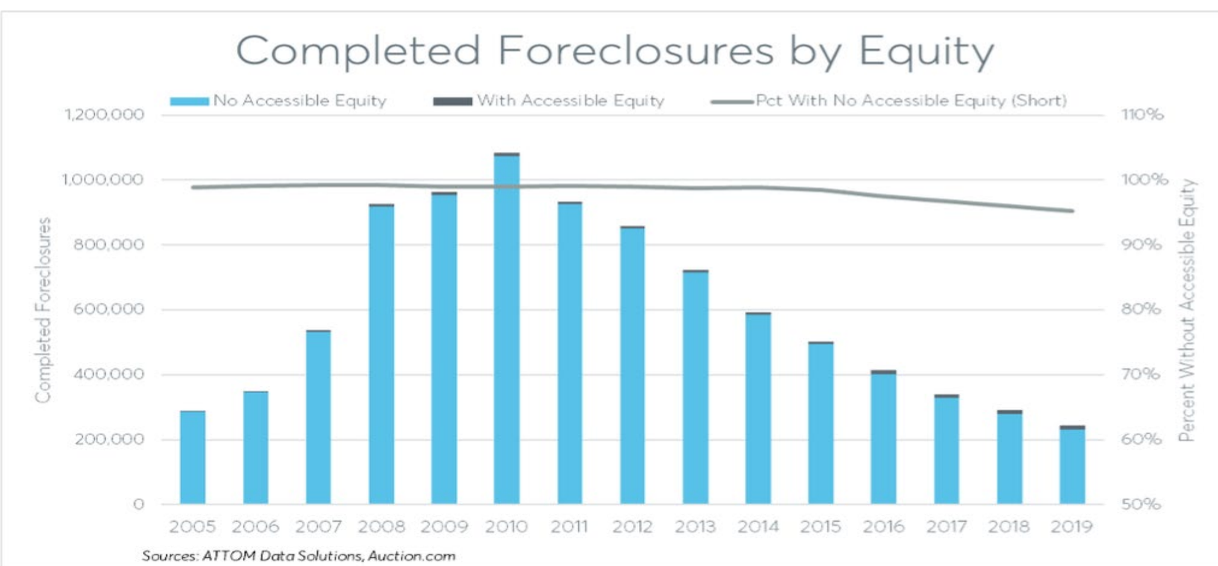
Pre-foreclosure and Foreclosure Lookback at 2008 – Is 2021 Similar or Different?

With serious delinquency rates in some mortgage programs such as FHA reaching all-time highs, is this 2008 again? Probably not and for a variety of reasons. There are many differences between borrowers at the beginning of 2008, the mortgage re-sale and capital markets industry in 2008, and additional alternatives for delinquent borrowers in 2020.

Looking at 2008, how many saw the movie *The Big Short?* How many actually understood what was happening in the movie as the trader at the heart of the movie first lost hundreds of millions then ended up profiting by billions? The lessons learned in the capital markets and evidenced by The Big Short are usually quickly forgotten in times where lenders are competing to make loans. But it's not going to happen in the magnitude of 2008. But first we need to look at some data from the 2008 crisis and some explanations of how we got there.

A proprietary estimate of the foreclosures from 2009 to 2019 showed 6.9 million foreclosures. At the peak, more than 1 million homes were foreclosed in 2010 with 2008, 2009, and 2011 close behind. As the graph shows, there are foreclosures which happen in any year for a number of reasons and that number has been above 200,000 per year for a long time. Good housing markets and high housing appreciation can't overcome choosing the wrong mortgage, a mortgage you can't really afford, a mortgage you haven't adequately planned for, or sudden events which aren't predictable. Many of those sudden events though may entail a job loss or an unexpected bill where planning and choosing the right mortgage may have delivered a different outcome for the borrower. [Winning Mortgage, Winning Home] helps avoid that challenge.

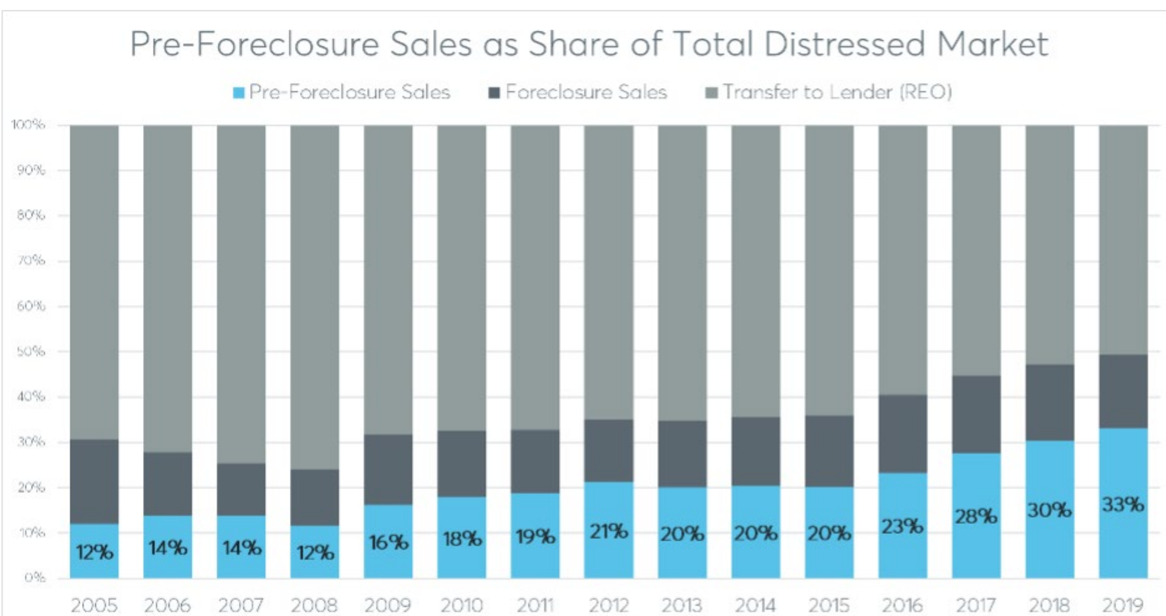
> Even with foreclosure from inability to repay a mortgage, some owners had equity in the home. Allowing it to go to foreclosure instead of proactively selling in a pre-foreclosure sale, short sale, or other approach likely cost a number of owners money which at least would have been in the pocket of the owner after the sale.



In order to help prevent foreclosures, Congress created the Making Home Affordable (MHA) program. This program provided some funding to re-cast mortgages. By re-casting, some limited alternatives became available to distressed borrowers. One option extended the number of years to repay the mortgage, going as long as 40 years or more total. A second option forgave some principal, but was more difficult to obtain. A third option created a low or no interest second lien mortgage which would become payable on sale or at a specific point in the future, usually the payoff of the first mortgage. The programs attempted to "right-size" the payments to help borrowers. However, right-sizing a mortgage for an unemployed individual indicated no ability to repay, so the mortgage could not be re-cast without employment.

What lessons did this MHA program instill? There were many mortgages which attempted to get modified, but most did not meet the requirements. However, more than 1.7 million mortgages were noted to have started a permanent modification. By the third quarter of 2020, reports show more than 45% of these had fallen back into serious delinquency. Another 20+% reflect a short sale completed (avoiding foreclosure, but giving up the home). Many are choosing to go the route of a short sale or pre-foreclosure sale to avoid foreclosure and possibly retain some equity. It's not an easy task, but one which has gained traction as the industry develops more digital platforms to move the process along. With more than 2.5 million mortgages currently in forbearance coupled with the prior track record of unsuccessful re-casts, a number of these homes will come to the market as distressed sales. The following graph shows the increasing share of distressed sales as alternatives to foreclosure.

One company indicates that its pre-foreclosure sale efforts netted offers on average $28,000 higher than traditional sales though Realtors. It's possible some of that money ends up in the hands of the borrower after the sale.



Back to *The Big Short* and 2008. Winning Mortgage, Winning Home outlines how programs like Nehemiah, NINA/SISA loans, Option ARMS and other programs played a role in the run-up to the 2008 crisis and causing the crisis to be as large as it was. These programs are either now banned or limited. The movie looks at the market for mortgage-backed securities (MBS). Obtaining low and stable interest rates on loans depends heavily on a smooth market and demand for this type of security. An MBS security typically holds mortgages in the millions or billions of dollars of principal amount (also known as UPB-Unpaid Principal Balance). This represent an aggregate of thousands of mortgages in each security. In the movie, the hedge fund “borrows” MBS from owners and sells them. Because there really aren’t these available to short, there were artificial and sometimes custom alternative securities created to mimic the MBS securities, like the artificial index to track lower credit score mortgage borrowers and known as the ABX Index.

The hedge fund in the movie had to pay interest every month to the owners from whom the MBS securities were borrowed in order to pay the interest the holder would have earned. So every month, the hedge fund had to write a check and leading to millions in losses. The hedge fund bet the price of the securities would fall. However, the pricing is not a normally traded stock or bond, so the price was held at an artificially high level by Wall Street firms which originated the MBS securities. The Wall Street firms had a risk of losing money if prices fell. By falsely indicating there wasn’t a looming surge in defaults, the firms hoped to avoid large losses. In reality, the Wall Street firms were putting bad loans in the MBS securities and calling them good using contrived math. Finally, the firms could no longer avoid reality and the prices fell precipitously, providing a large windfall for the hedge fund.

When this happened in 2008, the market for almost all bonds froze. There were little to no buyers. In one example, a city water utility saw its adjustable interest rate spike from a few percent to over 20% in one day, leading the utility to eventually declare bankruptcy.

In 2021, the typical borrower profile is different, underwriting standards are different, and interest rates are lower and have been for quite some time. Many offending programs were dealt a death blow and haven’t been resurrected. None of this means there won’t be pain for many borrowers in 2021 and 2022. Read what we foresee in the market in other posts and in Winning Mortgage, Winning Home!