

Five Fixes for the Foreclosure Crisis

“Research on home lending over the past decade clearly shows that during the run up to the crisis, lenders originated millions of loans they knew could not be repaid based on a borrower’s ability to pay.”

Roberto G. Quercia

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The foreclosure crisis has created two Americas: one prosperous and hopeful, the other hopeless and debt-burdened.

Sadly, the crisis could have been avoided if we had followed the same lending practices that enabled generations of Americans to buy homes and take that important first important step up the ladder to financial security.

Here are five policy actions that could help reduce foreclosures now.

Fix No. 1: Continue Economic Stimulus

UNC Center for Community Capital research confirms the important role that employment, or the lack thereof, plays in mortgage defaults, particularly among lower-income homeowners.

Reducing unemployment requires increasing the demand for goods and services, and recent testimony from the Congressional Budget Office finds that extending unemployment benefits and reductions in payroll taxes have the most potential for increasing economic growth and generating employment.

The U.S. Senate on Dec. 1 rejected two proposals that would have extended the payroll tax cut. One of the bills, the Middle Class Tax Cut Act of

2011, would have paid for the tax cuts with a 3.25 percent surtax on incomes over \$1 million. The measure gained a Senate majority but a filibuster prevented its passage.

Fix No. 2: Reduce Mortgage Principal

CoreLogic reports that 10.7 million residential properties posted negative equity – meaning the owner owes more than the value of the property – at the end of the third quarter 2011. Many of these borrowers cannot relocate to more promising employment opportunities because they cannot sell their house for enough money to get out of their mortgage. Consequently, negative equity is a strong predictor of foreclosure, which has significant adverse consequences for both the borrower and the neighborhood, including further reductions in property prices.

Center for Community Capital research finds that principal reductions in severely underwater markets have higher net present values than other forms of loan modification. However, programs to address distressed homeowners, such as the Home Affordable Modification Program (HAMP), have done little to address the issue of negative equity. According to the latest OCC and OTS Mortgage Metrics Report, only 5.5 percent of HAMP loan modifications in the first half of 2011 involved principal reductions, while most “capitalized” missed payments (added missed payments to the principal). And unlike most other forms of debt, mortgages cannot be modified through bankruptcy.

Fix No. 3: Restrict Loan-Level Price Adjustments

Mortgage interest rates are at historic lows, but many borrowers are unable to take advantage because their financial situation has deteriorated to the point that they do not qualify for the

headline rate. High loan-to-value ratios and low credit scores require higher interest rates, but the increase in debt burden affects the probability of loss – an important difference between risk-based pricing in car, health and property insurance and risk-based pricing in financial markets.

Center for Community Capital research shows a feedback loop exists in which credit scores impact future credit options and subsequently also the individual's future credit characteristics and score. Not surprisingly, a study by researchers at the Federal Reserve and Urban Institute finds one-third of prime borrowers do not return to their pre-delinquency credit score 10 years after foreclosure.

Fix No. 4: Aid State and Local Governments

Reliance on property tax revenue among many jurisdictions and general economic stress has caused severe and persistent budget shortfalls in many state and local governments. Required by law to have balanced budgets, many are forced to shed jobs. In the last two years, total private employment rose 2.6 percent nationwide, while employment by state and local governments declined 2.6 percent.

The Center for Economic and Policy Research shows local austerity has counteracted much of the federal stimulus over the past several years. A brief by The Brookings Institution argues federal programs designed to target distressed areas, such as the Neighborhood Stabilization Program, have been flawed by being insufficient and too restrictive.

Fix No. 5: Hold servicers accountable to do their jobs.

A key factor that has dragged the foreclosure crisis out longer than necessary is the failure of many mortgage servicers to take steps to reduce foreclosures. Instead, they are contributing to the problem.

One of the more scandalous revelations of the foreclosure crisis was the discovery of “robo-signing,” a practice in which bank employees signed thousands of foreclosure documents without properly reviewing the paperwork.

Further, findings from research conducted by the Center for Community Capital and recently confirmed by economists at the Federal Reserve Bank of Chicago and colleagues, show that who your mortgage servicer is effects how likely you will be to keep your home once you get into trouble.

Unfortunately, homeowners have little or no control over this critical part of the mortgage process. Borrowers cannot choose who services their loan, and the inner workings of the mortgage servicing and foreclosure machine are usually unfathomable to them.

Take for instance, the Mortgage Electronic Registration System (MERS). This clearinghouse for mortgage titles claims to hold title to roughly half of all mortgages, yet few borrowers have ever heard of MERS. Massachusetts Attorney General Martha Coakley has just filed a civil lawsuit against MERS and five major banks for unlawfully seizing properties.

Servicers are responding to government calls for greater responsiveness and setting up a “single point of contact” but this is just a small and long overdue step in the right direction. As a critical link in the chain between borrowers and investors, servicing weaknesses must be addressed.

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