



Understanding the Foreclosure Crisis And the Policy Responses

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*Center for Community Capital
Research and analysis on the
transformative power of capital*





Outline of Presentation

- Signs of the crisis
- How did we get here?
- Current paradox
- Examining the evidence
- Policy responses
- Looking ahead



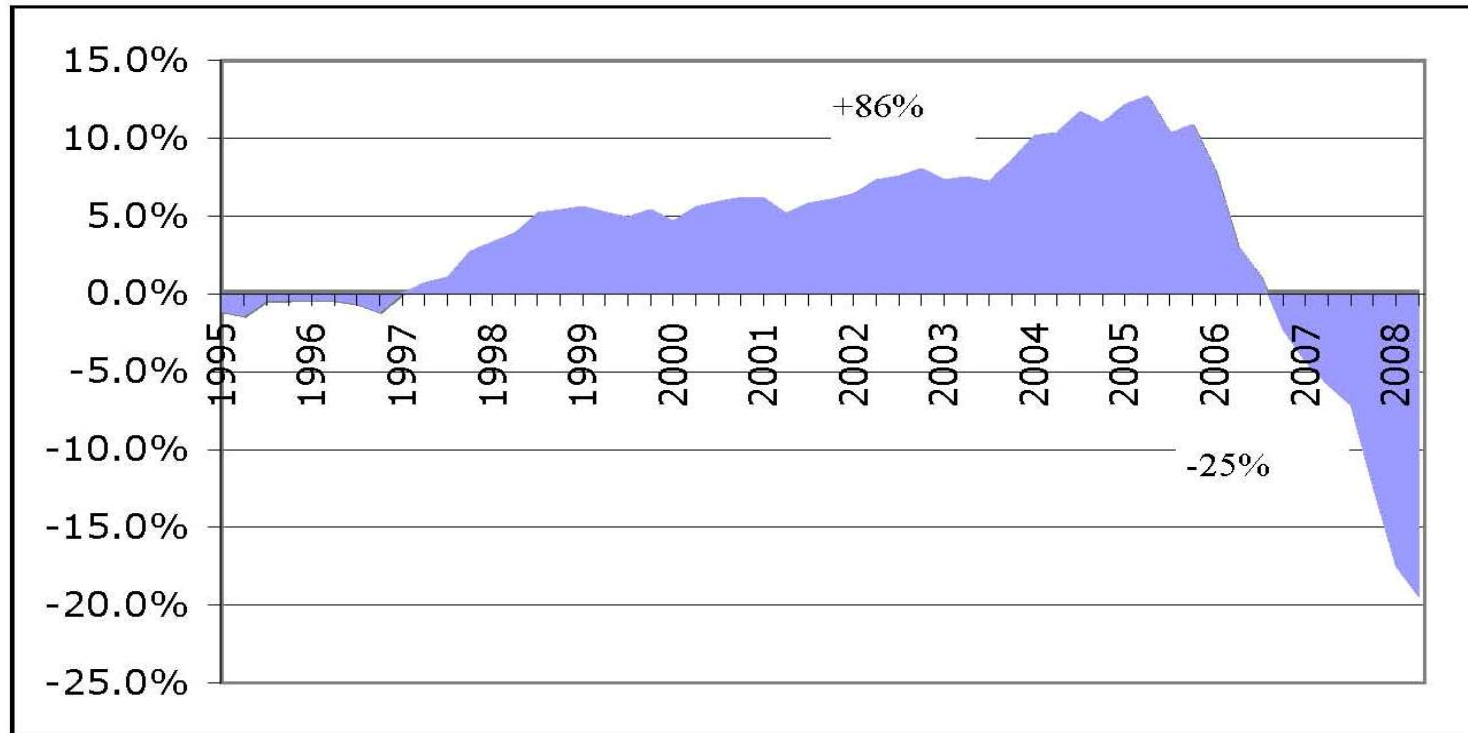
Signs of the Current Crisis

- Foreclosures are up
- Increasing number of homes for sale
- Many homeowners are “underwater”
- Economic downturn—unemployment on the rise
- Credit crunch—difficult to obtain all types of credit
- Fiscal deficits by states and localities



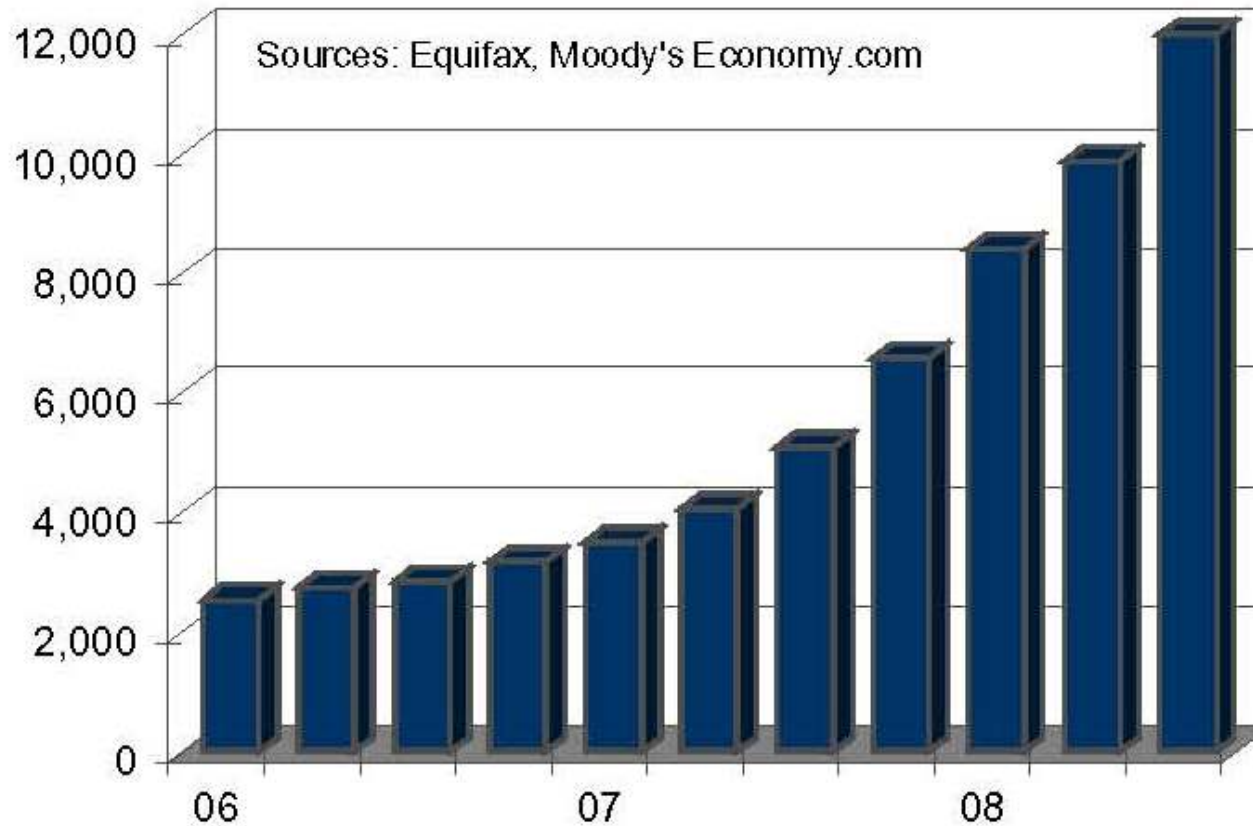
House Prices Are Declining

10 million homeowners have no/negative home equity





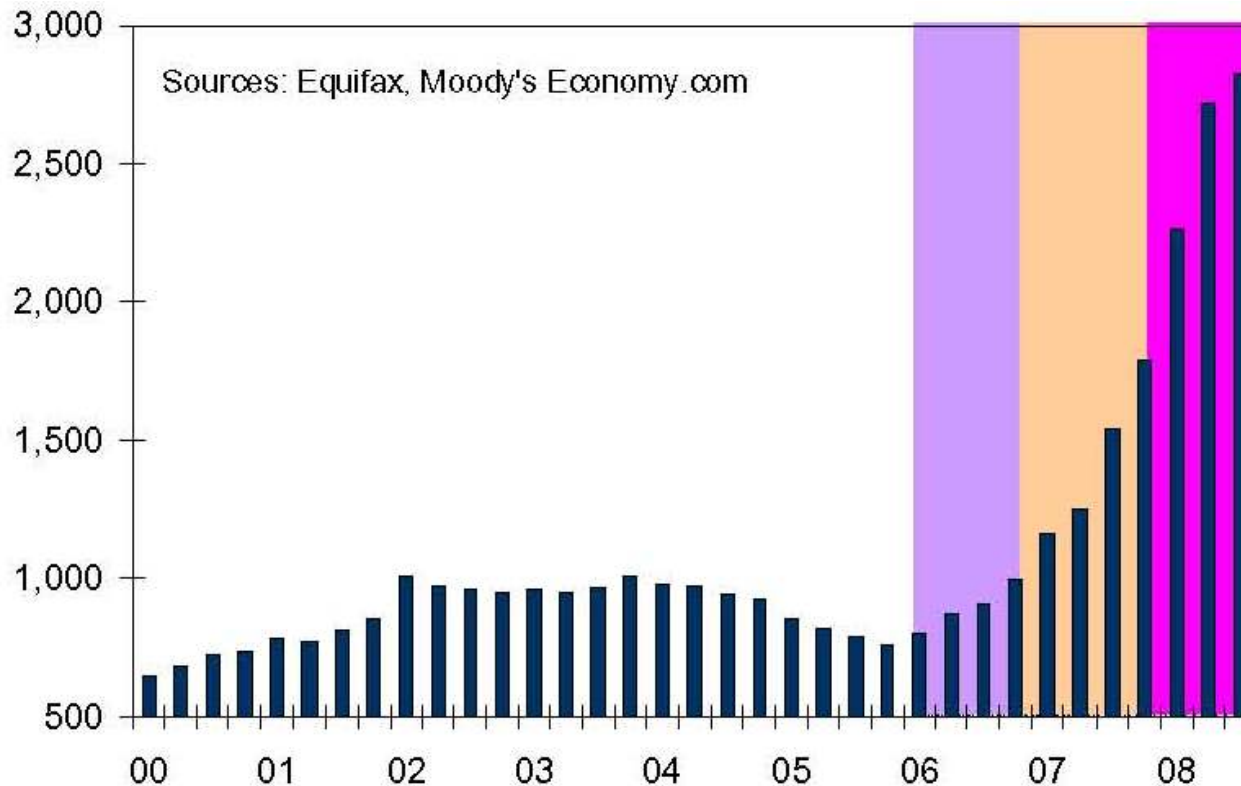
Properties with Negative Equity Increased Sharply



Source: Moody's Economy.com. In 1,000s.



First Mortgage Loan Defaults Increased Sharply



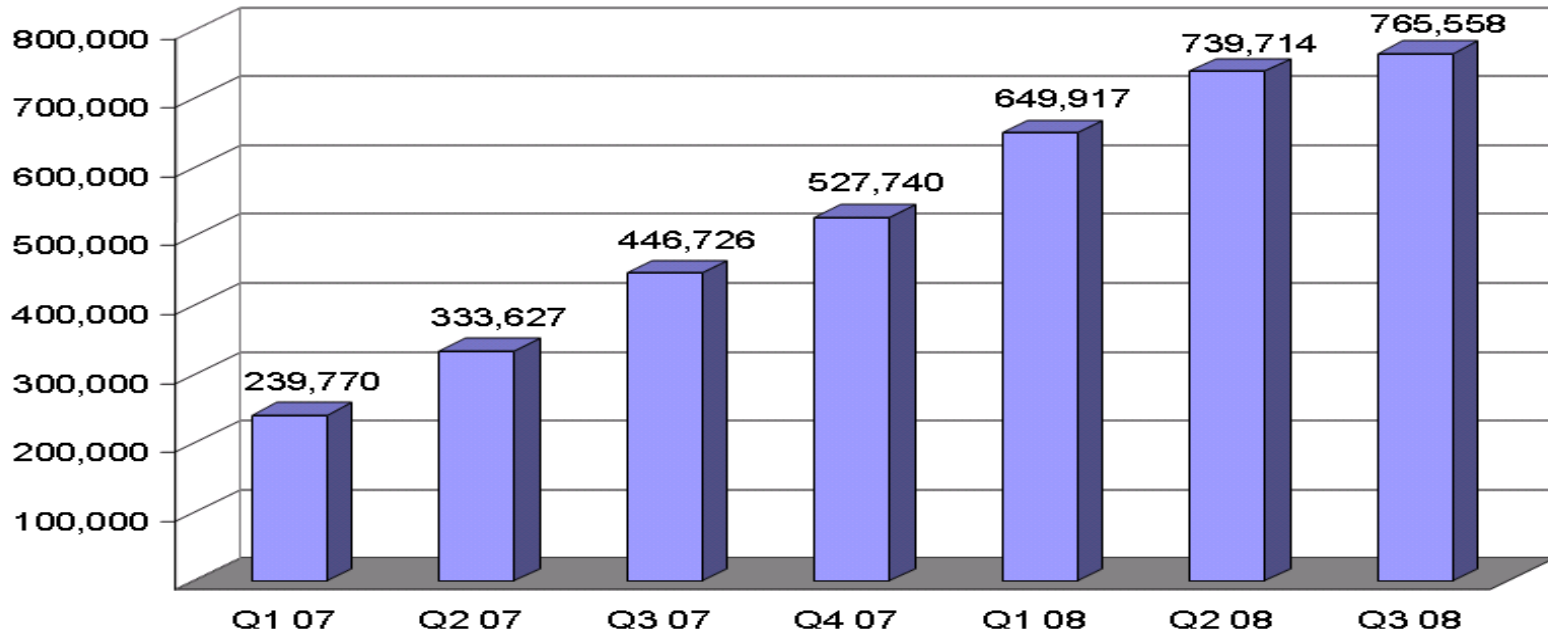
Source: Moody's Economy.com. Default here is defined as receiving the notice of default (in thousands).



Foreclosure Filings Are Increasing

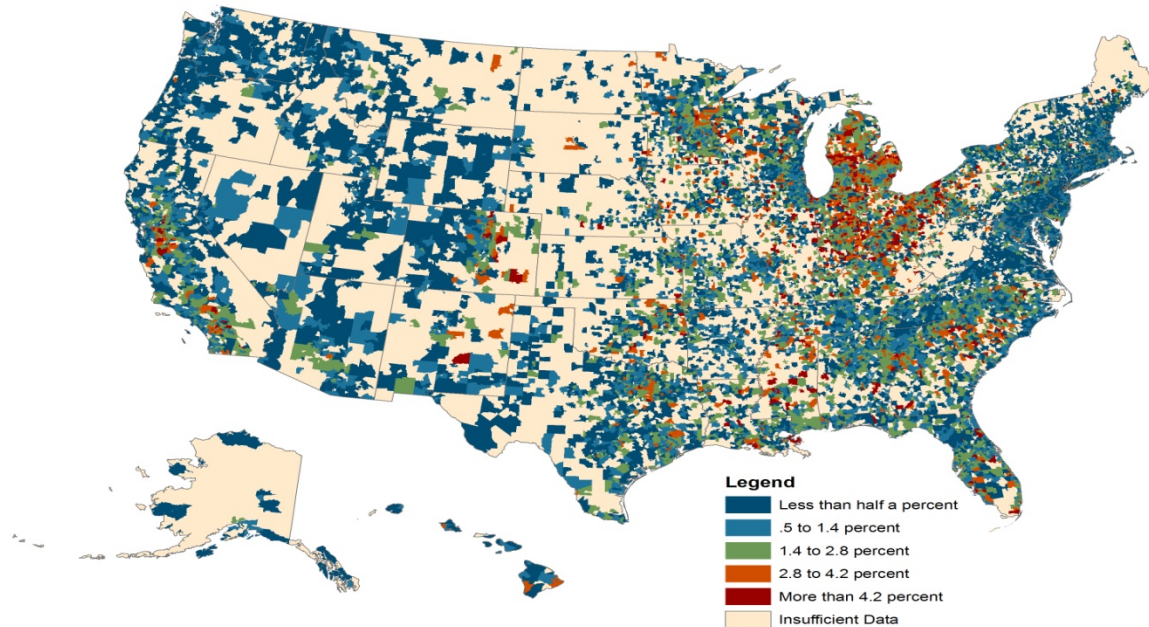
5 million households in default/foreclosure process
2700 families lose their home every day

Properties with Foreclosure Activity



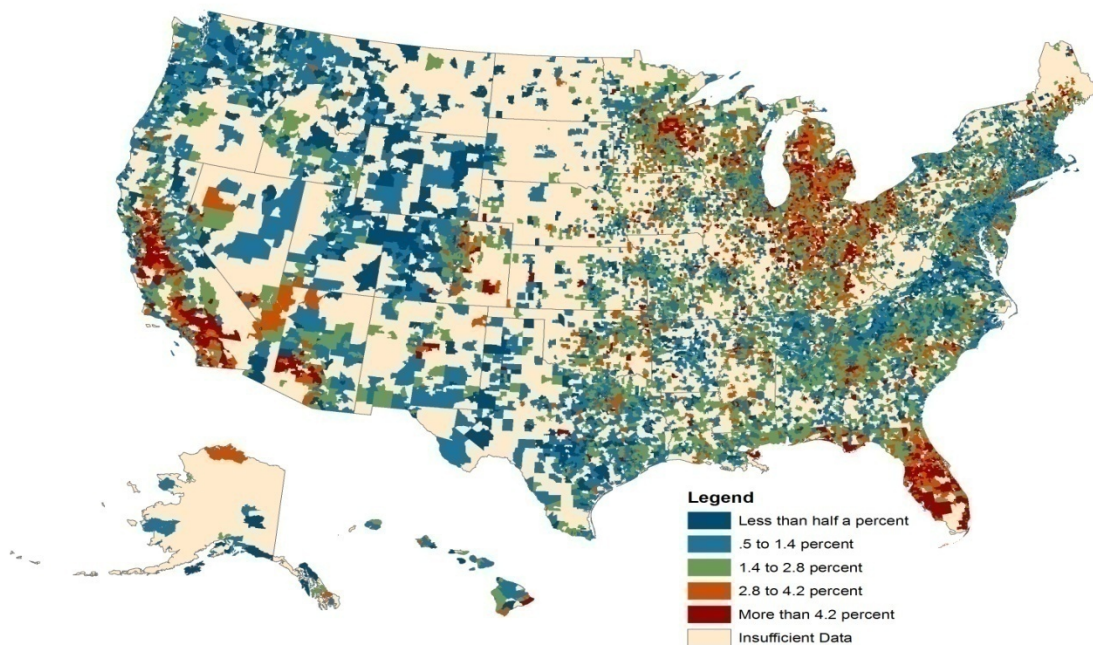


Percent of Mortgage Loans in Foreclosure or REO (by zip code) September 2007





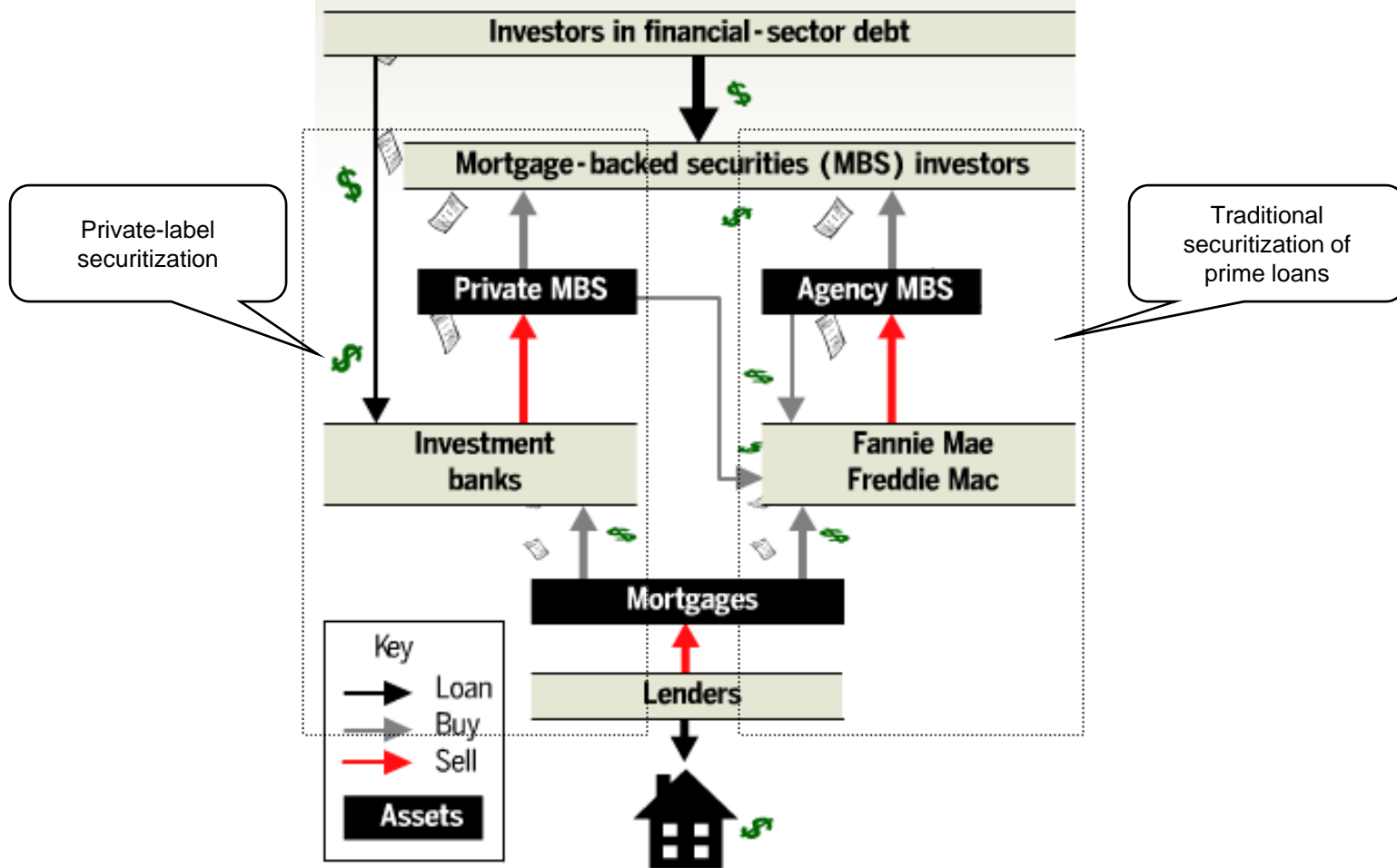
Percent of Mortgage Loans in Foreclosure or REO (by zip code) August 2008



Source: FRBSF calculations, McDash Analytics, LLC

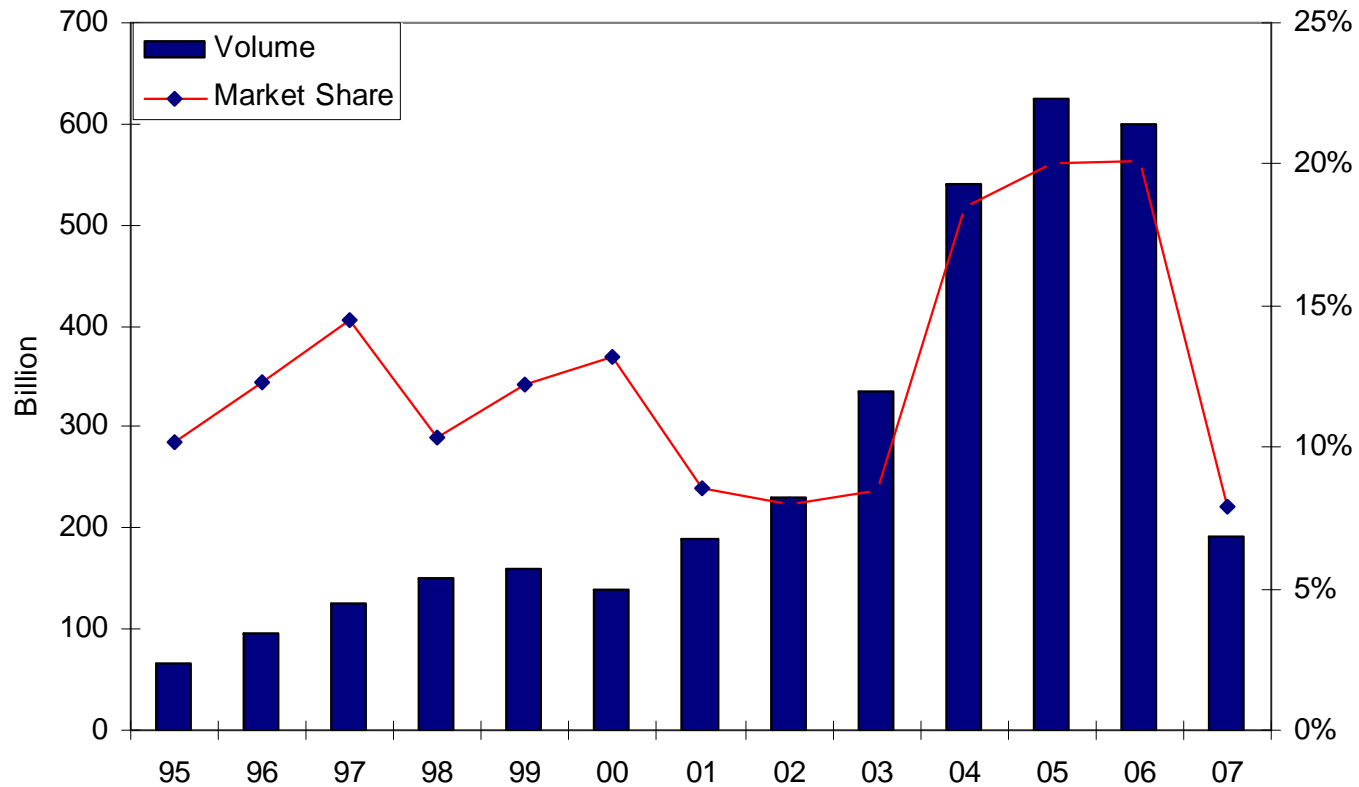


How Did We Get Here: The US Mortgage Market





Dramatic Growth of Subprime Lending



Source: Inside B&C and Inside Mortgage Finance (2008)



Mortgage Backed Securities

- A MBS is a bond whose payments are based on the payments of a collection of individual mortgages
- Initial sales of the bonds are put together either by the two GSEs or by private Wall Street financial institutions such as Countrywide, Lehman Brothers or Wells Fargo
- Rating agencies rate risk quality of bonds (e.g., Moodys, Standard and Poors)
- Insurance companies insure against losses through insurance or credit default swaps (e.g., AIG)

Structure of a MBS Security

| Bond Class | Percent of Pool | Rating |
|------------|-----------------|-----------|
| A | 94.15% | AAA |
| B1 | 2.00% | AA |
| B2 | 1.50% | A |
| B3 | 1.00% | BBB |
| B4 | 0.65% | BB |
| B5 | 0.40% | B |
| B6 | 0.30% | Not rated |

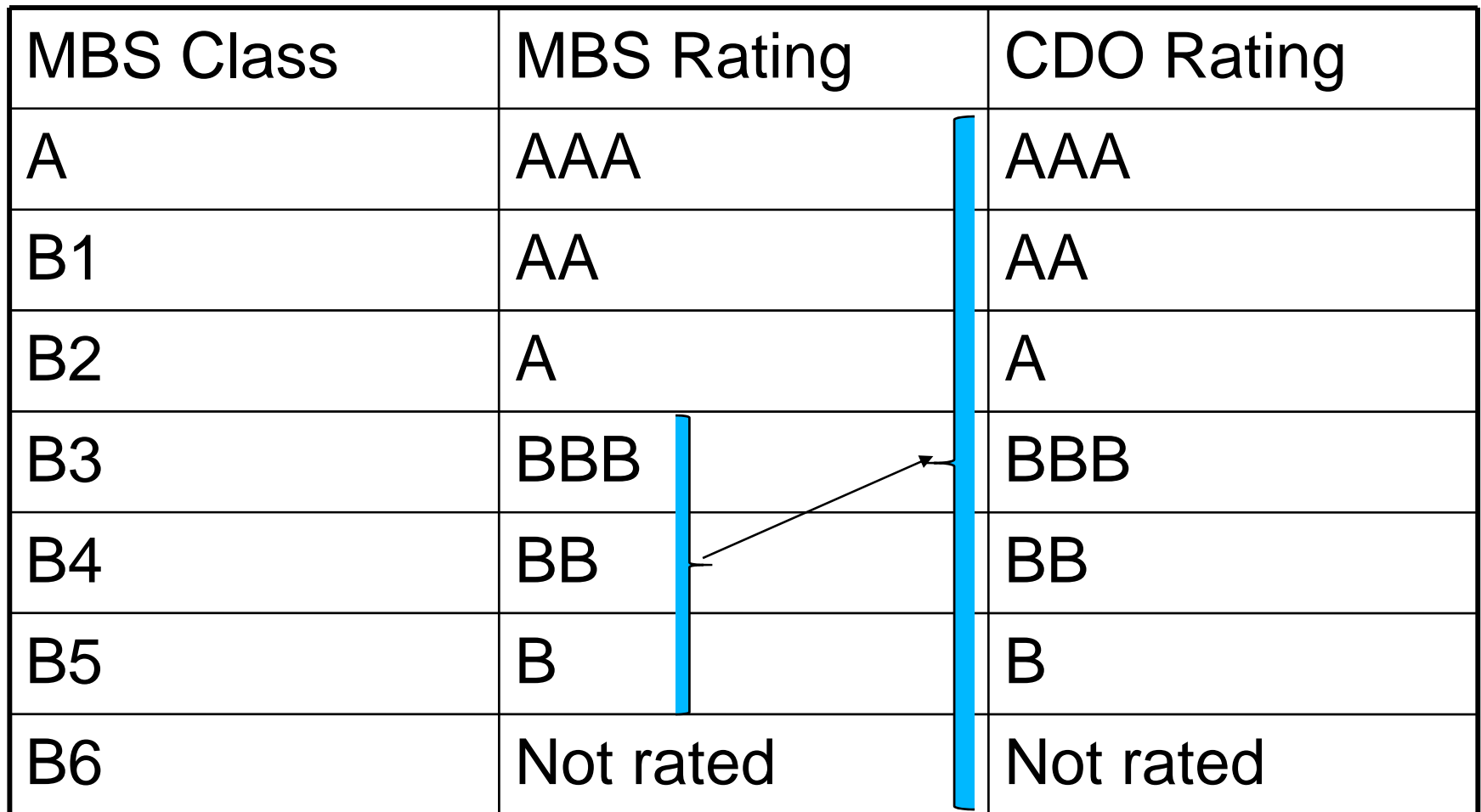


Re-Securitization

- Often pools of MBSs are/were collected and securitized
- Bonds that are themselves backed by pools of bonds are referred to as collateralized debt obligations (CDOs)

Problem of toxic or “legacy” securities...

| MBS Class | MBS Rating | CDO Rating |
|-----------|------------|------------|
| A | AAA | AAA |
| B1 | AA | AA |
| B2 | A | A |
| B3 | BBB | BBB |
| B4 | BB | BB |
| B5 | B | B |
| B6 | Not rated | Not rated |





Subprime Lending and Securitization 2006 – The Peak of Subprime lending

- Ginnie Mae guaranteed the mortgages underlying only 4% of all MBS issued
- Fannie and Freddie purchased conforming loans ($\leq \$417,000$) to back MBS
 - Accounted for 40% of MBS issued
- Remaining 56% packaged by private sector financial institutions (“Wall Street”)
 - 71% of total private sector MBS issuances are subprime and Alt-A



Who is to Blame? The Usual Suspects

- Borrowers for overextending themselves
- Real estate agents, appraisers, builders for focusing on short term profits without regard to ability to pay
- Wall Street for reckless securitization and lack of due diligence
- Credit rating agencies for poorly evaluating risky instruments
- Insurance companies for insuring them
- Fannie Mae and Freddie Mac for encouraging reckless lending
- Alan Greenspan for keeping interest rates low for a long time
- **Government regulators for not doing their job**
- **Lenders/brokers for not doing the one thing they are supposed to do: proper underwriting**

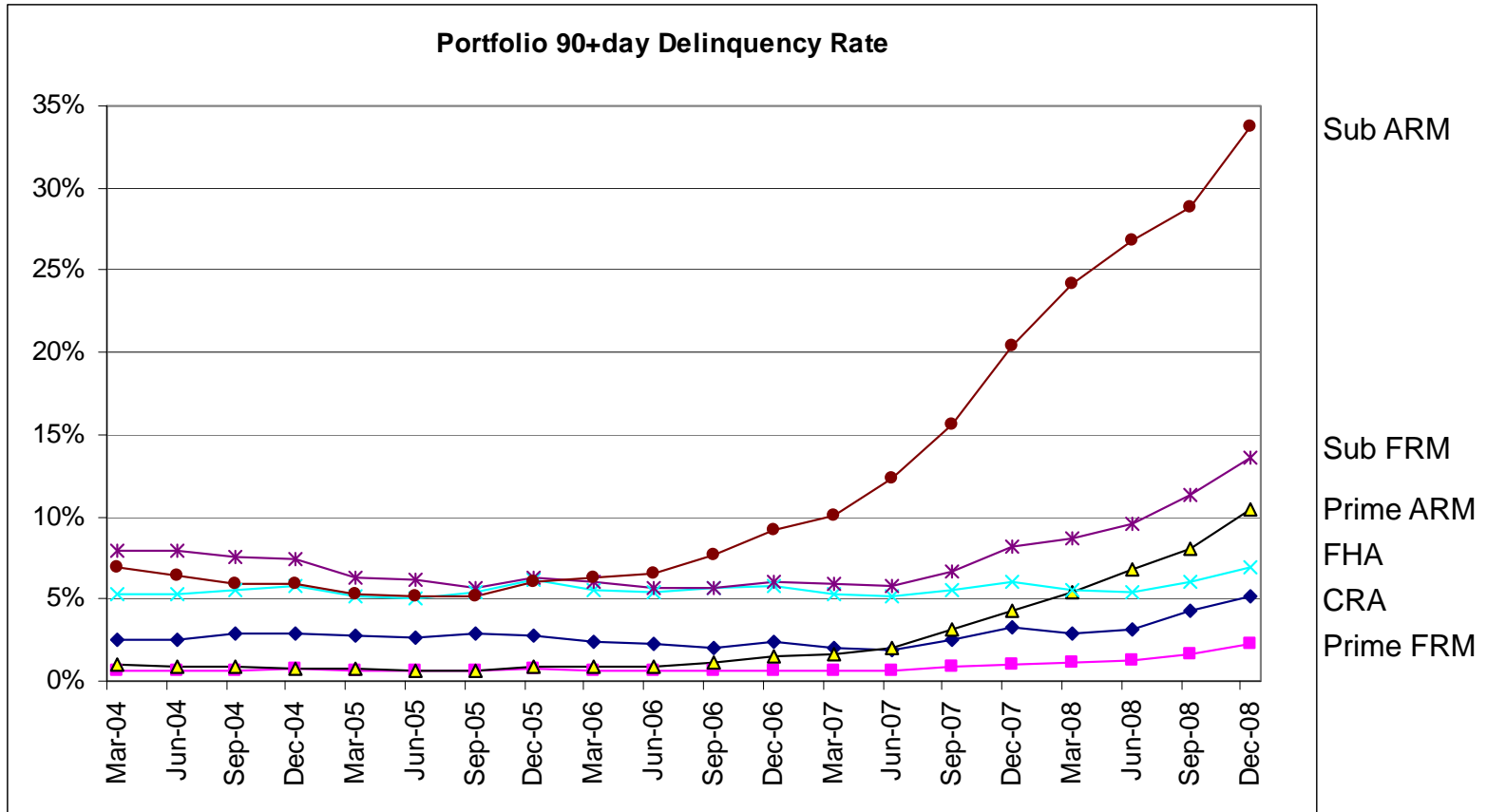


The Current Paradox

- For many, the pendulum is swinging towards re-regulation
- Yet there are those who would blame the crisis on the promotion of low income home-ownership
 - CRA
 - Affordable housing goals of the GSEs
- Who is right? The outcome of this debate is likely to have important policy implications moving forward



Performance of Community Lending is to Prime FRM Subprime Products have the worse Performance





Examining the Evidence: Risky borrowers? Risky products?

- Borrowers holding subprime loans are generally weaker across key underwriting criteria: down payment, credit history/score, and repayment capacity (debt ratios). Yet, many of these borrowers could have obtained a prime mortgage (Freddie Mac 2005)
- Subprime loans have features found to significantly add risk
 - Prepayment penalties and balloon payments (Quercia, et al. 2007; Danis and Pennington-Cross, 2005)
 - Adjustable rate (Calhoun and Deng, 2002)
 - Interest only, hybrid, option ARMs (Ambrose, LaCour-Little, and Huszar, 2005; Pennington-Cross and Ho, 2006)
- It is difficult to isolate the impact of loan features unless we are comparing borrowers with similar risk characteristics. This study compares the relative risk of loan products (CRA and subprime) for borrowers with the same risk profile.

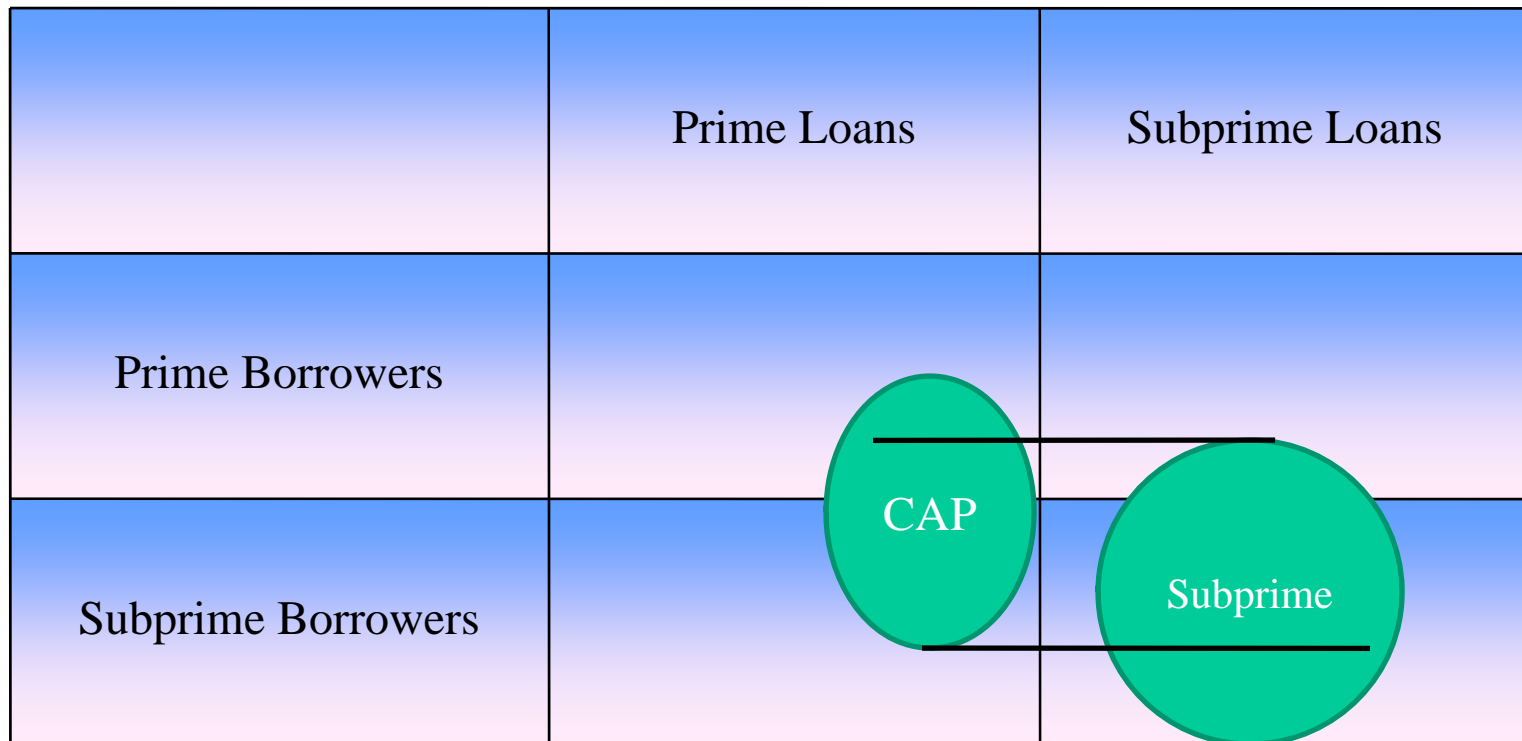


Data

- Subprime mortgages
 - McDash Analytics
 - Loan level info for 15 mortgage servicers
 - Tracking 20 million active loans (monthly basis)
 - Sample includes B&C loans, high-cost ARMs
- Community reinvestment loans
 - Since 1998, Community Advantage Program CAP provides secondary market outlet for CRA loans
 - Self-Help, Fannie Mae, Ford Foundation effort
 - 9,221 CAP loans originated during 2003-2006

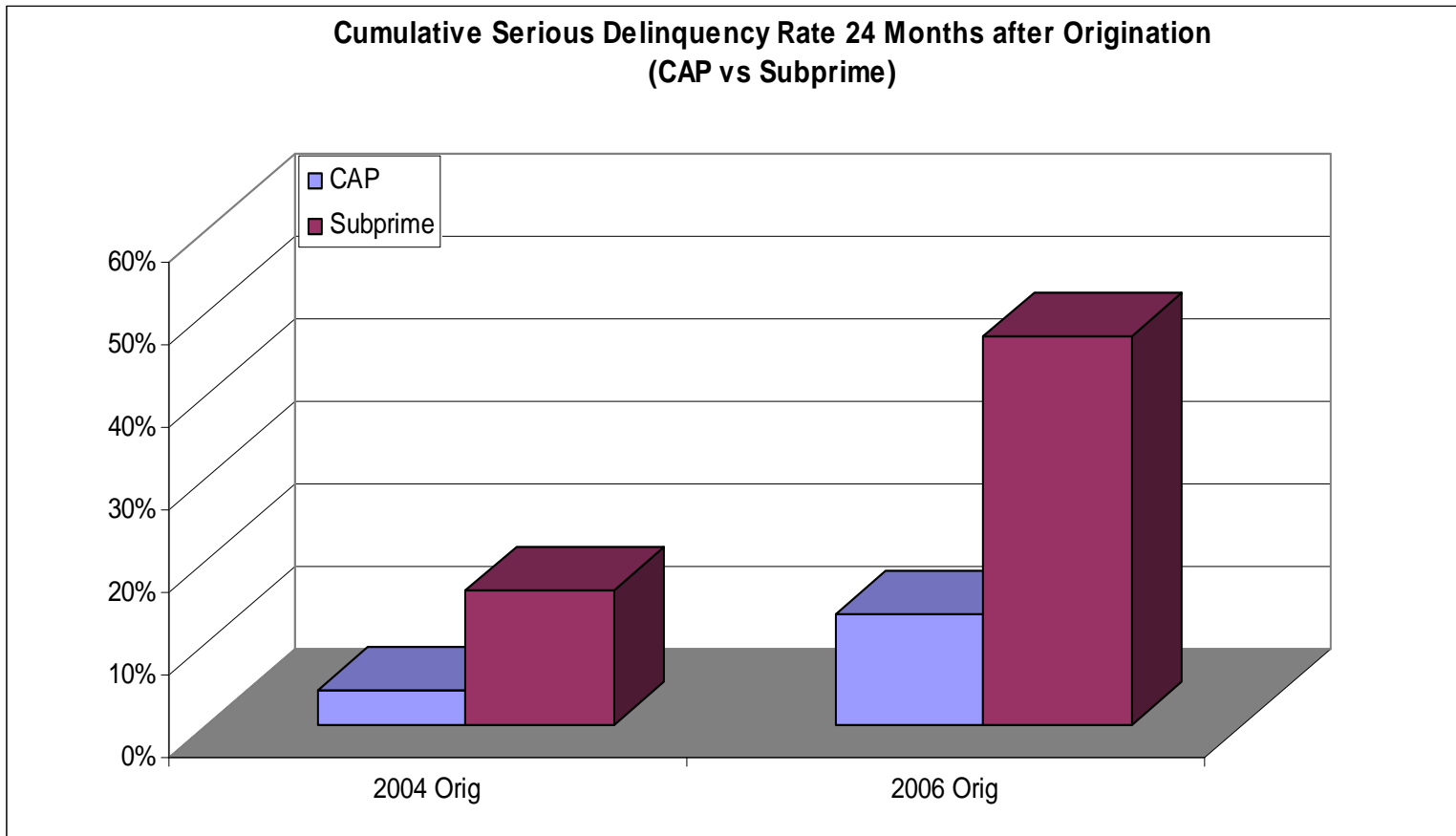


Propensity Score Match : focusing on borrowers with similar risk characteristics but holding different products (CAP or subprime)





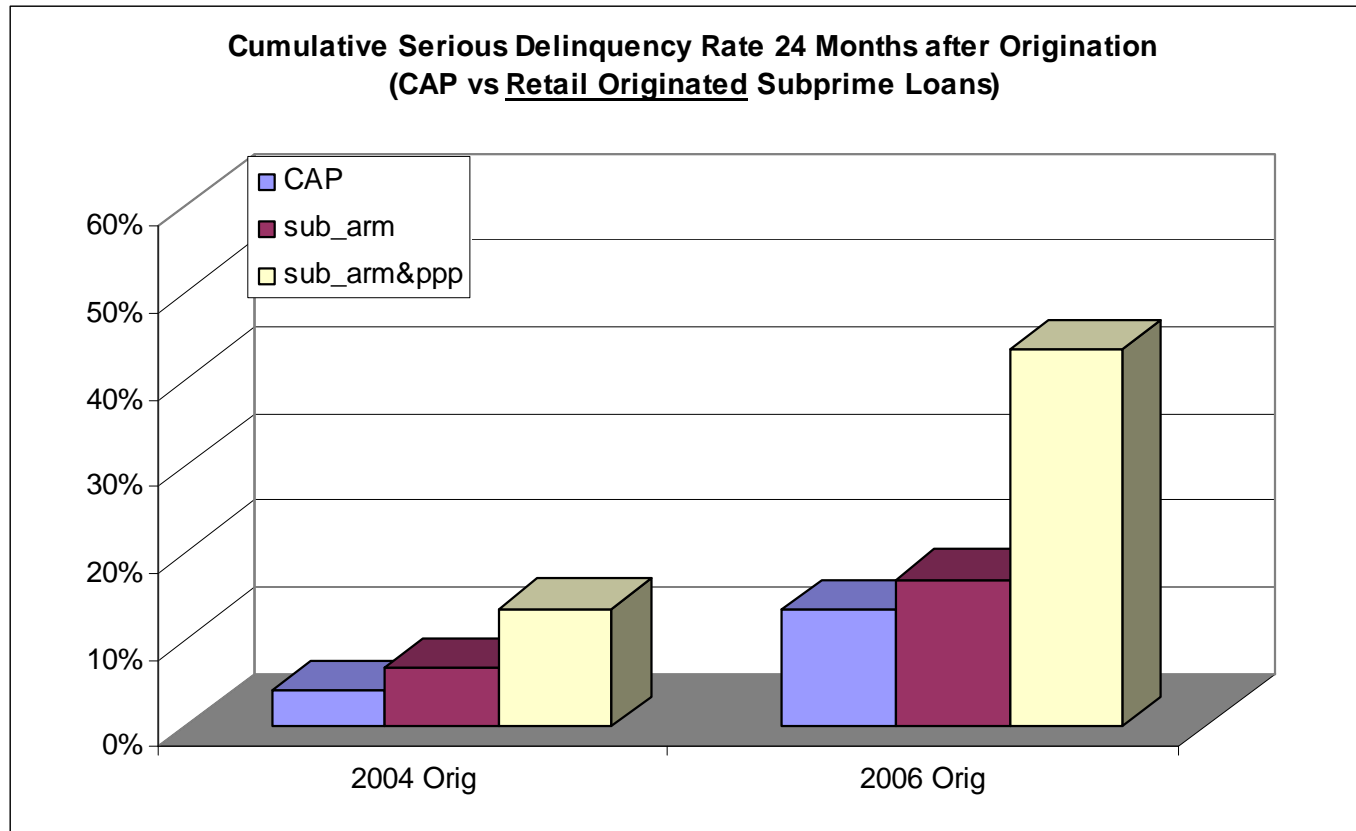
Matched Sample – Subprime Loans Do Worse Predicted Serious Delinquency 24 Months after Origination



: Estimation is based on a borrower with a FICO score between 580-620 with the mean value of other regressors. Controlling variables include borrower DTI, FICO_score, home equity, loan age, loan size, area credit risk, area unemployment rate, and interest rate environment.



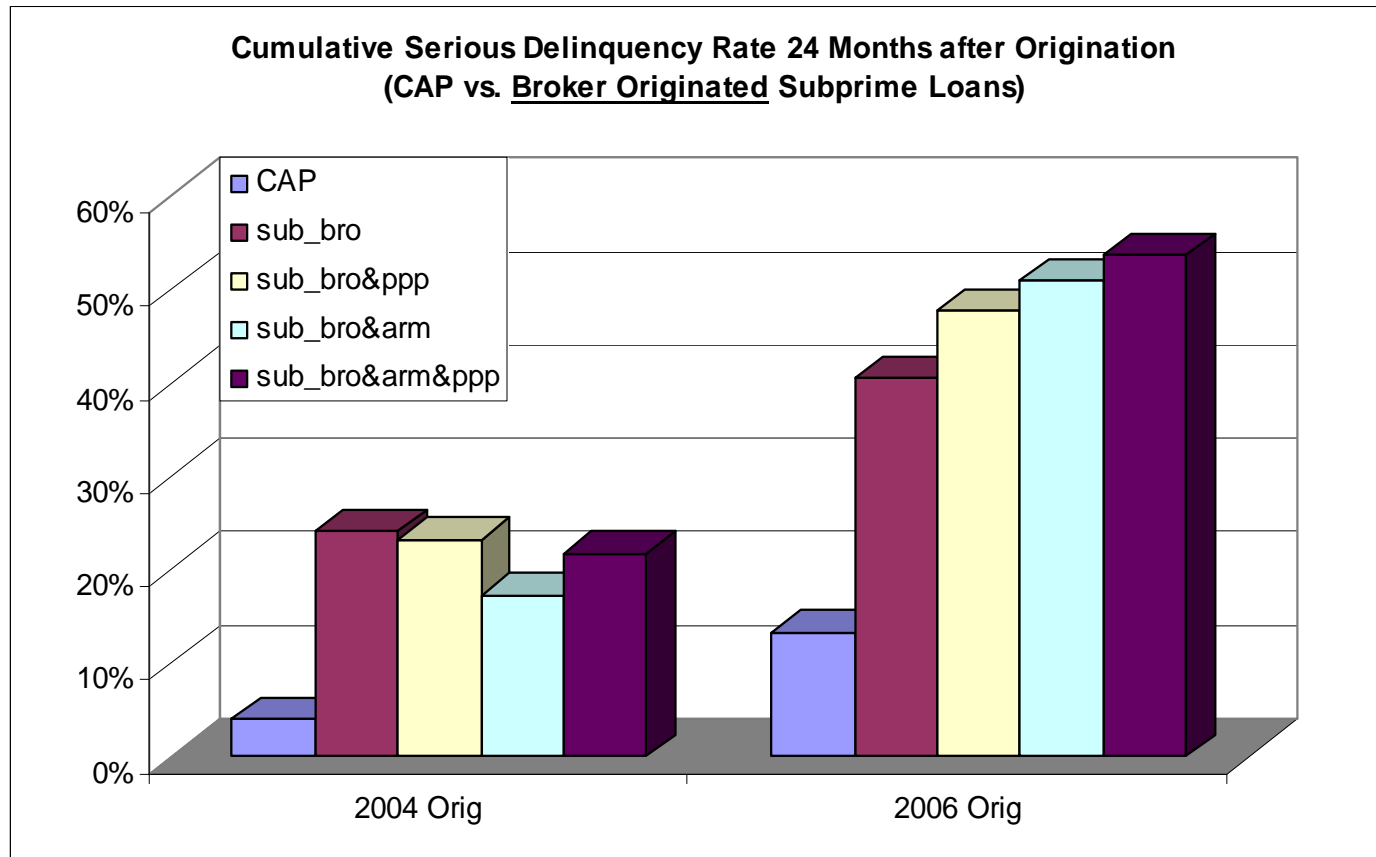
Predicted Serious Delinquency 24 months after Origination Community Lending (CAP) and Retail Subprime loans



Note: Estimation is based on a borrower with a FICO score between 580-620 with the mean value of other regressors. *sub_arm* represents retail originated subprime ARMs without prepayment penalties; *sub_arm&ppp* represents retail originated subprime ARMs with prepayment penalties.



Predicted Serious Delinquency 24 Months After Origination Community Lending and Broker Originated Subprime Loans



Note: Estimation is based on a borrower with a FICO score between 580-620 with the mean value of other regressors. *sub_bro&ppp* and *sub_bro* represent broker-originated subprime FRMs with and without prepayment penalties respectively; *sub_bro&arm&ppp* and *sub_bro&arm* represent broker-originated subprime ARMs with and without prepayment penalties respectively.



So it is risky borrowers or reckless lenders?

For borrowers with similar risk profiles, the estimated default risk would be much lower with community reinvestment instead of subprime loans

The study suggests that the problem was not the borrower but the loan, thus the lender/broker played the central role

The crisis has us believing that homeownership may be a bad idea for low income households. This is not the case. Done right, done responsibly, low-income homeownership can still be a viable and sustainable asset building tool



Key Policy Responses to the Crisis

- Home Ownership and Equity Protection Act (HOEPA)
- Revision of Regulation Z (Truth in Lending Act), July 08
- Housing and Economic Recovery Act of 2008
 - Hope for Homeowners (refinance loans with FHA guarantee ~\$300b)
 - Community Housing Grants (to redevelop high foreclosure areas ~ \$2b)
- Fannie Mae and Freddie Mac placed in conservatorship (~\$400b); Government support of AIG begins
- Troubled Assets Relief Program—TARP (initially to purchase distressed assets, later on to buy equity--de facto, partial nationalization of banks, insurance company, others ~\$700b)



Key Policy Responses II

- Government to back commercial paper, money market mutual funds, student loans, car loans, etc.
- Making Home Affordable Plan (loan modifications, refinancing of GSE loans)
- Federal Reserves keeps rates low and liquidity high (“monetary easing” through purchase of government debt and mortgage back securities)
- American Recovery and Reinvestment Act of 2009 (~787b)
- Change in Mark to Market rule (assets need not be valued at current price)
- Public Private Investment Partnerships to buy toxic—now called legacy--assets



THANK YOU

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