



Understanding the Foreclosure Crisis

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*Research and analysis on the
transformative power of capital*





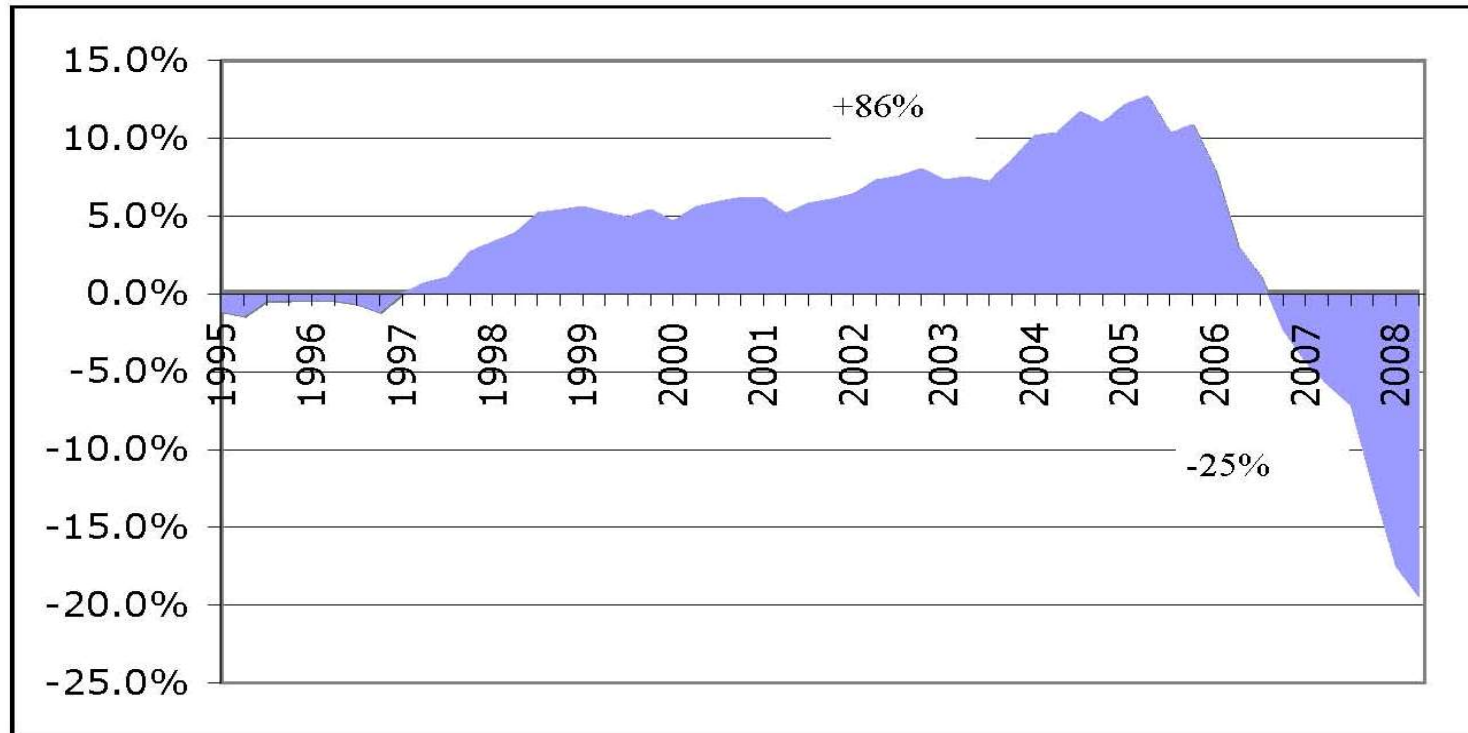
Signs of the Current Crisis

- Credit crunch—difficult to obtain credit
- Economic downturn—unemployment on the rise
- Fiscal deficits by states and localities
- Increasing number of homes for sale/more days in market
- Foreclosures are up



House Prices Are Declining

10 million homeowners have no/negative home equity



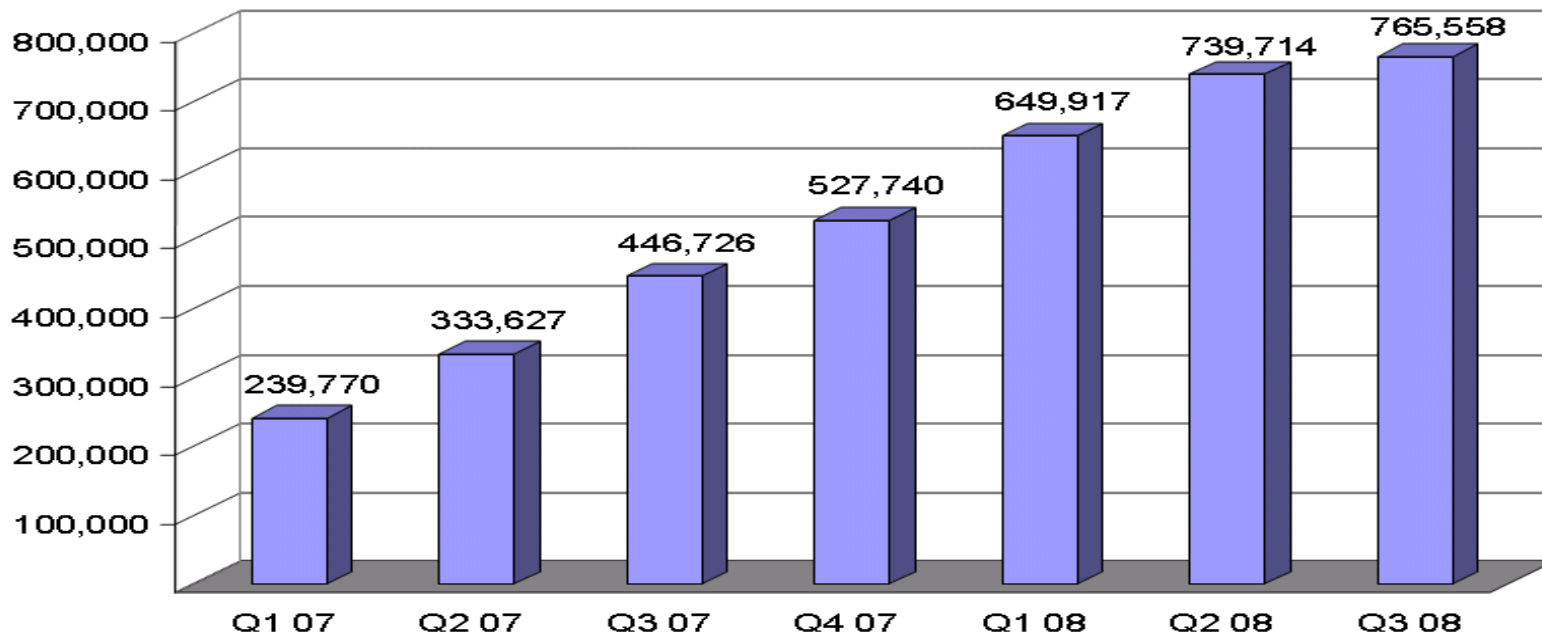


Foreclosure Filings Are Increasing

5 million households in default/foreclosure process

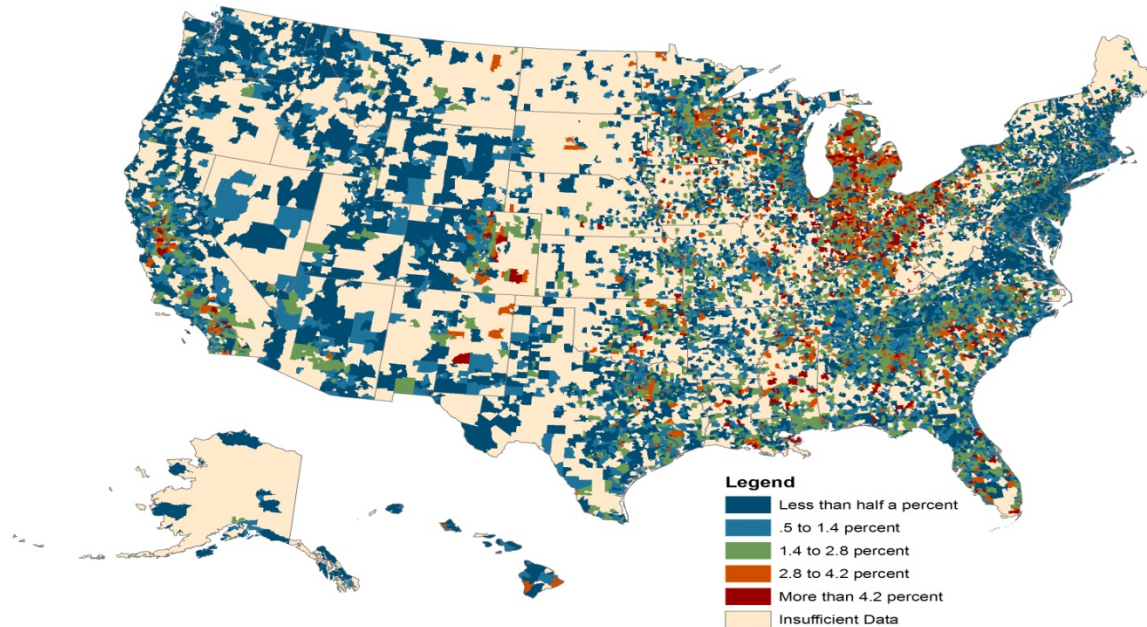
2700 families lose their home every day

Properties with Foreclosure Activity



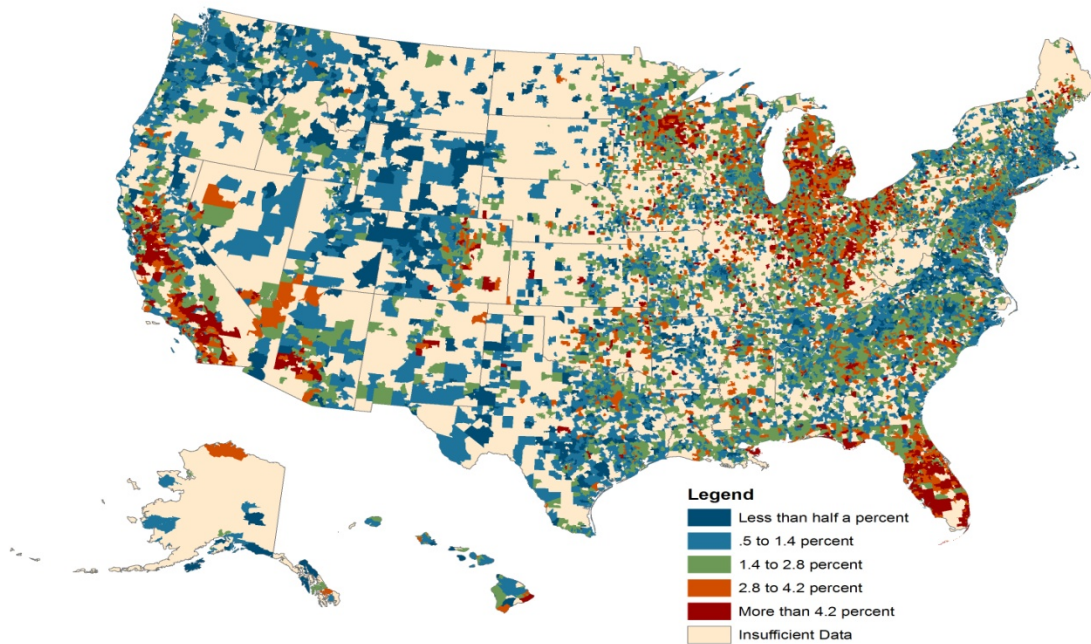


Percent of Mortgage Loans in Foreclosure or REO (by zip code) September 2007





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



Source: FRBSF calculations, McDash Analytics, LLC

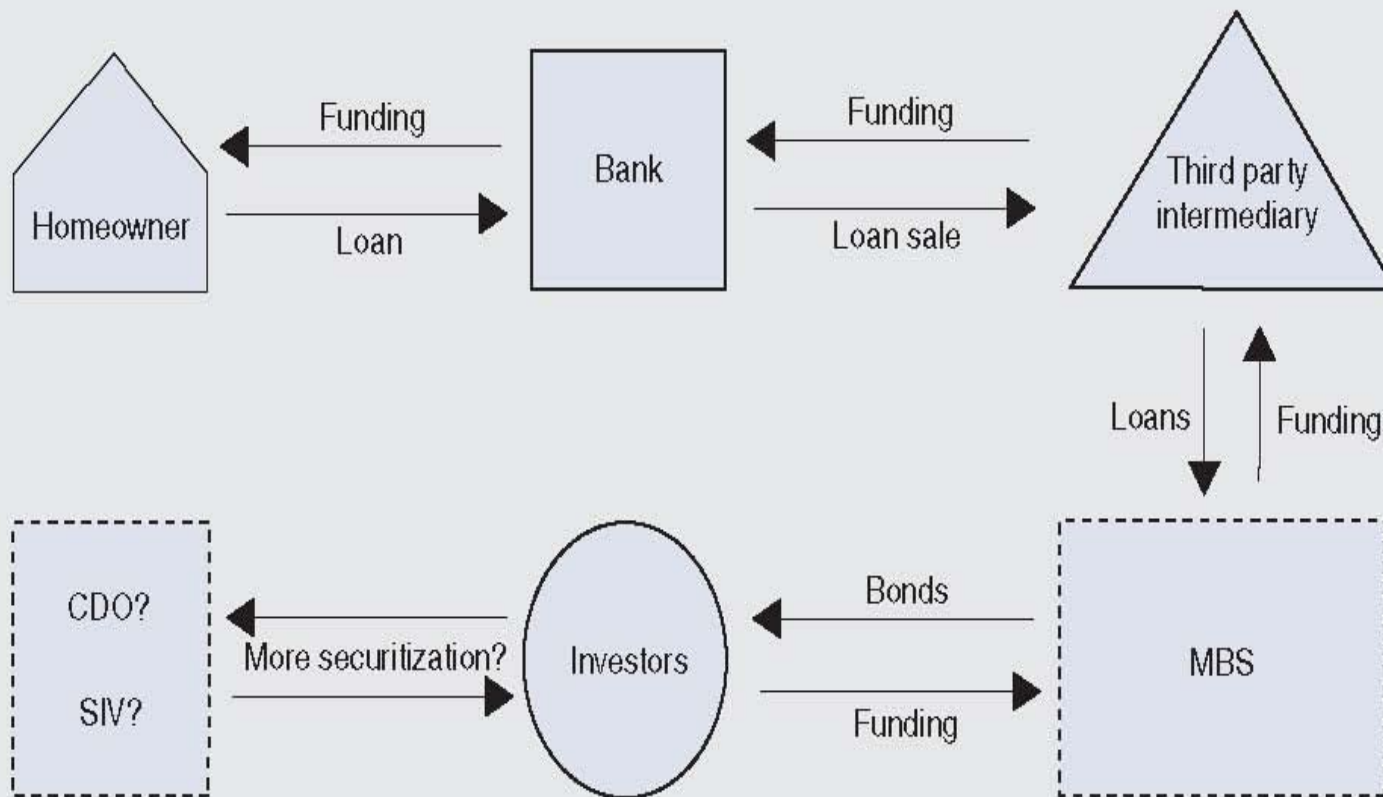
Housing Crisis Has Broader Impacts

- Borrowers, especially subprime borrowers, have difficulty making mortgage payments
- Property values are declining; a flood of foreclosed properties and REOs further depresses prices
- Payments to investors holding mortgage-backed instruments (MBS, CDO, SIV, CDS) are at risk
- Fear of failure of entities which had invested heavily in subprime loans securities triggered the financial crisis
- Financial crisis has lead to/worsen economic downturn and lower tax bases—nationally & globally, feedback loop



How the inability of borrowers to make payments ripples...

1. Mortgage funding process



NOTES: MBS means mortgage-backed security, CDO means collateralized debt obligation, SIV means structured investment vehicle.

Who is to Blame? The Usual Suspects

- Borrowers for overextending themselves
- Lenders, brokers, real estate agents, appraisers for focusing on short term profits, not on ability to pay
- Wall Street for reckless securitization and lack of due diligence (e.g., Lehman Brothers)
- Credit rating agencies for poorly evaluating risky instruments (Standards and Poor)
- Insurance companies for insuring risky products (AIG)—regulated insurance or unregulated credit default swaps 9



The Blame Game... Who is right?

- Fannie Mae and Freddie Mac for encouraging reckless lending
- Greenspan for keeping interest rates low for a long time thus encouraging over-leverage
- Everybody for pursuing own short term self-interest. But can we blame the market for that?



The Current Paradox

- When the pursuit of short term self interest by the market is detrimental to the common long term well being, there is a clear case for government regulations. Unfortunately, the regulators were absent.
- Problem then was one of lack of regulation
- Yet, some blame regulation promoting home-ownership among low income and minority borrowers: CRA & Affordable housing goals



Community Reinvestment Lending

- 1977 Community Reinvestment Act
- 1992 Affordable housing goals–(Fannie & Freddie)
- 30 year fixed rate mortgages, with escrows
- Only one underwriting guideline was liberalized
- Kept in portfolio—lack of liquidity/limited availability

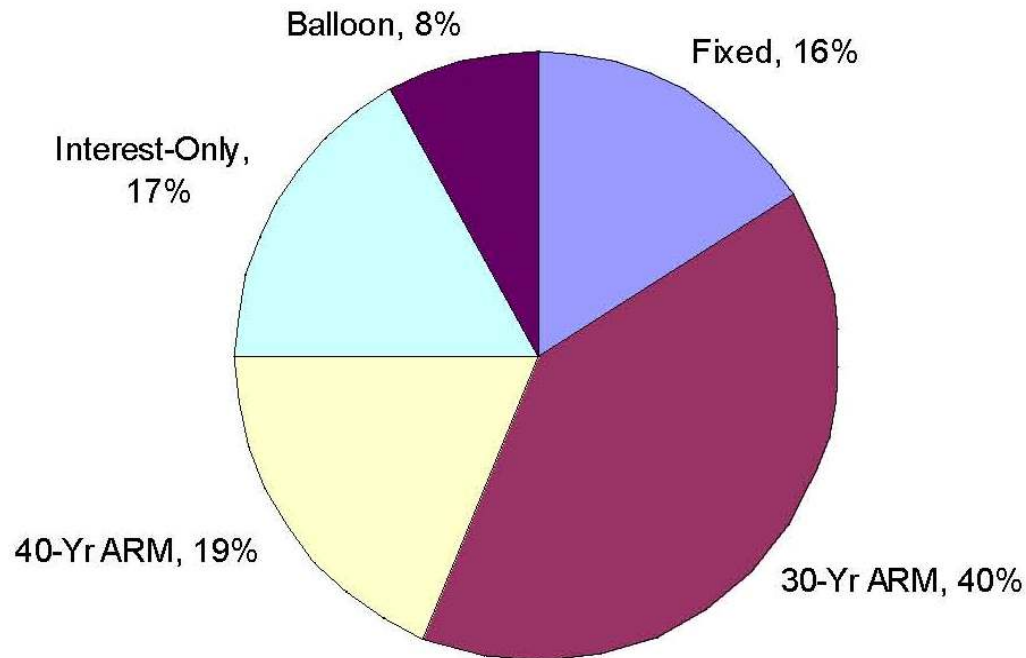


Subprime Loans are Characterized by...

- High rates/high fees
- Teaser rates/adjustable rates
- Interest only
- No down payment (125% of property value)
- No/low documentation
- High debt to income ratios
- Prepayment penalties
- No escrows
- Broker originated
- Originated based on expected appreciation, not ability to prepay



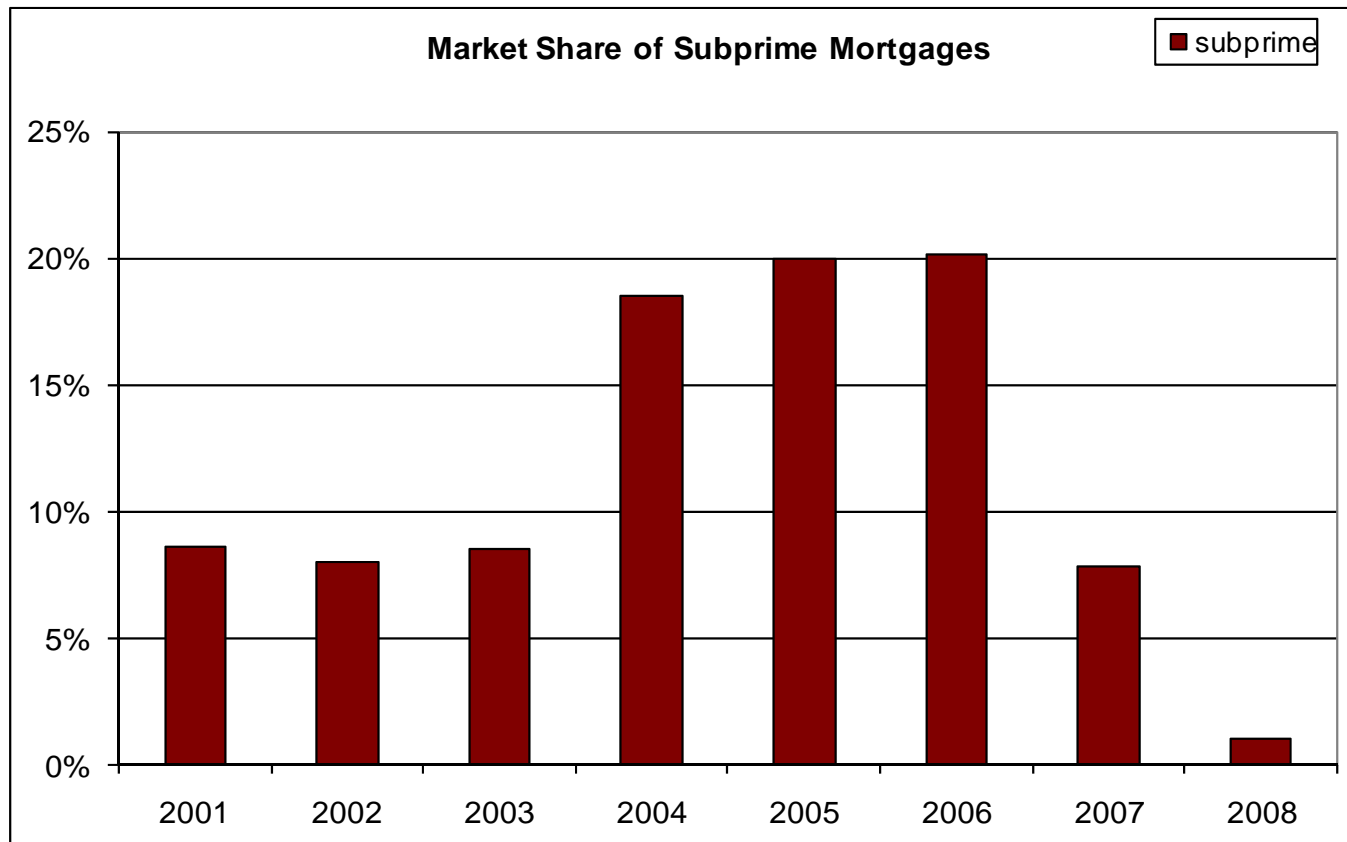
Subprime Mortgages



Note: Securitized subprime loans in 2006; Source: CRL, 2008



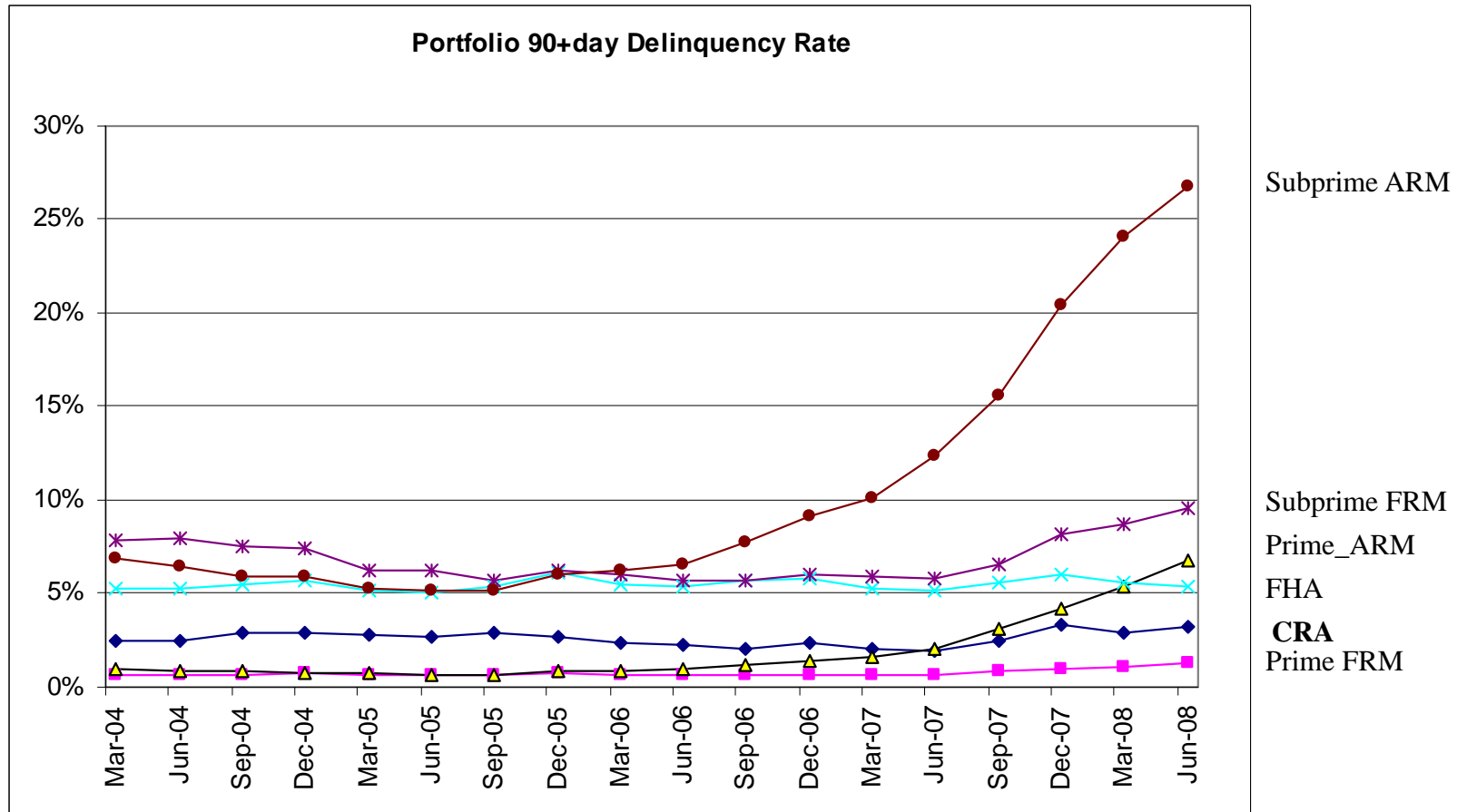
Share of Subprime Loans



Source: Inside Mortgage Finance (2008), the number in 2008 is estimated by authors.



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



Source: Mortgage Bankers Association and Self-Help. 90+day delinquencies include loans in different foreclosure stages.



Subprime Lending and Securitization 2006 – The Peak of Subprime Lending

- Fannie and Freddie purchased conforming loans ($\leq \$417,000$), turned them to securities
 - 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



Blaming the CRA or Subprime Lending? The Empirical Evidence

- For similar borrowers, subprime loans, ARMs, loans with prepayment penalties, and loans originated by brokers have significantly higher risks than community lending loans
- Alternatively, for borrowers with similar risk profiles, the estimated default risk is much lower for community reinvestment loans instead of subprime mortgages
- So was it risky borrowers or unregulated lenders? The study suggest that the latter plays the central role
- Subprime crisis has us believing that homeownership may be a bad idea for low income households. Not so. Done right, done responsibly, low-income homeownership can still be a viable and sustainable asset building tool



Policy Responses to the Crisis

- Home Ownership and Equity Protection Act (HOEPA)
 - Bans balloon payments; negative amortization; most prepayment penalties for high-rate/high-fee loans.
- Revision of Regulation Z (Truth in Lending Act), July 08
 - Bans making loans without regard to ability to repay
 - Requires verification of income and assets
 - Bans some prepayment penalties
 - Requires creditors to establish escrow accounts (property taxes and insurance) for all first-lien mortgage loans.
- Housing and Economic Recovery Act, Oct. 08
 - Fannie and Freddie reform; FHA reform; HOPE program
- \$700b bailout to buy distressed assets and equity in banks
- De facto, partial nationalization of banks, insurance company, others
- Gov to back commercial paper and money market mutual funds



More Needs to be Done

- Need to stabilize troubled borrowers, especially those with toxic mortgages:
 - Default Counseling
 - Voluntary loan modifications?
 - Bankruptcy reform?
 - Foreclosure moratoria?
 - Stimulus packages?
- No silver bullet due to complexity



Looking Forward...

- Current crisis is a paradigm shifting event



Thanks

<http://www.ccc.unc.edu>