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As homeowners head 'underwater,' another housing crisis looms

Almost half of homeowners with a mortgage could be underwater by 2011, says Deutsche Bank. We asked how that will play out.

By Scott Cendrowski, reporter
August 12, 2009: 12:25 PM ET

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COURTESY: DEUTSCHE BANK
Karen Weaver, global head of securitization research at Deutsche Bank

NEW YORK (Fortune) -- Karen Weaver, global head of Deutsche Bank's securitization research division -- responsible for analyzing credit default swaps, collateralized mortgage obligations, and other exotic Wall Street products -- said last week that 48% of U.S. mortgage owners will end up owing more than their home is worth by 2011.

The figure may have left many Americans wondering how this could be possible. But consider that 27% of U.S. homeowners with a mortgage are already "underwater." And according to Deutsche Bank, home prices may fall another 14% before hitting a bottom.

Fortune spoke with Weaver to understand the implications of her recent forecast, why it will affect regions that missed the housing boom, and why still-falling home prices are hurting even the best borrowers.

How many Americans are underwater?

Currently we estimate that 14 million homeowners have negative equity. However, based on our home price forecast, as prices continue to fall we think that number could reach 25 million, or 48% of all mortgagors.

Where does this leave us?

The obvious takeaway of falling home prices and being underwater is what it does for defaults. But there's a bigger implication, which is that when we look at the economy over the past decade or two, it's been very much a consumer economy.

What has been driving the consumer hasn't been gains in incomes. What has been driving them is easy credit and rising home values. And the fact that their home price was rising and they could borrow against that through home equity lines or loans or refinancing, it augurs for a very different economy going forward if people don't have that option.

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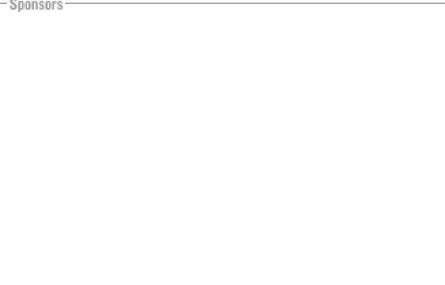

What mortgages are most responsible for this problem?

The subprime loan borrower is more likely to use a second mortgage when purchasing a home, so they'll put down very little equity when they've purchased. So the same decline in price is going to leave them in a worse negative equity position than someone who put down 20%.

On option ARMs (adjustable rate mortgages), the way those loans work is that the payments are very small. And the difference between a normal payment that would cover someone's full interest and principal, and these lower teaser payments, is added to the balance. So even if prices did nothing, an option ARM could end up with negative equity.

Isn't it the case that many of those were issued at the peak?

Exactly. These products -- option ARMs, subprime, etc. -- were regarded in the industry as "affordability products." What they were designed to do is to provide options to customers in areas where home prices were unaffordable. In other words, given an individual's income, it was prohibitively expensive to purchase the average home.

So by creating products that lowered the payment, or lowered the amount of down-payment, it enabled more people to buy a home. It also perpetuated the bubble.

To give an example, if you look at Los Angeles: At the peak of home prices in LA, only about 9% of people living in Los Angeles made sufficient income to purchase the average house. Now, a number of those people had purchased their homes beforehand, so it was moot to them. But for a first-time home buyer, it meant that it was highly unlikely that you were able to purchase a home unless you used one of these very aggressive products that stretched your [income].

This is occurring in states where speculation was rampant -- for example, Florida, California, and Nevada -- but where else?

People are surprised at the extent to which subprime mortgages were used in the Midwest. In a lot of cases the Midwest has had a manufacturing recession for a while now. It's going through a paradigm shift. So in the industrial Midwest, subprime lending was more popular than some people might think.

I think the surprise is prime quality mortgages. That's where the biggest deterioration could take place in the next leg. Right now about 16% of those borrowers are underwater. If our home price forecast is correct, down another 14%, we could have 41% of borrowers underwater in the prime mortgage space. That's what happens when another 14% decline occurs.

Does this lead to a new wave of foreclosures?

Well, we don't think that the wave has stopped in any sense. But the wave is clearly building. That is evident by looking at serious delinquencies. If you look at a chart of how many borrowers have missed more than two payments, a large portion of those people are going to end up being

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foreclosures.

Well, that rate of serious delinquency has been rising rapidly and continues to rise, pretty much in tandem with unemployment. As long as you have serious delinquencies going up, you know for the next year and a half, a large portion of those are going to turn into foreclosures.

Of subprime and Alt-A (Alternative A-paper) borrowers, about 33% of those borrowers are seriously delinquent. If you look at prime jumbo, the highest quality mortgages, 6.2% are seriously delinquent. That sounds like a low number. But two years ago that number was 1%. It's a very straight trajectory from September 2007, pretty closely mimicking unemployment.

At what point of being underwater do homeowners start falling into foreclosure rapidly?

Once you get to the point where negative equity is significant -- for example, 25% or more -- there have been studies that suggest you get more strategic defaults.

People say, "I bought my house for $500,000, it's worth $250,000, there are 10 available for sale in my neighborhood. It makes no economic sense to spend the rest of my life trying to pay off a $500,000 debt when there's no reasonable likelihood to expect this house to go back up to $500,000."

This might sound extreme, but we have borrowers who bought a $500,000 home in California at the peak of the market on $50,000 of income. So for them to devote their gross income for the next 10 years solely to paying off [their] mortgage doesn't make any sense.

The Federal Reserve of Boston recently studied a similar housing crash in Massachusetts during the 1980s. What did they find?

In Massachusetts, there was a downturn in their housing market in the late '80s. The Federal Reserve [Bank] of Boston put out a report last year, and in their report they looked at how many people defaulted once they had negative equity. If a borrower has equity, and they can't maintain their home, that borrower is going to sell rather than default. So the question is, once someone does have negative equity, what's the propensity to default?

In Massachusetts, less than 7% of borrowers who had negative equity defaulted. This speaks to the inherent credit worthiness of mortgages -- why they're always considered to be a low-risk investment.

Is it fair to say that that will play out the same now?

Now, for example, if we believe the Deutsche Bank forecast and 25 million borrowers fall underwater, unfortunately we think 7% will be too low. The reason is when you look at Massachusetts in the late '80s, you had much better quality borrowers. In addition to that, unemployment in Massachusetts peaked at 9.1%. We're already at 9.5% [nationally]. In California, unemployment is at 11.5%. We do know that most people try to maintain their home. They try to keep their mortgage current. But to expect it to be as low as 7% is very wishful thinking. ■

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