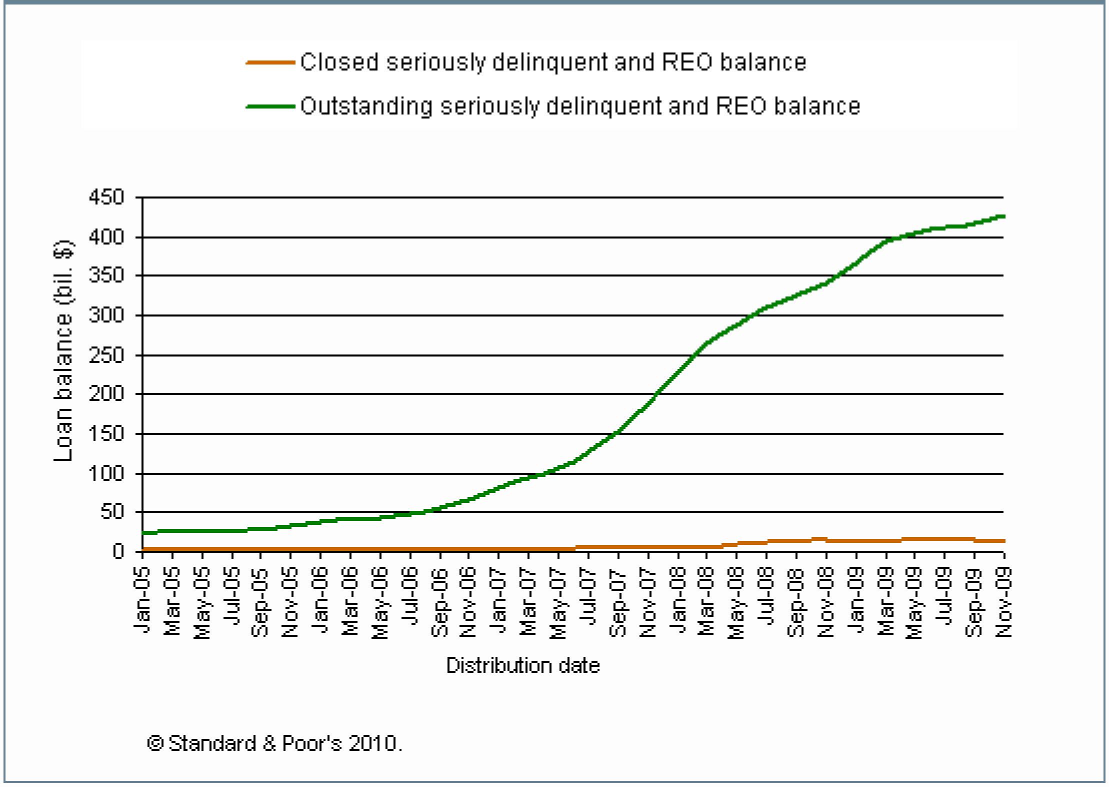


A Swelling Number Of Distressed Loans Creates The Shadow Inventory

The monthly balance of distressed loans currently outstanding relative to the monthly balance of those that pay off, or close, suggests that there is a growing shadow inventory of loans that need to undergo the closure process. In January 2005, the balance of distressed loans outstanding was about 18x that of distressed loans that closed. Today, the balance of outstanding to closed distressed loans has increased to about 31x (see chart 2).

Chart 2

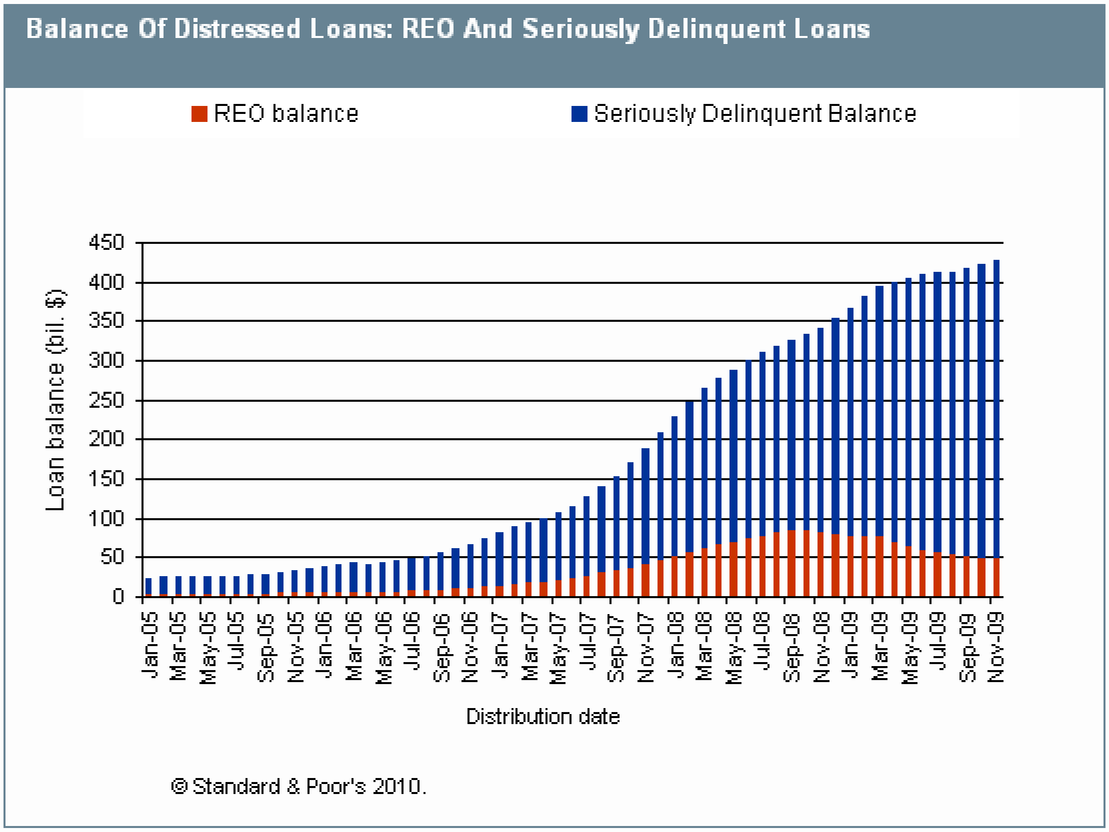
Outstanding Versus Closed Balances Of Distressed Loans



We broadly attribute the increasing shadow inventory of outstanding distressed loans to the fact that loans are becoming distressed at a faster pace than they are closing. However, while the balance of outstanding distressed loans has increased since 2005, not all of the components of distressed loans have similarly increased. Chart 3 displays the balance of distressed loans broken down into its components: REO and seriously delinquent loans. The balance of seriously delinquent loans has continuously grown since 2005, while the balance of REO loans appears to have peaked toward the end of 2008 and has since steadily declined.

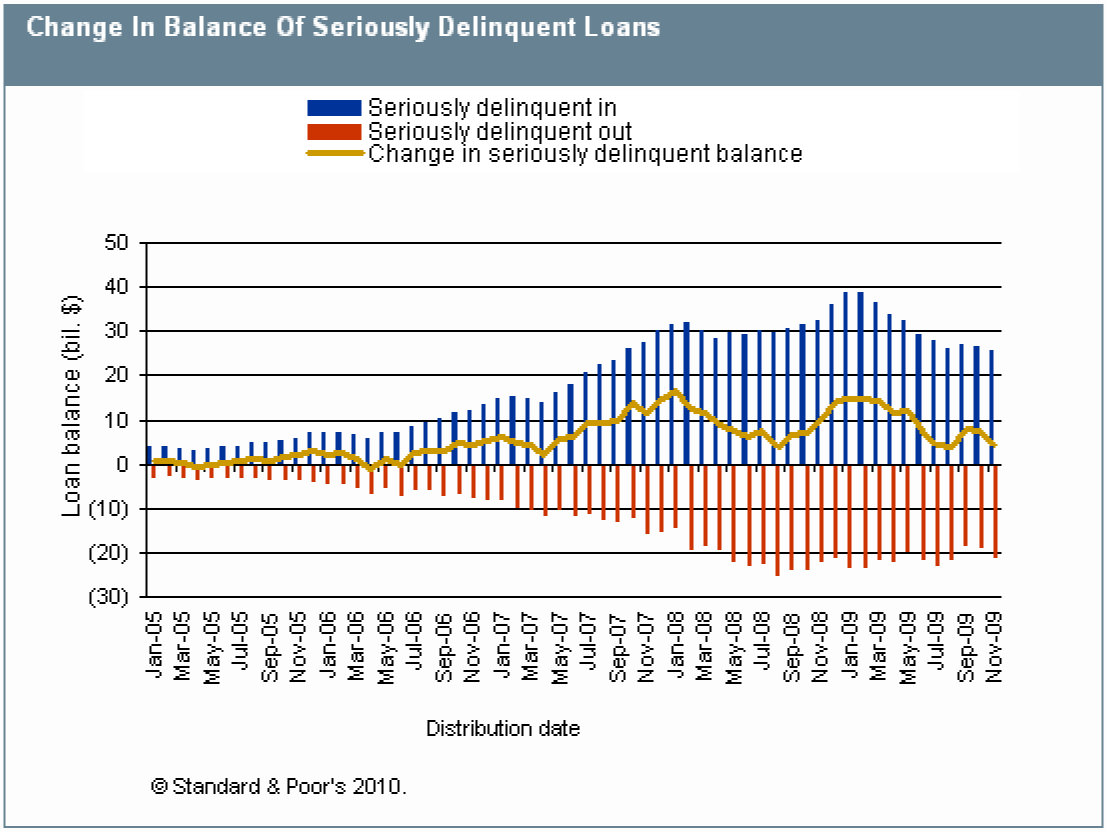
The typical path of a seriously delinquent loan involves a transition from its current state to REO and subsequently to liquidation. In our opinion, the demonstrated growing shadow inventory may be a result of delays that seriously delinquent loans are experiencing in their transition to REO.

Chart 3



Given the typical path of a seriously delinquent loan, we expect the balance of REO loans to change at a rate consistent with that of the balance of seriously delinquent loans. Chart 4 displays the consistent monthly increase in the balance of seriously delinquent loans since July 2006. The number of loans that joined the REO category, on the other hand, has significantly declined since fall 2008 (see chart 5). It appears that loans are becoming seriously delinquent, but are not becoming REO at anywhere near the same rate (see chart 6). Instead, they are swelling the ranks of seriously delinquent loans--forming the shadow inventory--while the pool of REO is waning (see chart 7). However, the data related to the change in the balance of seriously delinquent loans does provide a positive prospect. The rate loans are becoming seriously delinquent has been declining since January of last year (see chart 4).

Chart 4



Change In Balance Of Seriously Delinquent Loans
Seriously delinquent in
Seriously delinquent out
Change in seriously delinquent balance
Loan balance (bil. $)
50
40
30
20
10
0
(10)
(20)
(30)
Jan-05
Mar-05
May-05
Jul-05
Sep-05
Nov-05
Jan-06
Mar-06
May-06
Jul-06
Sep-06
Nov-06
Jan-07
Mar-07
May-07
Jul-07
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jul-09
Sep-09
Nov-09
Distribution date
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Chart 5

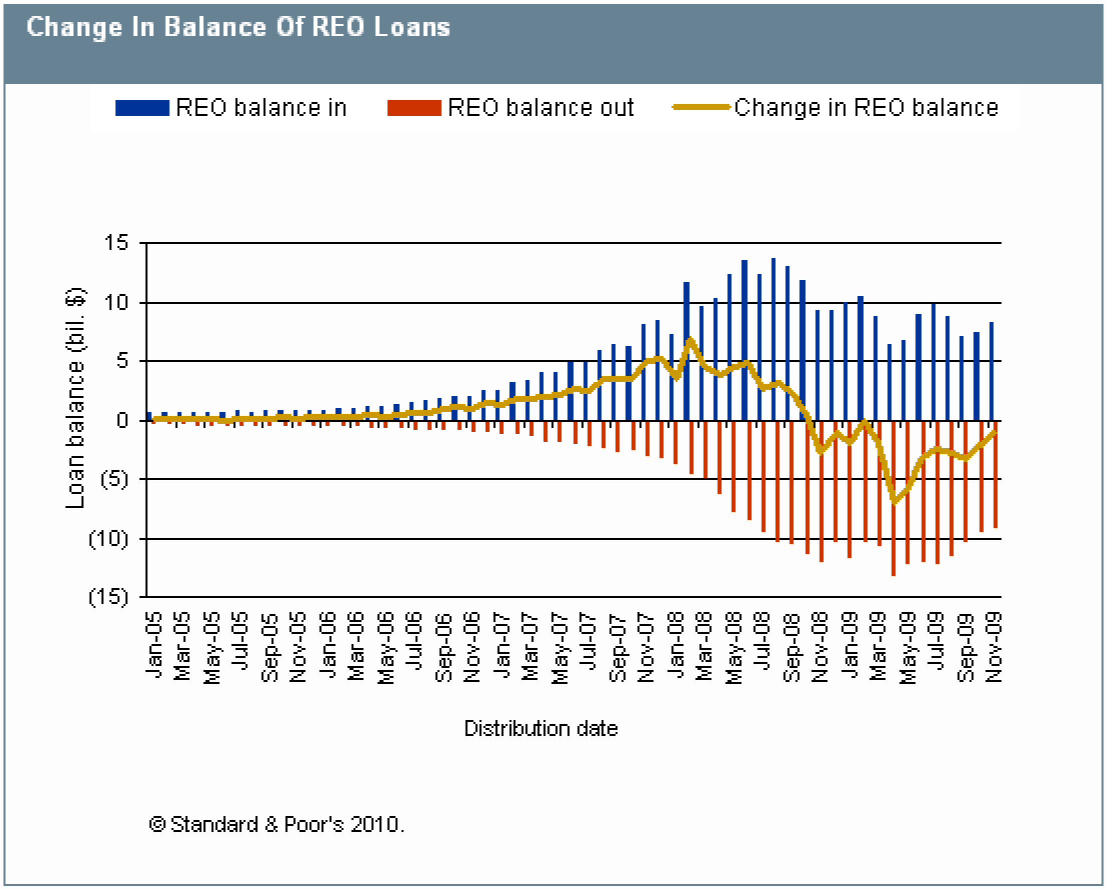
Change In Balance Of REO Loans
REO balance in
REO balance out
Change in REO balance
Loan balance (bil. $)
15
10
5
0
(5)
(10)
(15)
Jan-05
Mar-05
May-05
Jul-05
Sep-05
Nov-05
Jan-06
Mar-06
May-06
Jul-06
Sep-06
Nov-06
Jan-07
Mar-07
May-07
Jul-07
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jul-09
Sep-09
Nov-09
Distribution date
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Chart 6

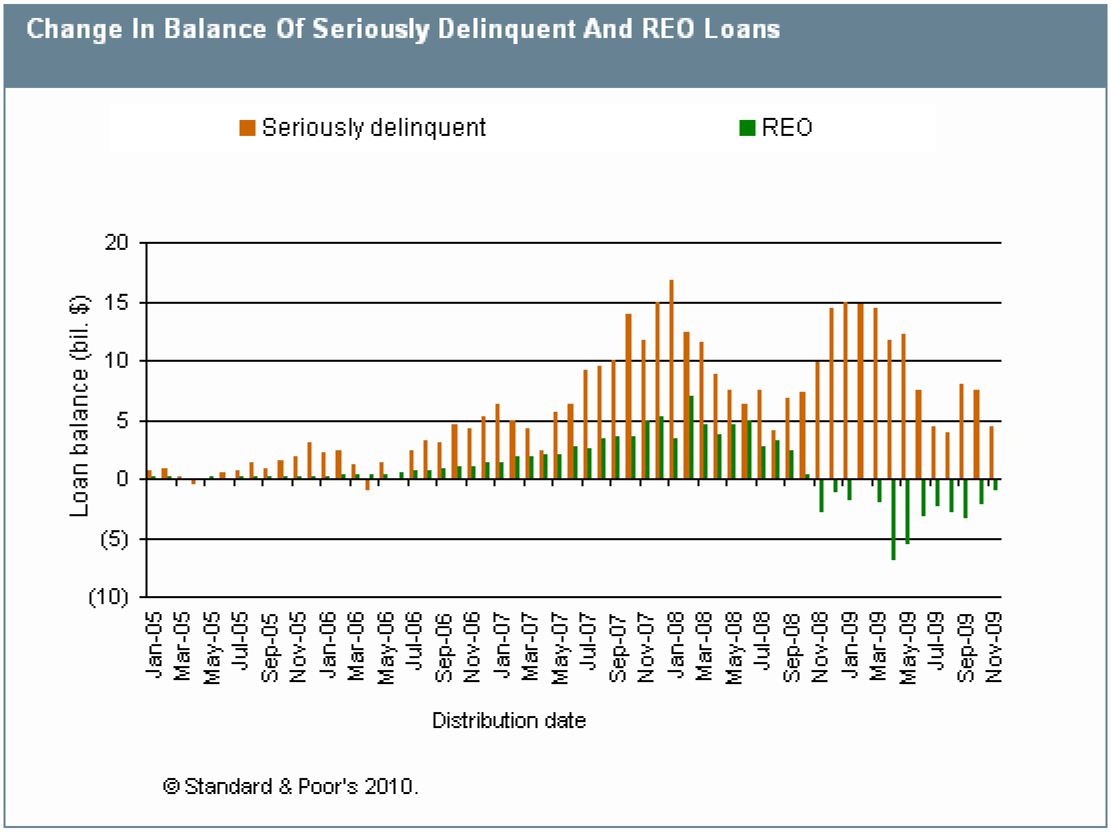
Change In Balance Of Seriously Delinquent And REO Loans
Seriously delinquent
REO
Loan balance (bil. $)
20
15
10
5
0
(5)
(10)
Jan-05
Mar-05
May-05
Jul-05
Sep-05
Nov-05
Jan-06
Mar-06
May-06
Jul-06
Sep-06
Nov-06
Jan-07
Mar-07
May-07
Jul-07
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Sep-08
Nov-08
Jan-09
Mar-09
May-09
Jul-09
Sep-09
Nov-09
Distribution date
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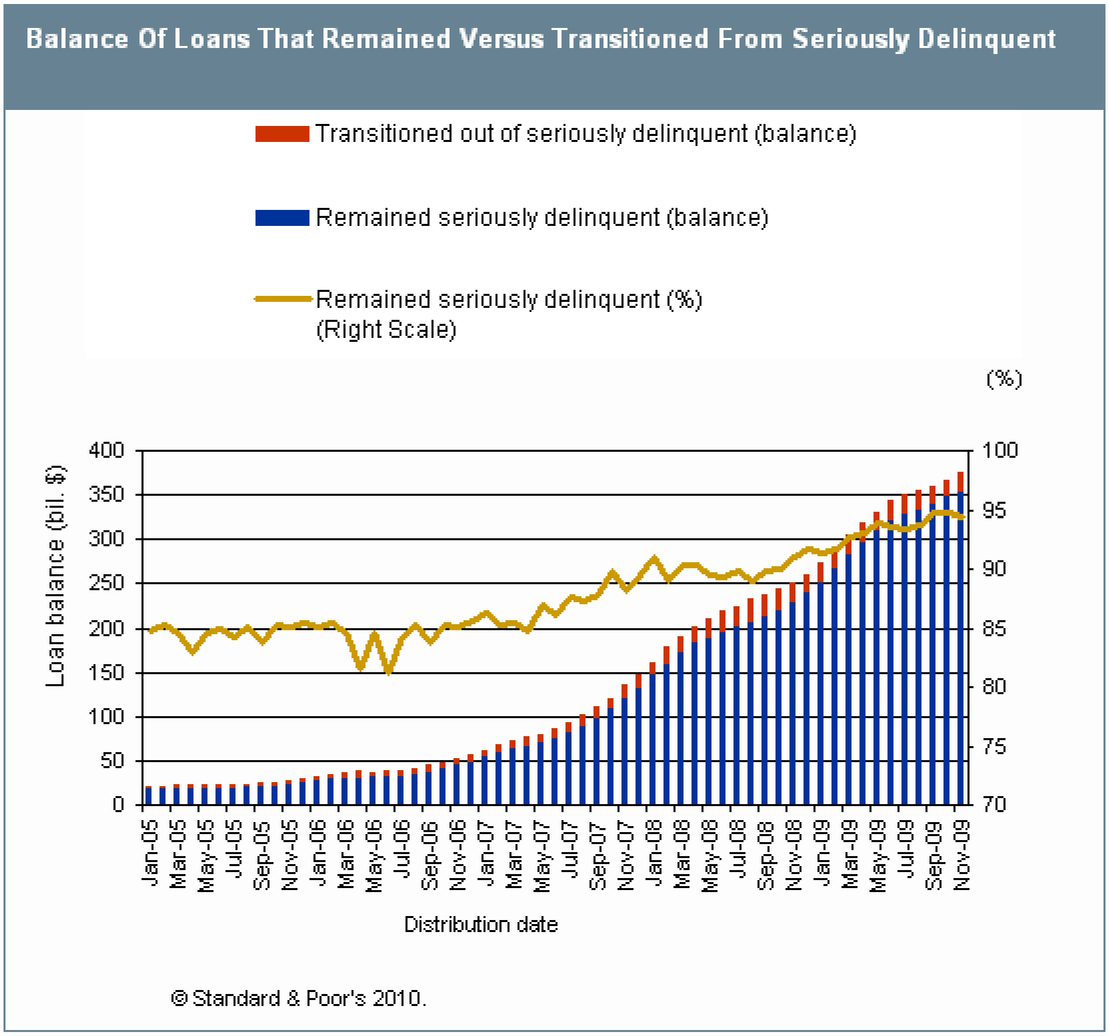
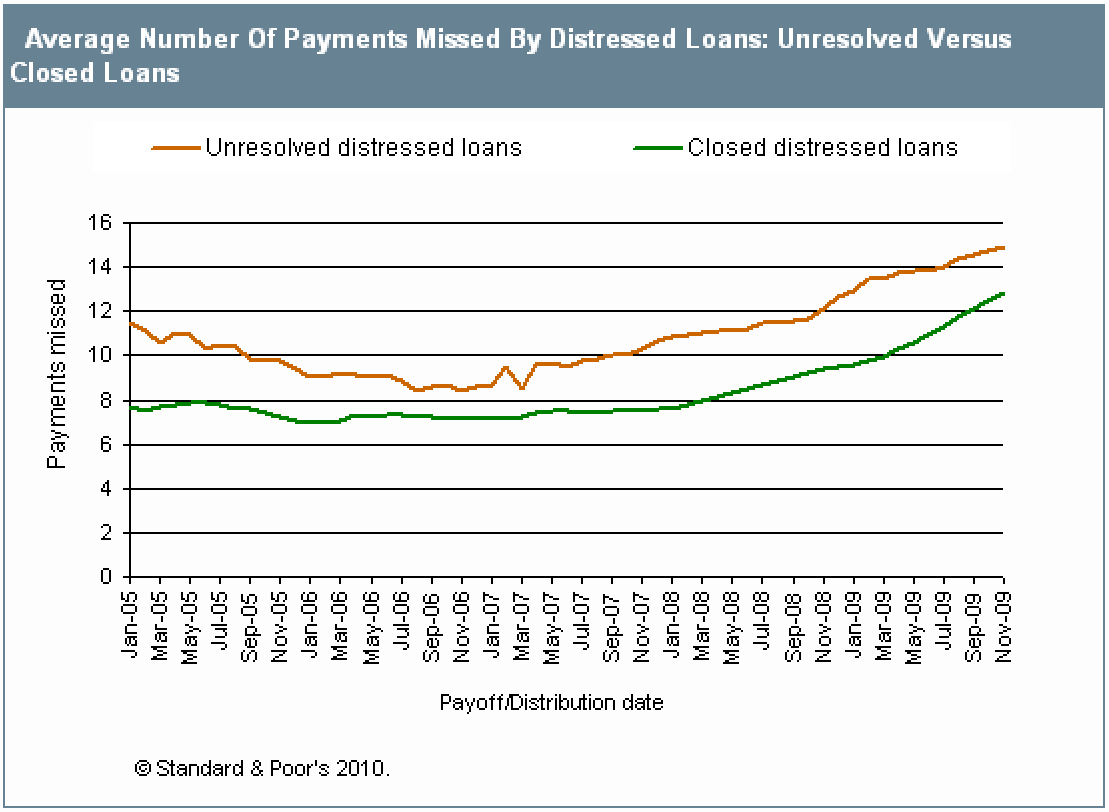
Chart 7



The delay seriously delinquent loans are incurring in becoming REO is increasing the time that distressed loans are remaining distressed overall prior to liquidation. We measured the weighted average number of payments missed for distressed loans currently outstanding in a given month as well as the number of payments missed for loans that were distressed prior to payoff that closed during the given month (see chart 8).

The weighted average number of payments that unresolved distressed loans missed increased by over 80% since the beginning of 2006 from a low of about seven months to almost 13 months in November 2009. The workout process time period for loans that closed trended similarly, with a low of about nine months at the start of 2007 to a high of about 15 months in November 2009.

Chart 8



Recently Cured Loans Amplify The Inventory

Since summer 2008, less than half of the loans that exited the seriously delinquent category entered REO. Some of these closed, but most of the loans that did not enter REO became recently cured (see chart 9). The recent push for loan modifications (see note 1) has precipitated a dramatic increase in the balance of recently cured loans (see chart 10).

Chart 9

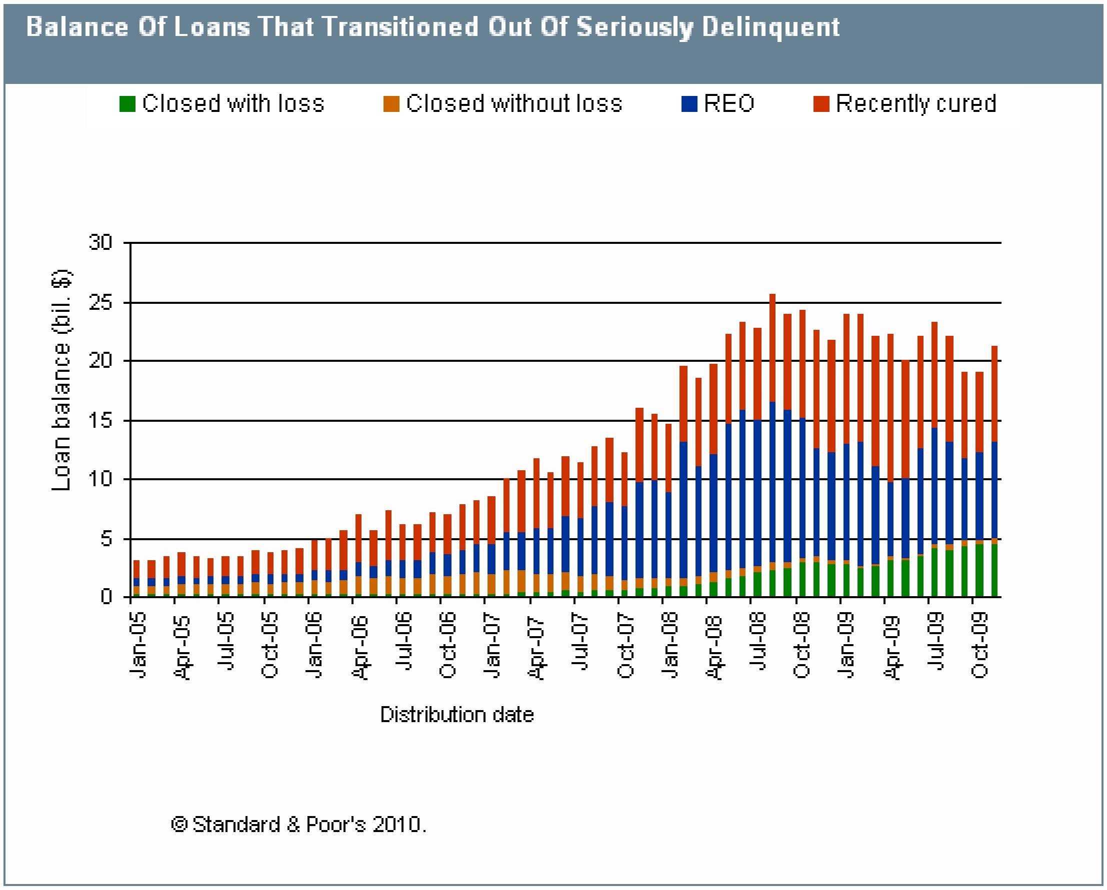

Balance Of Loans That Transitioned Out Of Seriously Delinquent
Closed with loss
Closed without loss
REO
Recently cured
Loan balance (bil. $)
30
25
20
15
10
5
0
Jan-05
Apr-05
Jul-05
Oct-05
Jan-06
Apr-06
Jul-06
Oct-06
Jan-07
Apr-07
Jul-07
Oct-07
Jan-08
Apr-08
Jul-08
Oct-08
Jan-09
Apr-09
Jul-09
Oct-09
Distribution date
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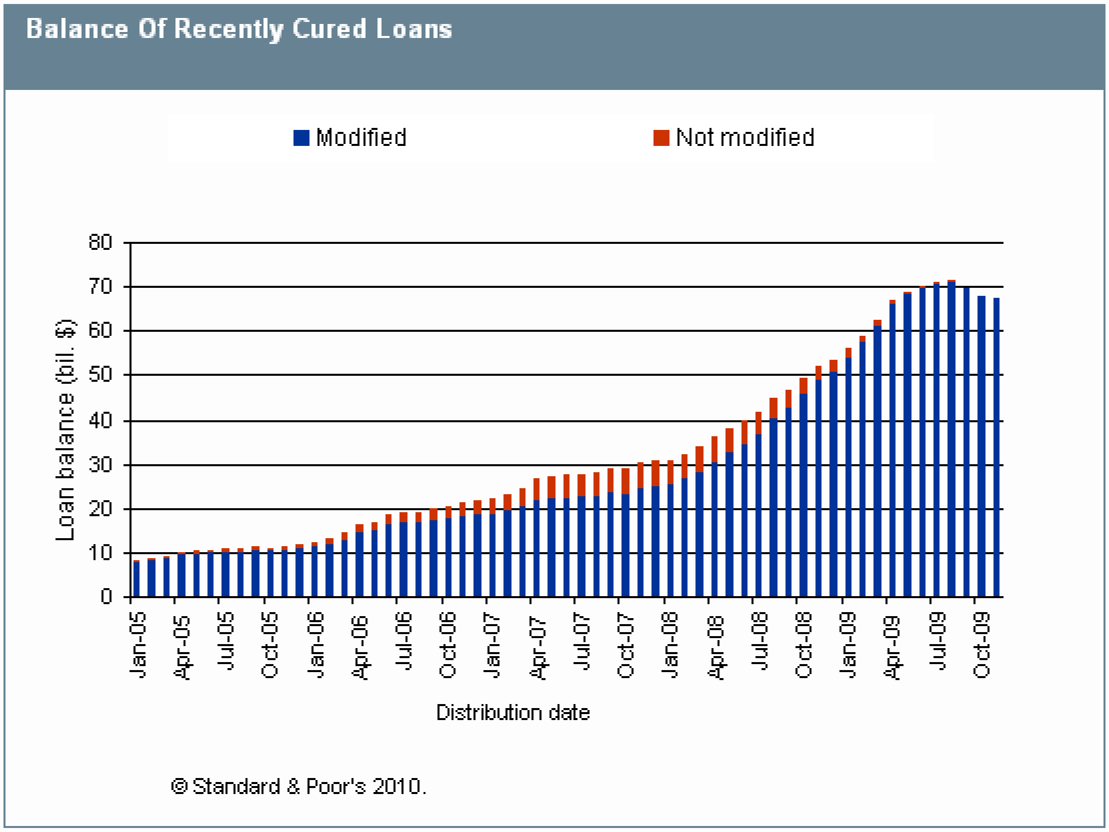
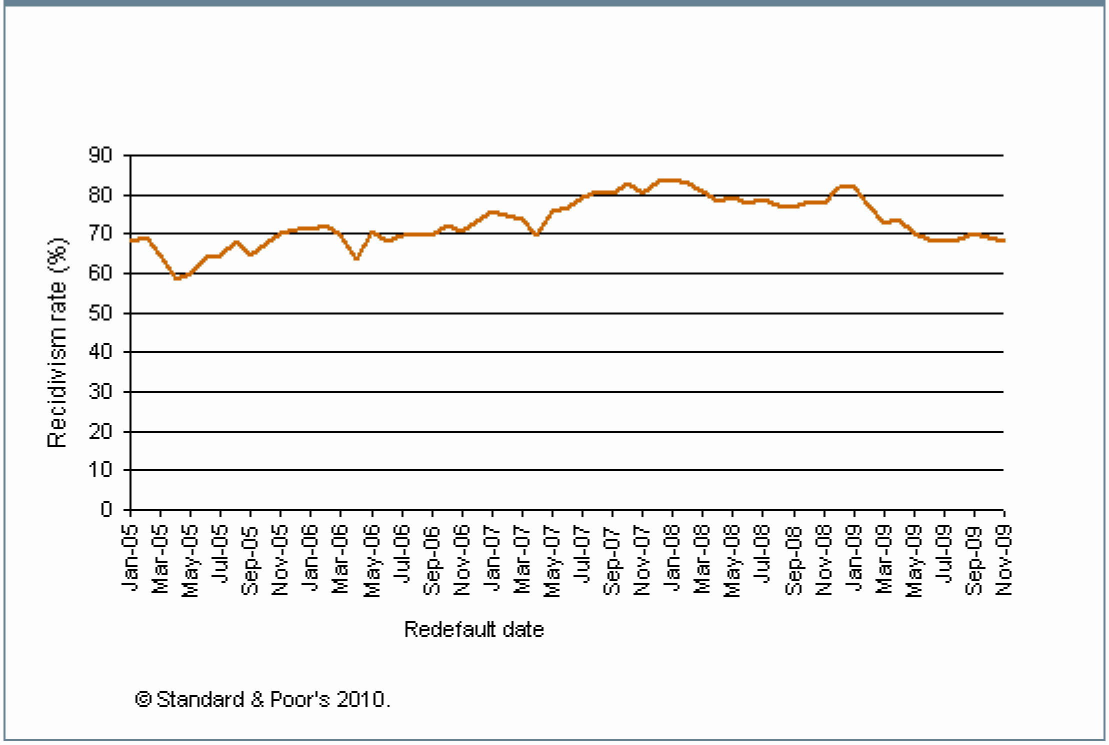
Chart 10



Unfortunately, evidence suggests that most of these cures may be unsustainable in the long run, although the most recent data provides a glimmer of hope. Overall, the rate of recidivism (see note 2) for recently cured loans has been very high even prior to the mortgage crisis, averaging about 65% in 2005 and 2006, and about 75% in 2008 and first-half 2009 (see chart 11). However, trends in the last six months or so were slightly more positive. In June 2009, the recidivism rate fell and has remained just less than 70% (see chart 11).

Chart 11

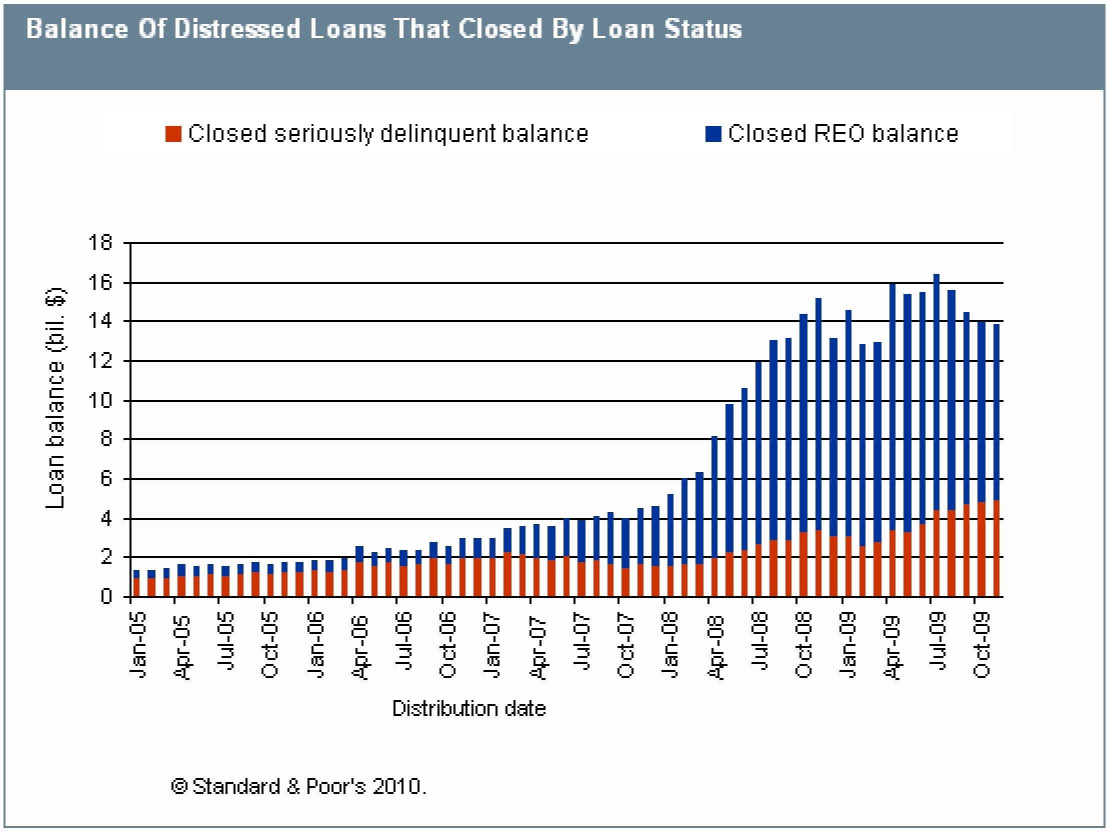
Annualized Recidivism Rate For Recently Cured Loans



The Shadow Inventory Will Need To Clear

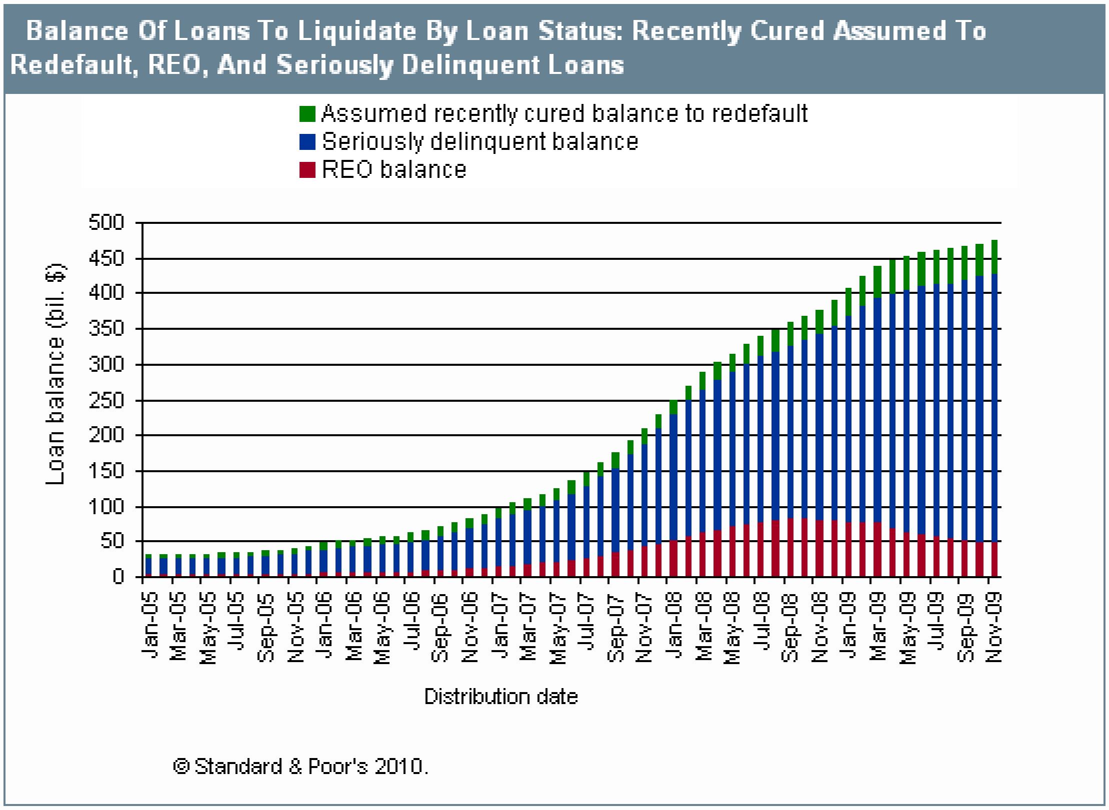
Generally, distressed loans ultimately close through liquidation. The average monthly rate of liquidations, based on original loan balance, of seriously delinquent and REO loans over the last 12 months is about $14.5 billion (see chart 12). The original balance of currently seriously delinquent and REO loans is $426.3 billion. If no additional loans default and only the current inventory of nonperforming and REO loans eventually must be liquidated, it will take 29 months to complete. This estimate of 29 months does not consider loans that have yet to default or, more significantly, those that have recently cured.

Chart 12



If, following current trends, we assume that 70% of loans that were recently cured will ultimately redefault, the balance of recently cured loans that will eventually have to be liquidated combined with the balance of currently distressed loans is $473.4 billion, a sum representing nearly 30% of the total outstanding balance of all privately securitized loans (see chart 13). This increase in the shadow inventory of homes extends our estimate in time to complete liquidation from 29 to 33 months. Moreover, this estimate still excludes loans that have never shown signs of distress at all, but may default in the future.

Chart 13

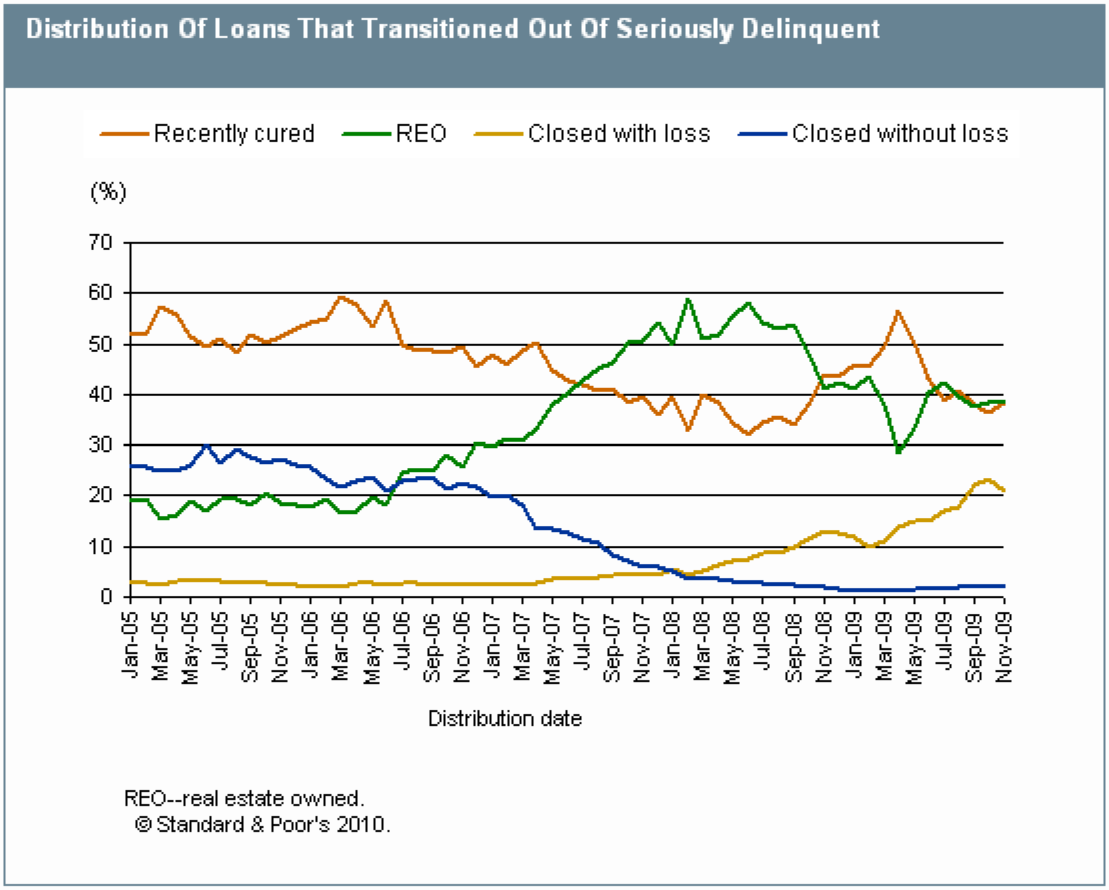


Servicers' Shifts In Strategy

At the onset of the mortgage crisis, when the number of distressed borrowers began increasing in the middle of 2006, servicers responded with workout strategies that most often included foreclosure and REO. In turn, the portion of loans that went from seriously delinquent to REO, and ultimately to liquidation, rose rapidly.

By early 2009, perhaps because of government pressure, servicers switched their strategy from rapid property liquidation to efforts to keep borrowers in their homes, primarily by modifying their loans. The portion of loans that experienced transition from seriously delinquent to REO fell to 28% in spring 2009 from 58% in June 2008. During this period, the balance of loans that went from seriously delinquent to recently cured increased to 58% from 32%. The inverse relationship between loans that exit seriously delinquent and enter either REO or recently cured is displayed in chart 14.

Chart 14



In addition, throughout this time, local governments extended the amount of time seriously delinquent loans remained in that category by delaying foreclosure activity (see chart 7). The governments placed moratoriums on foreclosures, extended the time between notice and execution of foreclosure, and enacted laws that made the potential liabilities of owning foreclosed properties very expensive.

In summer 2009, it seems servicers nearly exhausted the supply of plausible candidates for loan modifications and switched their emphasis back to liquidation. The balance of loans that became recently cured fell to just more than 35% by October 2009 from about 56% in April 2009. During this period, the balance of loans that directly closed or entered REO rose to 64% from about 44%. Servicers are requesting, and borrowers are accepting, short sales in increasing numbers. Many of these are strategic defaults, meaning borrowers have significant negative equity and determine that they can enhance their standard of living by foregoing ownership to rent at a lower monthly cost.

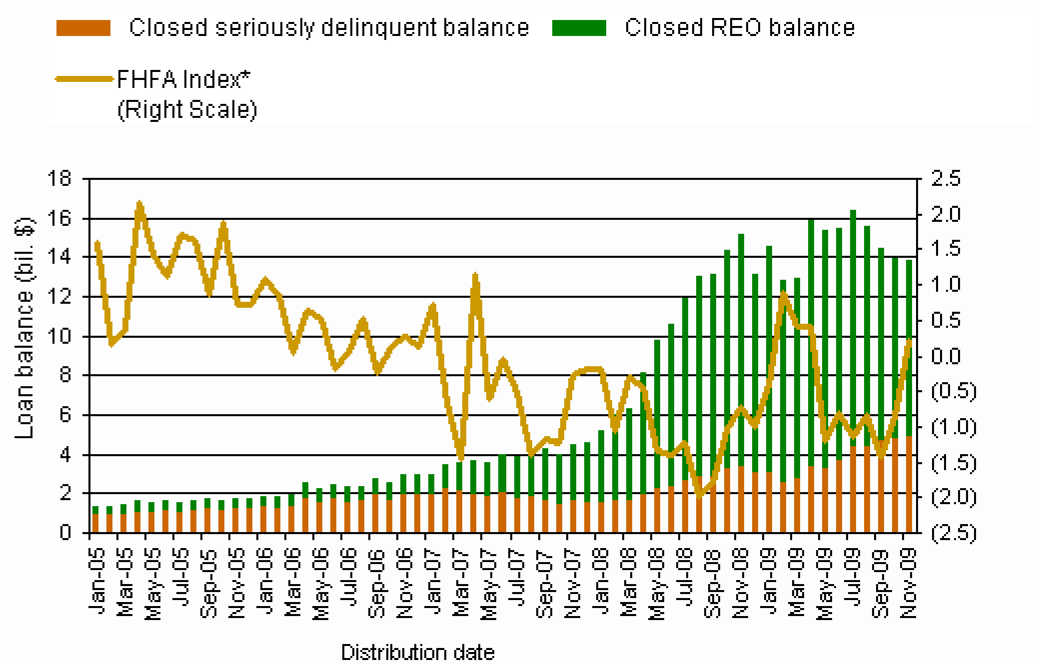
Additionally, the federal government appears to have slightly shifted its strategy regarding distressed loans in a manner similar to servicers. The government somewhat relaxed its focus on modifying loans that appear to be beyond saving. On Nov. 30, the Obama Administration added a modification to Home Affordable Modification Program--the Home Affordable Foreclosure Alternatives Program (HAFA)--that goes into effect in April 2010. The purpose of HAFA is to facilitate the liquidation of distressed borrowers' homes. HAFA will provide financial incentives to borrowers, lenders, and servicers to encourage voluntary short sales.

Liquidations Lead To Lower Housing Prices

Liquidated properties provide the market with a supply of homes for sale. Home prices directly reflect the relationship between the supply and demand of properties for sale. Prices will remain level if a comparable increase in demand accompanies an increase in supply. Otherwise, an increase in supply will result in a decline in prices to attract demand (see chart 15).

Chart 15

Balance Of Distressed Loans That Closed By Loan Status And Average Change In Property Values In Loans' Respective Areas



*Reflects the change in home prices in the specific areas represented by the liquidated loans.

The Rate Of Liquidations Is Likely To Increase

Our research suggests that various factors constrained the supply of defaulted homes in the past year. In our opinion, the increased time loans remained seriously delinquent and increased number of loans that went from seriously delinquent to recently cured were short-term diversions that temporarily restricted the number of loans that became REO and in turn liquidated (see charts 7 and 14). Trends in recent months may generate pressure to increase liquidations in the near future.

In the coming months, we believe that servicers will increasingly conclude that a significant portion of the pool of seriously delinquent loans is unredeemable and, with slightly increased government support toward this direction, will conclude that the optimal workout solutions for these loans will involve liquidation. In addition, we believe most of the loans that became recently cured within the past year will once again become seriously delinquent. Given their track record and servicers' recent tendency to increase liquidations, we believe that this time servicers will opt for the liquidation of the homes backing these loans, either through foreclosure, deed-in-lieu, or short sale.

The Supply Of Homes On The Market Is Likely To Grow

We believe that the recent constriction in the supply of foreclosed homes on the market is a temporary one. Loan modifications and the observed extension of time distressed loans remained as such may simply have delayed the inevitable, creating the demonstrated shadow inventory of troubled loans. Ultimately, the majority of the properties these distressed loans represent will likely have to be liquidated.

Our estimate of $473.4 billion in loans that will eventually need to be liquidated corresponds to approximately 1.75 million individual properties. This number represents almost 50% of the existing homes available for sale as of December 2009, and moreover, only accounts for expected defaults for mortgages outstanding in the private securitization market which makes up less than a third of the total securitization market and less than 5% of the total mortgage market. While we do not expect all of these distressed properties to liquidate at the same time, the significant percentage of the current supply that these distressed loans represent does reveal the potential future increase in housing supply. An influx of liquidated properties is likely to prompt a decline in prices if unaccompanied by a comparable increase in demand (see chart 15).

However, recent data provides some hope for recovery of the housing market. The number of loans becoming seriously delinquent each month seems to have peaked and initiated a sustained decline (see chart 4). Furthermore, the recidivism rate of recently cured loans appears to be trending down, implying that modifications may start becoming successful.

Nonetheless, unless modifications prove to be successful at a greater rate, in our opinion nearly all currently distressed properties and the majority of recently cured properties will indeed eventually need to be liquidated. Moreover, we believe that the monthly rate of liquidations may rise in the near future, consequently prompting a decline in home prices.

Notes

1. Loan modifications occur when servicers determine some concessions in payment terms are the best options to maximize investor returns. Reporting of loan modifications has only recently become common practice by trustees. Standard & Poor's developed an algorithm that identifies loan modifications based on numerous changes to loan characteristics. Our loan modification methodology is completely independent of the federal government's Home Affordable Modification Program (HAMP), and the majority of loan modifications according to our methodology occurred prior to the announcement of HAMP in March 2009.

2. We calculated monthly recidivism rates for recently cured loans as the percentage of the recently cured balance that entered seriously delinquent in a given distribution month. Chart 12 displays annualized values of these percentages.