Last year's model: stricken US homeowners confound predictions

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When Ray McDaniel, president of Moody's, addressed a debate in Davos last week, the mood was so hostile that some speakers joked that he was brave to appear "without a bodyguard".

No wonder. As the credit squeeze persists, ratings agencies are being forced to downgrade thousands of securities, after failing to foresee the recent wave of defaults, particularly in subprime loans. On Wednesday night alone, **Standard & Poor**'s downgraded more than 8,000 residential mortgage-related securities worth some $534bn (£268bn, €360bn).

These downgrades have triggered bitter recriminations, amid a wave of losses at asset managers and banks. "Much of the money lost has been held by people who held AAA securities [that were downgraded]," points out Wes Edens, head of Fortress Investment Group, a big hedge fund. "That has caused a tremendous loss of confidence."

But the downgrades have also left policymakers and analysts scrambling to determine what has gone so badly wrong. As this search intensifies, some economists are starting to suspect that the answer lies in a striking recent change in American household choices - a shift that could have important implications for policymakers and investors alike.

In particular, it seems that mathematical models used to predict future default rates, based on past patterns of losses, have gone wrong because they did not adjust to reflect shifts in household behaviour. Or, to put it another way, financiers have been tripped up because they ignored one of the most basic rules of investment, which is usually found in product literature: the past is not always a guide to the future.

"There has been a failure in some of the key assumptions which supported our analysis and modelling," Mr McDaniel admits. "The information quality deteriorated in a way that was not appreciated by Moody's or others." Mortgage borrowers, in other words, did not behave as expected.

The issue at stake revolves around so-called delinquency rates, the proportion of people who fall behind on their debt repayments. When American households have faced hard times in previous decades, they tended to default on unsecured loans such as credit cards and car loans first - and stopped paying their mortgage only as a last resort. However, in the last couple of years households have become delinquent on their mortgages much faster than trends in the wider economy might suggest. That is particularly true of the less creditworthy subprime borrowers. Moreover, consumers have stopped paying mortgages *before* they halt payments on their credit cards or automotive loans - turning the traditional delinquency pattern on its head. As a result, mortgage lenders have started to face losses at a much earlier stage than in the past.

"In the past, if a household in America experienced financial problems it tended to go delinquent on its credit cards, but kept on paying its mortgage," says Malcolm Knight, head of the Bank for International Settlements, the central banks' bank. "Now what seems to be happening is that people who have outstanding mortgages that are greater than the value of their home, or have negative amortisation mortgages, keep paying off their credit card balances but hand in the keys to their house . . . these reactions to financial stress are not taken into account in the credit scoring models that are used to value residential mortgage-backed securities."

One possible explanation is that it has become culturally more acceptable this decade for people to abandon houses or stop paying in the hope of renegotiating their home loans. The shame that used to be associated with losing a house may, in other words, be ebbing away -

particularly among homeowners who took out subprime loans in recent years, as underwriting standards were loosened.Consumers may also be rationally re-evaluating the costs that come with defaulting on different forms of debt, in the light of recent bankruptcy law reforms in America.

But there is a more fundamental economic explanation. In the past, it has usually been assumed that mortgage defaults occurred due to cash flow problems: if a borrower lost a job, for example, he or she would no longer have enough income to service a housing loan. However, if households were actually running out of cash, they might have been expected to stop paying credit card debt too, to a greater degree - implying a change is afoot.

Previously in America, the property market has softened during times of recession and rising unemployment. But this time, house prices have fallen even though unemployment has not risen. Mortgage delinquencies started to surge two years ago, or as soon as house prices stopped rising and then started to fall. That might be because overstretched households with unsuitable loans were no longer able to refinance their way out of trouble, when house prices stopped rising.

But another explanation is that people with high loan-to-value mortgages no longer felt as strong an incentive to maintain payments when house prices started to fall - even if they were able to. This is because of the negative equity phenomenon - where house prices have fallen below the value of the loan or will soon do so.

Thus faced with a choice between keeping their car and maintaining payments on a house in which they had no equity stake, some households apparently chose to keep their wheels. Indeed, International Monetary Fund data that show delinquency rates on prime loans made in 2006 and 2007 - too late to benefit from house price gains - are rising more quickly than delinquencies on prime loans made in 2003 or 2004.

Since the mortgage market is still in flux, it is difficult to tell which explanation is the most accurate. However, if consumer behaviour has shifted, it has potentially crucial policy implications.

In recent months, Washington politicians have devoted a great deal of attention to the problem of "resets". This refers to the fact that many subprime borrowers took out loans in recent years at initial, ultra-low "teaser" rates, which typically rise (or "reset") after a couple of years. Around 1m of these subprime loans are due to reset this year, which means that many households could suddenly face sharply higher repayments. That in turn has sparked fears of a looming further rise in delinquencies by increasingly cash-strapped households.

To offset this risk, the administration of President George W. Bush recently brokered a plan to freeze the resets. Yet in private, Treasury officials admit that while the scheme might help at the margins, it is unlikely to be a "silver bullet". This is because one dirty secret of recent mortgage data is that, thus far, there has been a surprisingly weak correlation between rate resets and delinquencies. That suggests that the reset freeze may have only a limited effect on foreclosures this year.

There is another implication - one that means debt holders may need to rethink their reliance on ratings. In earlier credit cycles, micro-level changes in household behaviour would probably have been spotted by bankers at an early stage, particularly if they had personal knowledge of their clients. But because banks have securitised mortgages in recent years, this contact between lender and borrower has shrivelled. "Nobody has stepped into the gap in terms of monitoring the quality of the loans," says Walter Kielholz, Credit Suisse chairman. Or as George Soros, the billionaire investor, puts it: "Securitisation had the effect of transferring risk from people who are supposed to know risk and know the borrowers to people who don't."

Investors have tried to fill this information gap by turning to ratings agencies. But these agencies have typically predicted defaults by using macroeconomic models that essentially extrapolated past trends into the future. Thus they have been ill-equipped to spot shifts in the fundamental economic drivers of delinquency or that loan underwriting standards had been collapsing to a point where fraud was often creeping into the mortgage chain.

In a sense, then, the securitisation industry has been fighting the last war, tracking the issues that created delinquencies in earlier recessions. Thus mortgage lenders and investors have been filtering loans in recent years on the basis of Fico scores (which measure cash flow management) rather than loan-to-value ratios (which denote exposure to house prices). While some officials inside the ratings agencies have tried to point out these shortcomings, the sheer volume of business that has engulfed the agencies has given them little opportunity to rethink their approach. "Ratings agencies have been very keen to rate things because they got fees," says Mr Kielholz.

The agencies and Wall Street economists are now scurrying to fix these problems in their models. Treasury and Federal Reserve officials are also conducting micro-level analysis to better understand the shift. But, making the problem doubly pernicious, it remains unclear how stable the current pattern is.

Some economists suspect that if house price declines continue but the US jobs market holds up, the pattern of high mortgage defaults relative to other forms of consumer credit could continue. However, if the US slips into recession or even a protracted period of rising unemployment, delinquencies might rise on a wide range of consumer credits, implying a return to a more traditional pattern. Indeed, some banks are starting to brace themselves for this latter shift. "The problems in the credit markets are spreading to the consumer sector - the next area of concern is auto loans and credit cards," says John Thain, chief executive of Merrill Lynch.

Nevertheless, one thing is clear: the credit crunch will force many institutions to rethink their reliance on backward-looking models and perhaps put a greater emphasis on behavioural economics. "Simply extrapolating from the past into the future is not good enough," says one US policymaker. Or as the beleaguered Mr McDaniel at Moody's adds: "We [in the ratings industry] know we have got to retool our processes."