Is It Worth It? A Closer Look at Borrowers' Negative Equity Positions

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Karen Leone de Nie: *Welcome to the Federal Reserve Bank of Atlanta's* Perspectives on Real Estate *podcast series. I'm Karen Leone de Nie with the Federal Reserve Bank of Atlanta. Today, we're talking with Mark Fleming, chief economist at CoreLogic. Mark served as a panelist at a conference hosted by the Atlanta Fed on December 1 called Exploring Impediments to a Real Estate Recovery: A Policy Discussion. This podcast will highlight some of his remarks on negative equity.*

Mark, thank you for joining me today.

Mark Fleming: Thank you for having me.

Leone de Nie: *So, to begin, I just wanted to ask, what is negative equity, and why might it serve as an impediment to real estate recovery?*

Fleming: Simply put, it's the situation where a borrower owes more on their home than the house is worth. And obviously that's a pressing issue in today's real estate economy, given the house price declines that have happened over the last couple of years.

de Nie: *And so, it's hard when we're talking about negative equity to not ask the question, what do homeowners finding themselves in this position tend to do? How do they react to being in negative equity?*

Fleming: That really depends in a lot of ways on how much negative equity they are under. If you are close to 100 percent, what we call CLTV—combined loan-to-value ratio—that's where your loan amount is equal to the value of your house. If you're only a little bit underwater, maybe by a couple of percent or two, you might do nothing. In fact, most people who are underwater at the moment are basically continuing to pay their mortgage because they feel that this is the house they want to live in, they can afford to pay their mortgage, they have their income coming in, so there's really no behavioral change. It's only when you reach deeper levels of negative equity that people start to think about choices around things like "strategic default," for example.

de Nie: *Can you tell us what a strategic default is, briefly, and also, what are the conditions that make a homeowner more likely to strategically default?*

Fleming: Simply put, strategic default is when someone willingly stops making their mortgage payments and goes into default even though they can afford to continue to make those payments. And there are three primary factors that drive strategic default based upon the research studies that have been done over the last couple of years.

One is, obviously, negative equity, and it's not just being underwater, but being deeply underwater. And most of the data suggest it's somewhere around 125 to 130 percent—so being more than 30 percent below your mortgage amount—that people start to really consider whether or not it's worth continuing to make that mortgage payment.

Whether or not it's an owner-occupied or an investor home. Obviously, if you live in the house, and it's your own home, the decision is much harder than if it is an investment property of yours.

And, then, finally, one of the most interesting ones, are that there seem to be very strong spillover effects in that people who know others who have strategically defaulted are much more likely to default themselves.

de Nie: *And so, what types of homeowners are experiencing negative equity?*

Fleming: It goes across a wide spectrum. It's mostly concentrated in a few states, the states that had big housing bubbles. So, we're talking about markets in Florida and Nevada and Arizona and California. It's also generally focused on exurban areas of large metropolitan areas, so the farther-flung suburbs are often places where you find lots of negative equity. People who bought new homes in those exurban areas, generally, during the house price increases of the earlier part of this decade are much more susceptible than those who bought homes in the '80s and '90s, for example.

de Nie: *And is there a specific price point at which houses are in negative equity right now?*

Fleming: Not really. It can go across the board. But we do find that it tends to be more concentrated in lower-priced homes—in the $100,000 to

$400,000 range—of course, that's where a large segment of homes in the United States do exist. But, I think the higher-priced homes—over $1 million, for example—generally, are less susceptible in large part because larger down payments were required when the home was bought in the first place.

de Nie: *And have you seen that there is any particular type of loan product that tends to be in a greater percentage of negative equity?*

Fleming: Certainly, the ARM [adjustable-rate mortgage] products that are associated more with certain areas or geographies. So, certain types of loan products were popular in the beginning part of this decade in certain geographies in response to the house price appreciation. So, the classic subprime 2/28 or 3/27s, as they're called, which were basically hybrid adjustable-rate mortgages, were very popular to keep up with house price appreciation, and those are now the ones, the people who are suffering from negative equity. I don't think it's necessarily because they have that loan product; it's because they were in a market that had a high appreciation rate and then, basically, the bubble popped.

de Nie: *And so, overall, what is the trend in negative equity, and where is it heading?*

Fleming: Negative equity is moving down very, very slowly. In fact, by such a small amount at the moment really that you could, sort of, characterize it as moving sideways, like many of the other housing statistics at the moment. It is declining not necessarily because of house price appreciation, which we don't see at the moment in most major metropolitan areas, but actually due to foreclosures, because foreclosed properties are often ones who are underwater and so, as foreclosures happen, negative equity is reduced. So, its reducing, I guess, is a good thing, but not necessarily for the best reason.

de Nie: *And how does that compare to the trends of the last couple of years?*

Fleming: It's come down consistently by a couple of decimal points on a percent, so, you know, 20 basis points a quarter for the last year and a half or so. But other than that, it's pretty much hovered right around 22 percent. When I say that, it's 22 percent of all mortgaged homes in the United States are underwater, that equates to about 10.7 million borrowers.

de Nie: *And so, if we were looking at some of those highly impacted states, like Florida or Nevada, what percentage of the homeowners in some of those states are in a negative equity position?*

Fleming: So, in places like Nevada, almost two-thirds of all homeowners are underwater. In fact, in the top five states for negative equity, almost half of all the negative equity borrowers are in just those five states. So, it's extremely concentrated in those markets where house price appreciation bubbles occurred.

de Nie: *And kind of thinking back more historically, what is the normal for negative equity? I think it's striking to say that over 20 percent right now is in negative equity, but what should we be looking to recover to?*

Fleming: All right, that's a great question. We, historically, never really tracked a long-time series of negative equity in large part because it's never really been a pressing national problem in the real estate industry up until the most recent decline in prices. But, we went back recently to 2006 with our data, and it looked like about a little over a million people were underwater in 2006, as compared to 10.7 million now, and 2006 happens to be, basically, where house prices peaked. So, even then, when house prices were running up, there were still a fair number of individuals who were underwater. Of course, I think, a lot of that has to do with, at that time in particular, people could leverage themselves highly. So you had folks who were getting 110 or 125 percent financing going into the sale in the first place.

de Nie: *And so, are you doing any forecasting to look at when we might get back to, or what we might see as, sort of, the "new normal" of negative equity in this housing market?*

Fleming: Yeah, so, forecasting for economists is obviously very tough, and in all likelihood I'll be wrong, but, of course, the fun is still doing it. So, we did look about a year ago at, basically, a scenario where we took the average underwater level of a borrower in different cities—so, Las Vegas, Detroit, Charlotte, places like Atlanta—and considered if they were to refinance into a new 30-year fixed-rate loan, and start to pay that down diligently, and house prices were to grow at an annualized pace of about 2 percent a year, it would take, on average, seven to 10 years in most major metropolitan areas for that average underwater borrower to get back to parity. And, in some markets—in, for example, places like Detroit—even after 10 years, they would still be underwater, in large part because, you know, such slow growth in the housing prices, combined with the level of depth of negative equity to start with, it's just really hard to make it up anytime soon.

de Nie: *Mark, thank you for joining us today.*

Fleming: Thank you.

de Nie: *This concludes our podcast with Mark Fleming, chief economist for CoreLogic. For more podcasts on this topic and others, visit the Atlanta Fed's website at frbatlanta.org. If you have comments or questions, please e-mail podcast@frbatlanta.org.*

Thank you for listening.