



**Today's Epidemic: Ideas for a Comprehensive Approach to the Foreclosure Crisis
Issue Brief by Asset Funders Network and Center for Responsible Lending
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When a country is struck by a natural disaster, such as a tsunami or earthquake, the effects are highly visible, and the challenges of recovery are easy to envision. With today's epidemic of foreclosures, the damage is harder to see, but the ultimate effects are similarly tragic and long-lasting. As of the summer of 2008, at least 20,000 families were losing their home every week; municipalities were already beginning to struggle with ruined neighborhoods and declining tax bases; and the housing market was in a severe downturn, weakening the entire economy.

The foreclosure crisis has only just begun, and the implications of this disaster extend well beyond the individual families who are losing their homes. Most communities in America also will feel the pain through devalued property, blighted neighborhoods, higher crime, and an eroded tax base to deal with it all. Because of this situation, foundations devoted to strengthening neighborhoods and expanding economic opportunity for low-income families are seeing decades of hard-won gains evaporate.

The Center for Responsible Lending estimates that 40.6 million homes in neighborhoods surrounding homes in subprime foreclosures will suffer price declines, resulting in a \$356 billion total loss in the property values and tax bases of local communities—that's more than twice¹ the cost of the January 2008 economic stimulus investment enacted by Congress. Some communities will be hit harder than others. For African-American and Latino communities, losses stemming from the foreclosure epidemic will result in the greatest loss of wealth in American history.

Although some efforts are underway to address this crisis, including limited relief provided through a federal housing bill, there is no existing solution that has been put in place that will come close to keeping pace with the level of foreclosures—a rate that has yet to reach its peak. Effective and sustained interventions are desperately needed now.

The magnitude of the losses, the likelihood that we are only part-way through the wave of foreclosures that are expected to occur through 2009 or longer, and the impact of foreclosures on neighborhoods and family wealth more broadly all suggest that long-term, comprehensive, and sustained investment is needed to address the results of widespread foreclosures. This brief, prepared by the Center for Responsible Lending in partnership with the Asset Funders Network,

¹ http://www.sourcewatch.org/index.php?title=Economic_Stimulus_Bill_of_2008

seeks to provide background on the foreclosure crisis and guidance to foundations looking for opportunities to strategically intervene in this crisis.

Understanding the Magnitude of the Foreclosure Crisis

In a 2006 study based on the performance of more than six million subprime mortgages,² the Center for Responsible Lending (CRL) estimated that that one in five homeowners who obtained subprime mortgages during 2005 and 2006 have lost or will lose their home to foreclosure. More recently, an analysis by Credit Suisse estimates that 6.5 million homes will enter the foreclosure process between now and 2012, resulting in a home loss for as many as 13% of all people who hold a mortgage on their primary home.³ In California in the month of August 2008 alone, more than 25,000 foreclosed homes reverted to bank ownership.⁴

According to the latest reports from industry and HOPE NOW⁵:

- **Seriously delinquent loans are at a record high for both prime and subprime loans.** At the end of June 2008, the Mortgage Bankers Association reported that 18% of subprime loans were “seriously delinquent” (90 days or more delinquent or in foreclosure). This is double the rate from only one year earlier, and the highest rate ever recorded by the MBA.
- **The number of borrowers who lost their homes to foreclosure soared in recent months.** HOPE NOW estimates that 85,000 families lost their homes to foreclosure in May 2008, the highest one-month figure since the alliance was formed. This represents a 35% increase over three months and more than double the number from July of last year. The total number of foreclosures since the program began last July is now estimated at over 650,000.

Even more disturbing, analysts expect foreclosures to get worse before they get better. Mark Zandi, chief economist of Moody’s Economy.com says that foreclosures are not likely to peak in the near future. In June of 2008 he said, “The problem is not going away. It is likely to intensify for the remainder of this year and into next.”⁶ Zandi estimated that approximately 9 million homeowners are in a negative equity position, meaning they owe more on their mortgage than their home is worth. Credit Suisse says that by 2009, 63% of subprime borrowers will be “upside down.”⁷

² “Subprime” refers to a type of mortgage lending intended to serve people who do not qualify for conventional loans because of credit problems or a limited credit history. Subprime loans typically have higher interest rates and fees, and research has shown that many borrowers who could have qualified for conventional (or prime) loans instead received more costly loans in the subprime market.

³ Reuters report: <http://www.reuters.com/article/bondsNews/idUSN2233380820080422>.

⁴ Foreclosure Radar, “California Foreclosure Activity Mix”, September 16, 2008

⁵ HOPE NOW is a nationwide coalition of mortgage lenders, servicers and housing counselors formed in late 2007 to help facilitate foreclosure preventions.

⁶ Mark Zandi, speaking at Demos press conference “Beyond the Mortgage Meltdown” (June 25, 2008).

⁷ <http://mortgage.freedomblogging.com/2008/04/24/credit-suisse-sees-65-million-loans-in-foreclosure-by-2012/>.

The After-Shocks as the Damage Extends

Not only do individual homeowners suffer when faced with foreclosure, but entire communities feel the spillover effects as property values depreciate, tax revenues decline, public services wane, and social fabrics fray. As previously noted, more than 40 million families who happen to live in the vicinity of one or more subprime foreclosures will see the collective equity in their homes decline by \$356 billion over the next two years – an amount far exceeding the \$145 billion economic stimulus package approved by Congress earlier this year.⁸

The implications are wide-ranging, they include:

Loss of ownership: Another disturbing outcome—one that is only beginning to receive media attention—is a reversal of the upward trend in homeownership. Recently Robert Schiller, a prominent professor of economics at Yale, reported that the homeownership rate has declined, dropping from 69.1% in 2005 to 67.8% this year.⁹ Given the importance of homeownership in a family’s stability and prospects for longer-term economic security, this represents a devastating setback for community development in this country.

Loss of jobs: A weaker housing market means fewer jobs in construction and many other housing-related areas. The number of failed subprime lenders is growing every day, including high-profile companies like Countrywide Financial, affecting all aspects of economic life both at home and abroad. Thousands of industry employees have lost their jobs and credit markets have shrunk dramatically.

Increases in crime and loss of services: Empty homes lead to higher crime rates. Concerns include vandals that break into abandoned homes to steal materials or fixtures, as well as illegal activity conducted out of vacant properties. For example, crime rose 33 percent between 2003 and 2006 in certain suburban areas of Charlotte that are hard hit by foreclosures, while the overall crime rate has stayed the same.¹⁰ Lost property tax revenue also hurts cities and counties that are already strapped.

Loss of family stability: Family stability is threatened by credit distress and savings depletion, and for those who file bankruptcy, the effects will endure for years to come. Seniors, stripped of hard-earned home equity, are seeing retirement dreams delayed. The psychological and emotional toll on families, and particularly children, who are displaced from their homes by foreclosure is only beginning to be understood.

Disparate effects on families of color: The problem is particularly serious for communities of color, since African-Americans and Latino households have received a disproportionate share of abusive subprime loans.¹¹ Should foreclosure rates remain unchecked, CRL estimates that

⁸ *Defaulting on the Dream: States Respond to America's Foreclosure Crisis*, Pew Charitable Trusts, April 2008.

⁹ New York Times Op-Ed (May 18, 2008).

¹⁰ Patrik Jonsson, Vacant homes spread blight in suburb and city alike. *The Christian Science Monitor* (July 1, 2008). See also *Abandoned Houses Invite Crime in Minneapolis*, NPR, (June 12 2008).

¹¹ The most recent lender information submitted to federal regulators, shows that among African-Americans who received home loans in 2006, more than half received a high-cost mortgage. Among Latinos, the share was more than 40%. By comparison, only 22% of white borrowers received high-cost mortgages.

subprime mortgages ultimately could be the cause of the largest loss of wealth for communities of color in American history.¹²

What Caused the Foreclosure Crisis?

Under ordinary circumstances, most foreclosures are triggered by an unexpected event that affects family income, such as job loss, divorce, or illness. But in the case of the current epidemic, the triggers have been both structural and systemic to the lending process itself – a process that has rewarded dangerous practices by underwriters, brokers and appraisers alike while enjoying relative immunity from regulatory scrutiny.

- **Dangerous products.** Until recently, the bread and-butter of subprime lenders were hybrid adjustable-rate mortgages, or *exploding ARMs*. Lenders offered fixed-interest initial rates for a two- or three-year period before resetting rates upward, generally every six months. Families saw their monthly payments abruptly increase by 30 – 50% even when interest rates remained constant, well beyond their expectations and usually beyond their means. Many lenders also offered low- or no-documentation products, charging a higher interest rate when the borrower could have provided income documentation to obtain a more affordable loan product.
- **Loose underwriting.** Many lenders ignored prudent underwriting practices, qualifying borrowers without verification of income, calculating ability to repay on initial teaser rates only, and failing to escrow for property taxes and insurance. These tactics helped convince borrowers their mortgages would be affordable, and since lenders knew they could pass the loans to the secondary market, safety and soundness was of little concern. Weaknesses in underwriting standards are also starting to surface well beyond the subprime market, into many other types of nontraditional loan products like payment option ARMs and into the prime market.
- **Housing Slowdown.** Lenders counted on home values rising to cover loose underwriting, and many believed that abusive loans would produce more refinances in the future when borrowers could not afford their loans. But as housing price growth slowed, exits through refinances were closed off, and borrowers had no options other than foreclosure.
- **Broker abuses.** While people engage mortgage brokers to look after their best interests, the truth is that brokers have every incentive to look after their own instead. Lenders offer brokers financial incentives called *yield spread premiums*¹³ to put borrowers in high-interest loans, even if they qualify for lower rates. They also reward brokers for *prepayment penalties*,¹⁴ which trap homeowners who want to refinance or sell or strip hard-earned equity. More than 70% of all subprime loans include prepayment penalties.

¹² *Losing Ground: Foreclosures in the Subprime Market and their Cost to Homeowners*, Center for Responsible Lending, December, 2006.

¹³ A yield spread premium is a payment a mortgage broker receives from a lender for delivering a loan with an interest rate higher than the minimum rate the lender would accept for that particular loan. Yield spread premiums provide incentives for mortgage brokers to steer borrowers into higher-cost loans.

¹⁴ A prepayment penalty is a fee charged by a lender when a borrower pays off a mortgage before all payments are due, often to refinance the loan at a more affordable rate. Prepayment penalties vary in size and how long they

- **Appraiser abuses.** Appraisers concerned about losing business from brokers and lender in many cases helped to inflate home valuations to make the numbers 'work' for underwriters. Inflating property values works to increase loan volume, but it doesn't work for homeowners with dangerous loans. When borrowers get into payment trouble, often they are surprised to learn they are *upside down* – owning property worth far less than the debt secured by it.
- **Investor support.** Attracted by the initial high yields offered by packaged securities, investors spurred the rapid growth of subprime lending and encouraged reckless underwriting practices, for example, by paying more for loans with minimal income documentation because of higher yields. When portfolios proved to be rife with problems, it was too late to hold originators accountable for poor loan quality.
- **Outdated Protections.** Congress has not taken any major action to address predatory lending practices since 1994, when it passed The Home Ownership and Equity Protection Act (HOEPA). Recent bipartisan support for legislation improving federal protections in the U.S. House suggest there is widespread agreement that HOEPA is inadequate and outdated, and most observers expect Congress to consider stronger consumer protections during the coming year. The Federal Reserve Board recently finalized regulations intended to prevent some of the common destructive subprime practices in the future (see next section).

Examples of Current Responses

With the housing industry in a tailspin, legislators, regulators, and the financial markets have been forced to take notice. Community leaders are stepping up to the plate in the hopes of preserving substantial investments in asset-building and averting irreversible damage. Meeting widespread challenges posed by the foreclosure crisis will require a concerted effort, sustained commitment, and targeted resources.

Focus on Policy Advocacy

Across the country, active efforts are underway aimed at changing public policy, uses of regulatory authority, and corporate practices around subprime lending. Among the many national non-profit organizations taking vocal positions on the issues are AARP, ACORN, the Center for Responsible Lending, Consumer Federation of America, the Leadership Conference on Civil Rights, NAACP, the National Consumer Law Center, the National Community Reinvestment Coalition, and the National Council for La Raza. In the states, community-based organizations, Community Reinvestment Act associations, organized labor, statewide NAACP chapters and other civil rights groups, housing and consumer advocates, community development corporations and community development financial institutions are taking the lead.

At the federal level, the policy debates are contentious and slow moving, though there has been some progress. Actions in the secondary market and government guidance have effectively eliminated the subprime exploding ARM product. Recently enacted Federal Reserve regulations

remain in effect. Some of the most pernicious are effective for three to five years and charge six months' interest. Prepayment penalties are rare in the prime market but common in subprime loans.

under the Truth in Lending Act make significant progress in curbing the underwriting abuses that led to current foreclosures, by requiring lenders to consider a borrower's ability to repay, requiring income verification, and requiring escrows for taxes and insurance. The Federal Reserve's rules also partially address abusive prepayment penalties, although states and further federal action could do more to limit these fees that make it difficult for borrowers to pay off unaffordable loans. The Federal Reserve also has expressed interest in addressing broker abuses such as yield-spread premiums in later rulemaking, and states are also taking a harder look at broker abuses. For example, North Carolina recently banned yield-spread premiums on subprime loans and Massachusetts' Attorney General addressed broker fees that violated the state's unfair trade practices law.

Congress recently enacted a set of proposals directed at stemming the tide of foreclosures, including giving the Federal Housing Administration (FHA) a larger role in refinancing mortgages that are at a high-risk of foreclosure. Among the provisions (but not inclusive): expanding the FHA's capacity to insure refinances on distressed mortgages; funding state and local governments to redevelop foreclosed homes; strengthening regulation of government-sponsored enterprises (Fannie Mae and Freddie Mac and the Federal Home Loan Bank system); strengthening protections for members of the military from foreclosures under certain conditions; and protecting mortgage servicers who modify loans from investor lawsuits.

While the recent federal legislation represents a positive step, it continues to rely on voluntary industry efforts to modify loans. Results are difficult to predict, and many observers remain skeptical that the impact will be sufficient to stop the ongoing flow of foreclosures in a meaningful way. Moreover, most of the interventions require substantial start-up time to implement, and while the necessary mechanisms get established, home losses will continue to occur at extraordinary levels. More effective action is needed to prevent unnecessary foreclosures by establishing requirements or stronger incentives for servicers and holders of subprime mortgage debt to modify loans now held by struggling homeowners. Of note, however, is that the bill puts in place \$4 billion in CDBG funds to support purchase, rehabilitation, and resale of foreclosed properties, an investment that will require significant infrastructure at the local level.

To keep families in their homes and prevent foreclosures that can be avoided, better solutions exist. For example, CRL estimates that up to 600,000 foreclosures could be prevented if policymakers were to make court-supervised loan modifications available to homeowners going through bankruptcy. Current bankruptcy law allows court-supervised modification of loans for owners of commercial real estate and yachts, as well as notorious subprime lenders like New Century, but it is denied to families whose most important asset is the home they live in. In fact, current law makes a mortgage on a primary residence the only debt that bankruptcy courts are not permitted to modify in chapter 13 payment plans.

State policy actions have proven to be more aggressive than federal efforts, particularly in states that are feeling the brunt of the foreclosure crisis. According to a 2008 inventory of state actions published by the Pew Charitable Trusts, Ohio alone is burdened with a full 6% of the nation's foreclosures. One in 11 homeowners in Nevada and one in 18 in Arizona are at risk of

foreclosure.¹⁵ Among the study's findings are that states are both acting to put additional consumer protections in place to prevent future foreclosures, and are looking for ways to help homeowners currently facing foreclosure:

- At least six states require lenders to calculate a borrower's ability to repay at the fully-indexed interest rate, not the initial ARM teaser rate.
- Nine states have affirmed that the interests of borrowers are a necessary consideration for brokers working on their behalf.
- Ten states ban most prepayment penalties and many more limit prepayment penalties in some form.
- More than a dozen states now define and substantively regulate "high cost" loans.

Some states have asked lenders and loan servicers to implement voluntary loan modification programs. Others have extended the foreclosure process period significantly or have mandated loan work-out periods prior to initiating foreclosure procedures.

As many states move forward to take significant action to curtail foreclosures, there is serious concern that some federal policymakers and industry proponents are pursuing efforts to preempt tough state regulations, effectively setting weaker federal policy as a ceiling for consumer protection. Both national and state-level coalitions are now calling for federal action to reverse this effect and encourage joint federal and state rules and enforcement to protect wealth in the community.

What Can Foundations Do?

Real solutions to the foreclosure crisis will require substantial and long-term investments if they are to be effective and enduring. The most far-reaching solutions will need to come from the public sector and changes in the mortgage market, but there are a range of strategies that foundations can invest in as well. Grants, program-related investments, and endowment management are all tools to be mobilized.

Support Direct Assistance to Borrowers

- **Support Foreclosure Prevention Counseling:** Homeowners at risk of default or foreclosure can benefit from homebuyer counseling programs with strong pre-purchase and early intervention components. Counselors can make a significant difference for borrowers who are currently facing foreclosure by serving as their advocate in negotiating with a lender to modify the loan and keep the borrower in their home. In addition, pre-purchase counseling has been shown to be effective in assuring that borrowers receive affordable and sustainable loans in the first place. These programs are very labor-intensive, offering budget assistance, financial counseling and assistance in negotiating with lenders. Local counseling agencies have been overwhelmed by calls, and staffs are backlogged by the intensive support needed by clients fearful of losing their homes.
- **Support Development of Specific Mortgage Work-Out Products:** Some financial institutions and regulators are exploring new work-out strategies for homeowners with

¹⁵ See note 3.

delinquent loans. One California Bank¹⁶ is piloting a program to buy out, write-down down and renegotiate the terms of loans to realign families' mortgages with the reality of their income and depreciated home value. The FDIC recently proposed authorizing the Treasury Department to make loans to borrowers and to pay down up to 20 percent of their principal in return for mortgage investors agreeing to concessions on the underlying mortgage.¹⁷ Philanthropy can support such innovations both through policy advocacy and investing in innovative finance strategies. Community Development Financial Institutions (CDFIs) may also be valuable partners in exploring strategies for developing mortgage work-out products.

- **Provide Legal Defense:** The number of foreclosure proceedings spawned by predatory lending has sent demand for legal assistance soaring to new heights. The complexity of the issues requires both extensive legal expertise and education within the courts. A lawyer's advocacy can make a critical difference in persuading a lender to work to find loan modification solutions that allow delinquent borrowers to stay in their home. One example of such a response is the Institute for Foreclosure Legal Assistance, a partnership between the Center for Responsible Lending and the National Association of Consumer Advocates, providing funding and training to legal aid organizations and law clinics that help homeowners negotiate alternatives to foreclosure.

Add Strong Voices to Policy and Education

- **Support Community Organizing:** The participation of families and communities most impacted by the foreclosure crisis is critical to efforts to strengthen state and national consumer protections. State and regional consumer protection coalitions need foundations to support their research, information dissemination, organizing and leadership development efforts. Foundations can further strengthen these coalitions while learning alongside them by offering convening support or technical assistance to advance their efforts.
- **Be an Advocate:** In recent decades, foundations have partnered with the public sector to invest in significant community revitalization efforts. As the foreclosure crisis undermines these communities, policymakers may be persuaded by their co-investors from philanthropy to act decisively.
- **Review Endowment Investment Strategies.** The consequences of the subprime problem are pervasive within both domestic and international holdings. Foundations can investigate current investment policies and holdings, and screen for companies that are perpetuating the foreclosure crisis and/or lobbying against anti-predatory strategies.

Invest in Communities

- **Preserve Foreclosed Properties for Affordable Housing:** Non-profit acquisition of bank-owned properties (referred to as Real Estate Owned or REO properties) offers an important opportunity to expand the stock of affordable rental and ownership housing. Non-profit community development corporations, often in partnership with local government, are

¹⁶ <http://www.onecalif.com/ContentPage.aspx?name=subprimeforeclosurepreventionstrategy>.

¹⁷ <http://www.fdic.gov/consumers/loans/hop/>.

undertaking new initiatives—through land trusts, land banks, and conventional purchase—to acquire, rehabilitate and sell or manage large numbers of REO properties dispersed throughout their communities. Foundations can play a key role in this strategy by offering program grants that build CDC capacity to engage in this work and by making PRI investments for development capital.

- **Invest in Community Development Financial Institutions.** By the time a family is facing foreclosure, it is usually too late for a Community Development Financial Institution (CDFI) to intervene with alternative financing, particularly when housing values are simultaneously overstated and depreciating. Foundation investments in CDFIs through operating grants and PRIs will help them better compete against abusive lenders and make quality financial products more broadly available in low-wealth communities.

Conclusion

The foreclosure crisis is far from over. Already we have seen the devastating consequences of widespread foreclosures and significant losses by financial institutions. Yet it is not too late to take action to prevent many more foreclosures and a much higher social cost. It is possible to keep families in their homes and avoid the neighborhood and societal costs of mass foreclosures, but only through comprehensive and sustained intervention. Foundations have an important role to play in helping to curb the foreclosure crisis and in ensuring that we prevent a similar crisis from occurring in the future.