

Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners

EXECUTIVE SUMMARY

Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest
Center for Responsible Lending

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About the Center for Responsible Lending

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is affiliated with Self-Help, one of the nation's largest community development financial institutions.

Visit our website at www.responsiblelending.org.



North Carolina
302 West Main Street
Durham, NC 27701
Ph (919) 313-8500
Fax (919) 313-8595

District of Columbia
910 17th Street NW
Suite 500
Washington, DC 20006
Ph (202) 349-1850
Fax (202) 289-9009

California
1330 Broadway
Suite 604
Oakland, CA 94612
Ph (510) 379-5500
Fax (510) 893-9300

I. EXECUTIVE SUMMARY

In this report, the Center for Responsible Lending presents research on how homeowners have fared with subprime mortgages. Analyzing the performance of more than six million subprime mortgages made from 1998 through the third quarter of 2006 and taking into account changes in housing prices, we find that foreclosure risk in the subprime market has escalated in recent years, and is likely to grow even worse in many areas.

As this year ends, 2.2 million households in the subprime market either have lost their homes to foreclosure or hold subprime mortgages that will fail over the next several years. These foreclosures will cost homeowners as much as \$164 billion, primarily in lost home equity.

We project that one out of five (19 percent) subprime mortgages originated during the past two years will end in foreclosure. This rate is nearly double the projected rate of subprime loans made in 2002, and it exceeds the worst foreclosure experience in the modern mortgage market, which occurred during the "Oil Patch" disaster of the 1980s.

In brief, these are the key findings:

Even during the recent period of strong housing appreciation, subprime foreclosures have been high. As many as one in eight (13 percent) subprime home loans ended in foreclosure within five years of origination.

The past housing boom masked the high proportion of homeowners who have struggled with subprime loans. For many borrowers, strong house price growth increased the amount of equity in their homes and enabled them to refinance their mortgages despite being behind on the monthly payments. When these distressed prepayments are added to the foreclosure rates, the total "failure rate" for subprime loans approaches 25 percent.

Key Findings

- 2.2 million subprime home loans made in recent years have already failed or will end in foreclosure.
- These foreclosures will cost homeowners as much as \$164 billion.
- One out of five subprime mortgages originated during the past two years will end in foreclosure.

About this Research

Our study projects foreclosures on subprime home loans made nationwide during each year from 1998 through 2006, and measures the effects of housing appreciation on loan performance. We estimate future foreclosure rates using housing appreciation forecasts developed by Moody's Economy.com, and predict subprime foreclosure rates in all major metropolitan areas in the United States. The study also examines factors associated with subprime foreclosures, including high-risk features typically included in subprime home loans.

As housing prices decline, subprime foreclosures will rise. Now that the housing boom has cooled, fewer delinquent borrowers will have the equity needed to refinance their loan or sell their home to avoid foreclosure. Our results confirm that foreclosures are more likely in housing markets with lower house price growth.

The chance of foreclosure on a subprime loan doubled between 2002 and 2005. Subprime loans originated in 2002 have a one-in-ten lifetime chance of foreclosing. For loans originated in 2005 and 2006, the probability shoots up to one in five.

Multiple subprime loans boost foreclosure risk even higher. Lenders often portray subprime loans as a stepping-stone to a prime loan. In reality, many borrowers in the subprime market refinance from one subprime loan to another, losing equity each time to cover the cost of getting a new loan. When we analyze the likelihood of foreclosure for borrowers who repeatedly refinance, we find that the risk of losing the home climbs to 36 percent. While more research is needed, this estimate relies on assumptions drawn directly from refinance patterns in the subprime market.

Why Subprime Foreclosures Matter

The report describes the first comprehensive research on foreclosures in the subprime market, assessing how frequently subprime mortgages fail and the associated costs to homeowners. The loss of home equity is significant because, for most families, the value of this ownership is their greatest financial asset. The performance of the subprime market is significant because it has rapidly grown from a niche market into a major economic force, now representing roughly one quarter of all home loans made in the United States.

Our research shows that subprime foreclosure levels have been extraordinarily high even during the recent past. As housing appreciation slows, subprime foreclosures will rise even higher in the future. The losses will inevitably have ripple effects throughout the economy and our society as over two million families lose their physical shelter, their major source of financial security, and the social benefits of homeownership.

Increased foreclosures will have an adverse impact on many local markets and specific communities.

Problem Markets. Real estate markets that have experienced high housing appreciation in recent years will see a marked increase in subprime foreclosures as housing prices cool. In fact, increases in subprime foreclosures will be the norm. Using recent Moody's Economy.com housing appreciation forecasts, we show projected subprime foreclosure rates in every major metropolitan statistical area in the U.S. Our data show that cities in California, Nevada, New Jersey, New York and Michigan, as well as the greater Washington, D.C. area, can expect a high rate of subprime foreclosures.

Vulnerable Homeowners. It is beyond the scope of our study to analyze racial disparities related to subprime foreclosures. However, the loss of equity resulting from subprime foreclosures will affect a great many African American and Latino homeowners, since these communities receive a disproportionate share of subprime home loans.

Subprime loans are riskier in and of themselves, not just because the borrowers may have weaker credit. Borrowers who are already financially vulnerable are receiving loans known to pose a higher risk of default.

The following factors contribute to subprime foreclosures:

Risky Loans. Subprime mortgages routinely include features that increase the risk of foreclosure. Such features include adjustable interest rates, balloon payments, prepayment penalties, and loans with limited documentation of borrowers' loan qualifications. We note that the dominant type of subprime loan today is an adjustable-rate mortgage called a "2/28" that features semi-annual interest rate adjustments after a two-year fixed-rate period. The initial fixed rate is often a discounted or "teaser" rate, so the rate adjustment can lead to a significantly higher payment. Because of the resulting payment shock, these loans are sometimes referred to as "exploding ARMs."

We also note an increasing share of loan products in the subprime market that limit the amount of equity a borrower builds. These loans also carry a high risk of payment shock and may limit homeowners' ability to acquire the equity needed to refinance out of an unaffordable loan.

Loose Underwriting. Lax underwriting standards magnify the risk of loans that already include high-risk features. Subprime lenders who market exploding ARMs and other high-risk loans often do not adequately consider whether the homeowner will be able to pay when the loan's interest rate resets, even if rates stay constant. Lenders escalate the risk of foreclosure even further when they fail to require escrow for the cost of property taxes and hazard insurance, and when they approve loans without verifying the borrower's income and employment.

Predatory Lending. This report does not attempt to measure how predatory lending may contribute to subprime foreclosures, but we make several points that suggest predatory practices may play a large role: In recent years, more subprime lenders with significant market share have been successfully prosecuted for predatory lending activities. In addition, high-risk loan products and terms, so common in the subprime market, make it easier for unscrupulous lenders to entice borrowers with a low **initial** payment, regardless of whether the borrower can manage future payments. Costly fees and prepayment penalties associated with predatory loans also strip equity, making it harder for borrowers to refinance and forcing them into foreclosure more quickly. We also note reports of increasing problems associated with foreclosure "rescue" scams.

Third-Party Originators/Lack of Accountability. Mortgage brokers, who originate the majority of subprime mortgages, have a strong incentive to close as many loans as possible, but very little reason to consider the loans' future performance. Lenders shield themselves from the full potential cost of foreclosures by selling their loans to investors through the secondary mortgage market. Together, third-party originations and the risk dispersion made possible through the secondary market help distance loan originators from seriously adverse consequences of foreclosures.

Inadequate Oversight: Today there are insufficient legal and regulatory consequences for making home loans that are not appropriate or affordable for the borrower. Recently federal and state regulators issued guidance requiring lenders to tighten credit standards on certain high-risk home loans. However, these standards do not apply to all risky loan products and questionable business practices common in the subprime market.

Proposed Solutions

With billions of dollars in equity already lost, there is an urgent need to curtail foreclosures in the subprime market and mitigate losses families will incur in the future on unsustainable mortgages. In brief, CRL recommends the following:

Establish that every borrower has the means to repay his/her loan—without resorting to selling the property or refinancing under pressure. Unless subprime lenders ensure borrowers can afford their loans, other efforts to prevent foreclosures will have minimal success. For example, when offering loans with scheduled interest rate changes, lenders should consider whether the borrower will be able to afford the mortgage after the initial fixed “teaser” rate expires. Subprime lenders also should require escrow payments and appropriate verification of the borrower's income, and they should confirm that the loans they offer make economic sense for a given borrower's circumstances.

Ensure that all parties involved in the loan operate in good faith, and that everyone—not just the borrower—has a stake in a successful loan outcome. Recently several major banking regulators issued guidance on nontraditional mortgage product risks. The regulators' guidance, which recognizes the risk posed by imprudent underwriting practices, should apply to all subprime ARM loans and non-traditional products. Similarly, the principles of the guidance should be applied to all subprime mortgage lenders. Mortgage brokers should be subject to standards that apply to other financial professionals, and they should have an affirmative duty to ensure that the products they recommend are suitable for their customers. Lenders and appraisers should uphold existing standards to ensure that appraisals are accurate and independent. And regulators should hold secondary market investors to basic standards of fair dealing and require them to take reasonable steps to avoid supporting abusive subprime loans.

Help existing subprime borrowers who are in danger of losing their homes. Opportunities for reasonable work-out plans can go a long way to help struggling homeowners avoid foreclosure, and regulators should focus on banning predatory lenders/servicing practices and enforcement actions against servicing practices that facilitate subprime loan failures. Community groups, lenders, and state and local governments have demonstrated the efficacy of a variety of home preservation programs, including those that involve targeted outreach to delinquent borrowers, financial counseling, and restructuring consumer debt. Another successful model comes from the states that have passed strong laws against foreclosure “rescue” scams, banning predators from targeting struggling borrowers.