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Remarks on the Meaning of the Mortgage Market Meltdown  
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I can't say I'm exactly pleased to be talking about the meltdown in the mortgage market; it would be much nicer if I could talk about how the capital markets are making our communities stronger and how homeownership is truly the asset-building American dream for all Americans. But I'm afraid the events of 2007 and 2008 (if we're lucky and get through it all by then) mean that we need some serious rethinking about both the structure of the market and the nature of homeownership.

First, let's make sure we're all on the same page with respect to some basic facts about the mortgage market. Just released Census data for 2006 tell us that there are about 75 million household who own their own home, a 67.3% homeownership rate. The rate is 73% for non-Latino whites, 46% for African Americans, and 49% for Latinos. About 68% of these homeowners carried a mortgage, and about 26% of those also carried a second mortgage, a home equity line, or both.

About \$10.4 trillion of 1-4 family mortgage debt is outstanding. Estimates of how much of this is sub-prime vary, but a good estimate is that about 20% is sub-prime, i.e., it carries an interest rate at least 200 basis points above comparable Freddie Mac prime loans, and another 13% is "Alt-A." Most of these are adjustable rate mortgages (ARMs), and many have such additional risk factors as:

- Initial teaser rates—of which about \$263 billion reset between January and August of this year, with an additional \$700 billion scheduled to reset between now and the end of 2008, which is estimated to be a total of at least 2 million loans.
- Options to pay interest only, or even less than that, for some period
- No escrows
- Prepayment penalties
- No or low documentation, even for wage earners (often called "liar loans")
- Simultaneous second loans ("piggy-back" loans) that mean there is effectively no equity in the house

Whereas in 2003, about 9% of the single family mortgage debt issued was subprime (\$342 billion), by 2006 that had skyrocketed to 23% (\$644 billion). About half that subprime debt was for refinancing. In fact, the Center for Responsible Lending (CRL) estimates only 11% actually went to first-time homebuyers to buy their home.

Although subprime loans are only about 20% of outstandings, by the end of 2006, 60% of new foreclosure filings were of subprime loans. CRL estimates that 20% of all subprime

loans originated in 2005 and 2006 will end with foreclosure or other involuntary home loss (e.g. deed in lieu of sale). Even Lehman Brothers thinks the rate for the 2006 cohort will approach 30%.

Both foreclosures and their precursor, delinquencies, continue upward. By August 2007, foreclosures were up 115% from the prior year, and 36% from the prior month. In the second quarter of 2007, almost 15% of subprime loans (17% of subprime ARMS) were more than 60 days overdue, and over 9% more were either 90 days or more overdue, or in the process of foreclosure. Both are way up from 2006, and the increase is much higher than for prime loans.

State and local differences are large and important. Nationally, in August 2007 one out of 510 households was in foreclosure, but this ranges from one in 27,940 in Vermont to 1 in 165 in Nevada. The highest foreclosure rates are in Nevada, California, Florida, Georgia, Ohio and Michigan, in that order.

These states divide into essentially two groups: those where house prices ran up spectacularly at the beginning of the decade and are now declining almost as fast (Nevada, California, Florida and Georgia) and those where the broader economy is in deep trouble (Ohio and Michigan).

To put the first group into perspective, nationally, real house prices rose 86% between the fourth quarter of 1996 and the first quarter of 2006, while real rents rose only 4%. Since the peak, real house prices have already declined 3.4%. The national situation is not good. However, the situation in the boom states is worse. For example, from June 2000 to June 2006, prices in Los Angeles went up 135%; in the year since, they have declined 5.1%. For Miami the equivalent numbers are up 140% and down 4.8%.

The result of this kind of house price run up is that, notwithstanding strong state economies, homeowners are paying a huge share of income for housing. In California, with a median home price of \$536,000 (compared to the national median of \$185,000), more than half of the homeowners pay more than 30% of their income for housing, and 22% pay more than 50%. If those payments become unsustainable—which can happen for any number of reasons, including a mortgage reset but also such normal human events as death, divorce, disability and unemployment—the price decline makes it unlikely they will be able to get out of the situation by selling or refinancing.

In the other group, prices didn't increase as much, but they have nevertheless also turned negative. And moreover, these states have high and increasing unemployment rates, increasing the likelihood that someone hit with higher payments will not be able to make them, and will also not be able to refinance or sell. In July 2007, with the national unemployment rate at 4.6%, Michigan's was 7.2% and Ohio's was 5.8%. House prices in Detroit were down an astounding 11% from the second quarter of 2006 to the second quarter of 2007 and continue to fall; one out of 87 households in Detroit is in foreclosure. In Cleveland, house prices declined 3.6% during the same period, but appear to be

stabilizing. Nevertheless, foreclosures in Cleveland have left about 10% of the city's single-family homes vacant.

Over the last several weeks, there has been increasing focus on the systemic risks to the broader economy and credit markets that the situation presents. I'd like to take us back to a focus on the effects on individuals, communities, and how our financial system interacts with consumers. It's not that I don't think the macro effects are worthy of attention; I just don't want to lose sight of the more micro issues that also merit our close attention.

First, with respect to individuals, it's important to remember that for most low-wealth people, and most minorities, virtually all their net worth is represented by home equity. For example, according to 2004 Survey of Consumer Finances the median net worth for the bottom quartile by wealth is \$1,700; within that group, the median value of houses owned is \$65,000, and median debt on it is \$60,700. For non-whites or Hispanics, the median net worth is \$24,800; within that group, the median value of houses owned is \$130,000 and debt on it is \$63,900. For these people, and indeed for most of the middle class, losing their house means losing everything they've built up, their credit standing and their hope for the future.

The situation is exacerbated by the fact that high-cost loans have been made disproportionately in low-income and minority communities. Just-released 2006 Home Mortgage Disclosure Act (HMDA) data show that 53.7% of home purchase loans (52.8% of refinance loans) to African Americans and 46.6% of home purchase loans (37.7% of refis) to Latinos were high cost, compared to 17.7% of purchase loans (and 25.7% of refis) for whites. In census tracts with incomes under 50% of the area median, 46.5% of loans were higher-priced (compared with 18.3% for tracts over 120%); in tracts with over 80% minority population, incidence was 46.6%, compared with 21.7% for tracts with a minority population of less than 10%. Other sources indicate that over 1/3 of both interest only and payment option borrowers had incomes under \$70,000 and over 12% had incomes under \$48,000.

It is also important to understand the effect of all this on communities. During the 1980s and 1990s, major strides were made by cities, banks and credit unions, community development corporations, community development financial institutions, and other community based organizations around the country in stabilizing and bringing back communities that had seen substantial disinvestment in the 1960s and 1970s. This was especially the case in the Northeast and Midwest, but other neighborhoods also benefited. Home-ownership was a major strategy in this effort, not only for individual wealth building, but for civic engagement, crime prevention, and physical rehabilitation. Some of those same communities are now being hard-hit by foreclosures. These include Slavic Village in Cleveland, Back of the Yards in Chicago, and North Minneapolis.

A foreclosed house is more than a financial statistic; it generally turns into a vacant house, which in turn reverses gains in community stability, results in increased crime, costs city governments money in both increased expenses and decreased taxes, and

reduces nearby property values. The best estimate of total costs per foreclosed and vacant house to local government is about \$20,000. Dan Immergluck at Georgia Tech, one of the best researchers on this topic, has shown that a single foreclosure lowers the value of homes within one city block by .9% and by 1.4% in low and moderate income communities. In another study, he has also demonstrated the close, positive relationship between foreclosures and increases in violent crime

One of the implications of this is that, while I think it is totally appropriate to focus attention, and especially any outside funds, on owner-occupants, and in particular lower income owner-occupants and those who appear to have been misled, confused or only mildly excessively optimistic, the community effects are there no matter who owns the house. In many ways, the fact that in 21% of California serious delinquencies and new foreclosures and 32% of those in Nevada are in investor-owned homes (compared to 13% in the rest of the country), makes the problem for communities in those states harder, not easier, because these are the people who will walk away quickly, from multiple properties, and create vacancies and no tax revenues.

About the only benefit of all this is that house price declines may once again make sustainable homeownership, with good solid mortgage products, affordable for more Americans. However, tightened credit standards threaten to shut out from homeownership at least some current and potential homeowners who could in fact sustain homeownership, reducing the community's ability to recover. The effort to get the FHA back into the game should be helpful in this respect.

The financial system has also taken some serious hits, of course. There is the obvious: a good many investors have lost a good deal of money as a large number of sub-prime lenders have gone into bankruptcy or been sold at bargain prices, the value of securities has dropped, losses on home loans have increased and bank stock prices have declined. And of course lately we've had an extension into a broader liquidity crisis as both those who hold and those who might want to buy credit instruments are uncertain of their value and therefore will not engage in transactions.

However, there are other less obvious, but still extremely important effects. First, the crisis has laid open the problems related to disconnecting responsibility for making loans from responsibility for collecting on them. It has destroyed the unity of interest between borrowers—who want loans that are both affordable and sustainable—and lenders, who want to make loans they can collect on. This is not just a problem relating to mortgage brokers, who in too many cases feel no responsibility for the quality of loans they originate because they're paid on commission, entirely up front. There are also inconsistent incentives between originators and packagers (including banks who originate for sale without recourse) who make money on volume and up-front fees; servicers, who must try to collect on the loans; and investors, who would like to be paid but are increasingly uncertain about the value of the instruments they hold.

The crisis has more recently laid open the problems related to infinite slicing and dicing of risk, which leads to a lack of understanding as well as responsibility. About 56% of

mortgage loans are securitized today, and a higher percentage of sub-prime. As Lew Ranieri, the inventor of the mortgage backed security, said at an Office of Thrift Supervision conference last December: “Today, the transparency of the past has been obscured by a massive proliferation of new products, and as a consequence it is very difficult for investors -- institutional and otherwise -- to accurately quantify the value and the risk of the opportunities available to them -- IO's, Option ARMs, 80-10-10s, stated income, low doc, no doc, ABMs, automated evaluation models, forty-fifty year loans -- create instruments which can be combined in an innumerable combination and permutations.” In other words, for those who understood this market, the inability to value the more exotic instruments—Ranieri explicitly excluded securities issued by Fannie, Freddie and Ginnie from his criticism on this score—was no surprise.

The crisis has also demonstrated the positive role of Fannie and Freddie (and FHA and depositories to a lesser extent) with respect to standard-setting, and what happens when they're not in the game. Whereas as recently as 2003, 78.5% of mortgages securitized were securitized by Fannie/Freddie and Ginnie, by 2006, that share was down to 44.6%. The FHA share fallen from 16% in 2000 to under 3% in 2005 and 2006. To quote Ranieri again: “One of the little-noticed roles that Fannie and Freddie played in the market was as a sort of gatekeeper. Whether loans were Prime, or Alt-A, or Sub-prime, whether they are conforming or non-conforming -- everything was always written on agency-standard documentation. If it wasn't done to agency-standard docs, nobody bought it, and that acted as, in effect, a form of control and gatekeeper on what you could and could not do. That standard has completely gotten pushed aside.”

Flaws in the regulatory system were also exposed in a number of ways. Mortgage brokers, who initiated almost 60% of loans as of 2006, are inconsistently, and generally very lightly, regulated, and only at the state level. Unlike securities brokers, there is no suitability standard applicable to mortgage brokers. Some of the hardest hit states, such as Colorado, have no licensing or regulation at all. Independent mortgage bankers are also subject to inconsistent, often limited, state supervision, often by regulators whose budgets are not up to the task. Disclosures to consumers are too many, too dense and come too late to enable comparison shopping. And the holder in due course doctrine, which is an important part of a vibrant capital market, ended up shielding purchasers of mortgages (and those who purchase tranches of pools, etc.) from the sins of the originators, reducing incentives not to sin.

Even among bank and thrift regulators, the light hand with which the mortgage companies that were non-bank holding company affiliates were treated (in contrast to the banks and thrifts themselves) probably contributed to the problems in the market. This is not insignificant. In 2006, even before the major meltdown, affiliates of depositories made 13.4% of the high-priced loans. Taken together, depositories, their subsidiaries and affiliates originated almost 54% of the high priced loans—a higher total share than the independent mortgage companies.

More subtle regulatory issues are also worth considering. For example, have too-strict rules on capital and oversight driven sub-prime lending out of the regulated institutions

and into places that are less well supervised? And can disclosures ever work with respect to mortgages, or is this a product where those who deal with customers must be held to high standards of knowledge, behavior, and an unconditional obligation to customers; advisors are essential; and certain products and practices should simply not be allowed? So what should we do? With respect to homeowners who are currently in trouble and their communities, I submit there are four primary goals:

- Maximize the ability of owner-occupants who can afford the home they're in at the lower of the amount of outstanding debt or current home value, to stay in the house through refinancing and loan modifications, with public dollars concentrated on lower-income homeowners.
- Help those who are in over their heads to get out with the least possible economic and psychological damage, into decent rental or more modest owned housing.
- Help communities whose tax bases have taken a major hit, with an emphasis on regional efforts to create long-term, sustainable economic development that reduces the vulnerability of individual communities.
- Use existing mechanisms wherever possible, enhancing their capacity and resources; time is too short to create new things, and there is no shortage of structures that can work, if they are supported sufficiently.

With respect to foreclosure prevention, the bank regulators have issued guidance to banks, thrifts and credit unions, including holding company subsidiaries, urging them to proactively move to keep people in their houses, whether the loan is held on the institution's books or securitized. This is an important step; less than a year ago, especially with respect to securitized loans, we were hearing that modifications and refinances to retain homeownership were impossible. It is still not easy, especially to with respect to loans that have been securitized in multiple pools (e.g., the loan in one, the prepayment penalty in another), but we're making progress. We need to reach down deeper into organizations, create models for modification (rather than one-at-a-time solutions) and bring the incentives of all parties, including foreclosure attorneys, in line with the desire to maximize sustainable modifications. Is it time to establish failure to move quickly to seriously consider sustainable modifications a defense to foreclosure?

And let's not forget about the prepayment penalty situation. For those servicers who don't "get it," or for borrowers who decide that they'd like to be with a dependable community bank who will not abuse them again, the prepayment penalty can be a substantial barrier. If servicers won't modify, they should be required to waive prepayment penalties to facilitate sustainable refinancing—which almost always will be a net benefit to all parties.

For both modifications and refinancings, it will be important to make sure that results follow rhetoric. Asking servicers to report regularly, and publicly, on what they have actually accomplished, could provide valuable information, and would not require legislative or regulatory action.

Unfortunately, the problem is not only a capital markets or legal problem.<sup>1</sup> We have known for some time that it is difficult to get borrowers who are behind on their mortgages to either contact their servicers or, indeed, to respond to servicer outreach. This is particularly true in the sub-prime market, where 50% of borrowers in foreclosure are said never to have spoken to their servicers. It is even harder to get people to anticipate that they will have trouble in the future, especially when many of them didn't fully understand that the payments on their loan will increase substantially. Especially for borrowers without much of a cushion, a delay may mean that a problem that might have been solved with early intervention becomes virtually unsolvable. (The problem is not by any means all the borrowers'; heavy-handed collection tactics are not all that unusual.)

Those who have looked at the situation are convinced that the only way to break this pattern is with aggressive outreach by trusted, competent, non-profit intermediaries. There are many of these, including NeighborWorks America, ACORN, and the various Legal Services organizations. However, they all have major funding and capacity issues. Earlier this year, NeighborWorks, a number of Credit Counseling agencies, and the National Urban League teamed up with the Homeowner Preservation Foundation (which is funded by large lenders) to establish the National Foreclosure Hotline (888-995-HOPE) through which borrowers can get immediate access 24/7 to independent counselors who themselves have effective access to servicers to maximize the chances of a successful modification or refinancing. The Hotline is receiving about 2,000 calls a day, and is having substantial success. However, it costs \$200,000 a day to operate, and it too is in need of additional funds.

Of course, some situations are so difficult that modification or refinancing is impossible unless the principal amount of the loan is substantially reduced. For some of these people (those who can afford the home they are in at its current value with a quality mortgage, even if they cannot make the payments on the loans they have), help may be possible through proposed changes in the Bankruptcy Code, which would enable a judge to reduce the amount due on mortgage debt to the current value of the home.

For those for whom continued support of their current home is impossible even if such a modification to the Bankruptcy Code were to be enacted quickly, it will be important to provide the counseling resources and foreclosure alternatives (e.g., deed in lieu of foreclosure) that can soften the landing. Assistance may also be needed to help them find appropriate rental housing or, potentially, a less expensive ownership opportunity.

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<sup>1</sup> There is a tax problem that also needs to be dealt with. In general, because funds lent are not taken into income, when a loan or a portion of it is forgiven, the beneficiary has "cancellation of indebtedness income." Lenders forgiving a debt are, in general, required to provide the borrower with a Form 1099. Borrowers may or may not be taxable on the income; there are, for example, exceptions for debt forgiven in bankruptcy and debt forgiven to insolvent debtors. While the insolvency exception will frequently apply in the case of a loan modification to protect a homeowner, counselors working with borrowers believe many are at least confused, and at worst, dissuaded from agreeing to a modification because of the fear of being taxed on money they have not received. The IRS has recently put helpful information about this on its website (<http://www.irs.treas.gov/newsroom/article/0,,id=174022,00.html>). Legislation to deal with the problem is moving in Congress.

There are some difficult questions involved in attempting to minimize the loss of home-ownership. For example, can prepayment penalties, and other examples that could be interpreted as “rewarding those who have already profited from making bad loans,” be avoided when a refinance is the best alternative for the borrower? What about future moral hazard? And how do we deal with mortgage fraud, appraisal fraud, and other situations in which the borrower may or may not have been part of the problem? How should responsibility (and funding) be shared among the federal, state and local governments; between public and private solutions? **While these can be difficult problems, we cannot allow them to paralyze the opportunity to help, especially since indications are that problems are likely to get worse, not better, as mortgages reset and house price declines continue.**

With respect to preventing future problems, it seems to me there should be four major goals:

- Restructuring the mortgage finance system so that the interests of borrowers and lenders are, once again, aligned with each other
- Putting a stop to certain practices that have no redeeming social value, and moreover make assessment of risk, by potential homeowner, lender and funder, virtually impossible
- Establishing uniformity in obligations and enforcement of those obligations, among those doing the same thing, no matter what their business structure or place of incorporation
- Developing sufficient financial capability of potential borrowers so that they are able to understand transactions, and to look for—and find—competent assistance when they can’t understand a transaction

Several action areas seem fairly obvious places to start. We need to consistently license and regulate mortgage brokers and other originators, and set standards for dealing fairly with borrowers. Mortgage bankers should be subject to the same rules and supervision as banks who are performing essentially the same functions.<sup>2</sup> Some products and/or terms need to be banned on certain classes of loans, such as high-cost loans of less than the conforming loan limit. These include teaser rates, prepayment penalties, loans made without income verification, and loans without escrows for taxes and insurance. And we need more and better counseling to make borrowers more financially competent, better funded from both the public sector and lenders who benefit from well-advised borrowers.

We also need to consider seriously some other issues. For example, can assignee liability be limited without sacrificing capital markets liquidity? How can we improve disclosures, both in substance and timing, which probably means fewer, simpler disclosures, certainly not more? What should be the role of the GSEs and FHA; how can they be focused on those who need help that their standard products and standards have not provided, while keeping any additional risk transparent and under control? How do

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<sup>2</sup> Because banks have access to deposit insurance and the payments system, some differences in regulation and supervision is appropriate; what is most relevant here is regulation and supervision related to consumer protection.

we improve the funding mechanisms for state financial institutions regulators so they can effectively implement any new standards?

It is also time to revisit some important structural issues in the way we think about housing. Can we get back to building equity through savings before people are encouraged to take on the very significant financial and other responsibilities of homeownership? What mechanisms can we establish that make it easy for people to save, and hard not to? The State of the Nation's Housing, an annual publication of the Joint Center for Housing Studies at Harvard, finds that there is a 5.4 million unit shortage of affordable rental housing; 1.2 million units were lost between 1993 and 2003. While some additional rental housing will likely come on the market because of the current crisis, the number of households looking to rent is also likely to increase. How can we improve the supply of quality affordable rental housing so that those who either do not want to buy or are not yet ready to have a decent place to live at a price that is consistent with saving, for a downpayment, if they aspire to be homeowners, and for other purposes? And finally, how can we promote and develop alternatives or precursors to fee ownership, including hybrids like land trusts, limited equity coops, and mutual rental housing?

The current crisis raises a huge host of issues, and solutions will be required to be multifaceted, subtle and, at times, large. But we are where we are; our challenge will be to help those in need, learn from our mistakes, minimize the likelihood of future ones, and bring asset-building back to homeownership.