High-Risk Defaults Could Be ‘Canary in The Coal Mine’ For Mortgage Market and Other News

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Mortgage defaults are on the rise among the highest-risk borrowers, a trend some see as a harbinger of a weaker economy.

The prepayment rate, defined as at least two missed payments during the first six months of a mortgage, has doubled over the past year for borrowers on loans secured by the Federal Housing Administration, according to data from mortgage analytics firm Recursion.

The trend is even more pronounced in the lowest credit profile of FHA mortgage holders. Among those with a credit score of 550 or less, nearly 10% had early payments as of October 1, compared with 5.5% a year ago and 4% before the pandemic.

“You can really see a cohort of borrowers starting to get into trouble even when the unemployment rate is low,” said Richard Koss, chief scientist at Recursion and associate professor at Columbia University.

Among homeowners, FHA mortgage holders tend to have the least financial security. They often have more debt, lower incomes, and fewer savings opportunities than other types of mortgage borrowers.

These vulnerabilities make FHA borrowers acutely sensitive to changing economic conditions. Because of this, some economists and housing policy experts believe that an increase in early defaults may be a sign of weakness in the labor market, such as reduced working hours, which has not yet been reflected in the unemployment rate.

“If the consensus forecast of a global recession is correct, we will start to see cracks somewhere in the labor markets, this will not happen immediately,” said Mark Calabria, a former director of the Federal Housing Finance Agency current senior adviser to the Cato Institute “This is a part of the mortgage market that is worth keeping an eye on. The FHA is the canary in the coal mine for the mortgage market.”

The default rate among FHA borrowers was 1.7% as of October 1, almost a full percentage point higher than since summer 2021 and well above its pre-pandemic level of 0.5%. The overall delinquent rate on FHA loans was nearly 8%, compared to about 3% for loans backed by the Department of Veterans Affairs and less than 1% for loans backed by state-funded enterprises Fannie Mae and Freddie Mac.

Experts attribute this surge to the depletion of savings in the pandemic era, the end of some COVID-19-related support and protection programs, and the impact of inflation on household budgets. Calabria suggested that this trend may reflect working conditions not included in employment statistics, such as shorter working hours.

Calabria said the FHA delinquencies provide the closest-to-real-time insight into how labor market trends are affecting low- and moderate-income households. Trends in the rental market will give a better idea, he said, but that data is tracked locally and is often reported with a delay.

"FHA borrowers are the ones most exposed to the job market among homeowners," he said. "This is a kind of indicator of what is happening among the tenants. If we had good data on evictions and past due rents with broad coverage, they would begin to reflect the same. So this may just be the beginning of the first signs of the recession that many are seeing."

FHA-backed loans do not have a direct impact on banks' balance sheets because they are insured by the federal government. In addition, over the past decade, banks have largely abandoned mortgage lending. However, the surge in mortgage delinquencies often correlates with delinquencies on other loan products commonly offered by banks, including credit cards, auto loans, and home equity lines of credit.

"This phase of the delinquent mortgage is of particular concern because [such delinquencies] didn't rise during COVID like credit cards did, and the emergency phase of COVID is over, so no one is expecting a new mortgage phase," said Derek Tang, co-founder of Washington-based research firm Monetary Policy. Analytics. "Renewable delinquencies in real estate stocks have already shown little signs of growth."

Tang noted that while the trends in arrears across different types of loans are often similar, they do not necessarily evolve in sync.

"Of course, there are joint dynamics between mortgage delinquencies and other loans, but the patterns are different," Tan said. "So when households have to decide, it's interesting what they prioritize. During previous stresses, credit card delinquencies rose slightly later than mortgages, but were essentially the same. In contrast, the spike in student loan arrears came later as they cannot be repaid and are declining more slowly."

Peter Earl, an economist at the American Institute for Economic Research, said housing costs have historically been seen as a top priority for households when it comes to servicing debt. That has changed in recent decades, he says, as consumers have begun to prioritize paying with their credit cards, which carry immediate penalties for non-payment, rather than mortgages, which can go unpaid for months before foreclosure becomes possible.

However, it's hard to predict how consumers will behave or how markets will react in the current economic environment, Earl said. He noted that the country is still absorbing the shock of COVID-19-related closures, as well as record fiscal and monetary responses to them.

"The old scenario, going back to 2008 and earlier, is hard to apply now," Earl said. "The economy is shrinking, we see it, but the combination of supply chain issues and the first inflation we've really had in 40 years makes it hard to use old models and examples of how things have played out in the past."