Mortgage defaults at lowest levels in five years

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(PhysOrg.com) -- Default risk on home loans fell once again this quarter to its lowest level in more than five years, says a professor at the University of Michigan's Ross School of Business.

Dennis Capozza, professor of finance and real estate and the Dykema Professor of Business Administration, says that under current economic conditions, investors and lenders should expect defaults on loans currently being originated to be just slightly higher than mortgage defaults in early 2005.

Capozza's UFA Default Risk Index, which measures the risk of default on newly originated prime and nonprime mortgages by tracking local and national economic conditions, registered 143 during the current quarter.

This means that homeowners are 43 percent more likely to default on their loans than the average of loans originated in the 1990s—but still much less likely than the worst years of the economic downturn from 2006 to 2008. The peak level of 362 was set in 2007.

While the index shows that default risks remain high, mortgage originators should be less apprehensive about new originations, Capozza says. Rising inflation expectations and decelerating rates of house price decline have helped spur lower default rates.

"If the Fed is successful in raising the inflation rate with a new round of quantitative easing, nominal house prices will not have to fall as far to restore equilibrium, and defaults will be mitigated," said Capozza, who is a founding principal of University Financial Associates (UFA), a risk-management firm that forecasts mortgage and consumer loan performance.

"Furthermore, we are seeing a deceleration in the decline in house prices, although this may be a temporary result due to the expiration of the federal government home-purchase subsidy program. Initial evidence is already suggesting that the surge in buying at the expiration is being reversed out."

The UFA Default Risk Index measures the risk of default on newly originated prime and nonprime mortgages. The analysis is based on a "constant-quality" loan, which has the same borrower, loan and collateral characteristics. The index reflects only the changes in current and expected future economic conditions, which are much less favorable currently than in prior years.

Provided by University of Michigan