GSE Activity Report

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Brother, Can You Spare a Job?

Summary

A new FEDS Note unpacks the unprecedented patterns of mortgage default risk during the pandemic to find that unemployment will tell the default tale. Forbearance and stimulus payments have averted a repeat of 2008's negative feedback loop, but only improved employment will avert significant mortgage risk once COVID subsides.

Impact

As the FEDS Note reiterates, mortgage defaults – like most other consumer loans – are usually closely associated with the business cycle when measured by employment. This historic correlation was not in fact observed in the 2007-09 crash, where mortgage defaults were initially dissociated from the cycle due to lending practices and related policy. However, as conditions normalized after 2010, the correlation again seemed ironclad as speculative losses subsided and the real housing negative-equity crisis began. Running a series of risk variables through 2020 data lead the Fed researchers to conclude that, while this time is indeed different, unemployment after forbearance and stimulus policy ebbs will prove the market's defining criterion.

Using delinquency data unavailable to researchers outside the Federal Reserve, the paper looks at mortgage and auto loan defaults in the post-2008 Great Recession and after COVID struck. The data of course show that the employment/default correlation collapse in COVID. After March of last year, unemployment rose to Great Depression levels, but defaults remained surprisingly low – in fact, they actually fell.

The critical differentiating factor is, of course, forbearance and family economic support. However, also unsurprising, the data show that the relationship between delinquency/forbearance and unemployment remains strongly procyclical – that is, forbearance substituted in 2020 for the delinquencies seen after 2008. Because loans that were current before COVID that then go into forbearance are now deemed to be current and cannot be reported to the credit bureaus, data on delinquencies may thus be a misleading indicator of both mortgage- and auto-loan risk as forbearance ends unless employment rebounds or substitution between income and federal payments continues.

The unprecedented nature of the pandemic also adds an array of health and prevention policies to the complex mix of forbearance and economic-stimulus interventions. To assess these as a whole, the FEDS Note uses multi-variant regression capturing wide variation in state experience. This analysis interestingly also captures differences between government-mandated and voluntary mortgage forbearance. At a 95% confidence level, higher unemployment rates correlate most

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strongly with delinquency or forbearance in 2020 even though government support reduced overall delinquencies, at least so far. Risk is of course compounded by COVID, with the regression finding that COVID infections come close to – but do not surpass – unemployment as a default/forbearance driver.

Outlook

The paper concludes by noting that delinquency and forbearance have different macroeconomic and financial-stability effects, going on only to hint at a few. First, forbearance supports house prices, preventing the negative-equity downward spiral all too evident after 2007. This finding is consistent with an earlier analysis of California's aggressive loan-mod program in the 2008 crisis, which also found considerable macro benefits from averting foreclosure.

Although mentioning financial stability, the paper doesn't even suggest forbearance's likely impact. This is uncertain over the long term, especially at entities – e.g., the GSEs, FHA – with no asset diversification and a whole lot of forbearance on the books. Studies going back to the S&L crisis show that nonpayment for longer means losses grow bigger. This has led to an array of troubled-debt recognition requirements culminating in CECL. However, prior cases were incidents in which borrowers receiving forbearance were borrowers who couldn't service debt for reasons generally of their own making. In COVID's case, we expect forbearance will have significant macroeconomic and financial-stability benefits if borrowers are allowed, as is often the case, to make up losses very gradually or at loan maturity. However, the powerful unemployment correlations shown in this paper means that prolonged unemployment will clearly do no good not only to borrowers, but also to financial institutions holding what could become zombie mortgages.

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