Joint Economic Committee
Senator Charles E. Schumer
Chairman

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NEW JEC REPORT: SUBPRIME CRISIS TO COST BILLIONS IN FAMILY WEALTH, PROPERTY VALUES, AND TAX REVENUES UNLESS ACTION IS TAKEN TO PREVENT FORECLOSURES

Schumer's Joint Economic Committee Report Estimates 2 Million Subprime Homes Could Go into Foreclosure; Property Values, Personal Wealth, and Tax Revenues Poised for Big Declines

JEC Report First of Its Kind to Project Economic Losses on State-by-State Basis from 2007-2009

Schumer: Strong Action by Administration Needed to Stave Off Broader Economic Downturn

Washington, D.C. – **U.S. Senator Charles E. Schumer**, Chairman of the Joint Economic Committee (JEC), released a report today analyzing the greater financial impact of the subprime foreclosure boom. The JEC report entitled, *"The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here"* reveals that families, neighborhood property values, and state and local governments will lose billions of dollars as two million subprime mortgage homes are foreclosed. The subprime fallout report argues in favor of foreclosure prevention, which can save the economy billions in housing wealth and ease falling housing prices. Sen. Schumer was joined by Senators Amy Klobuchar (D-MN), Sherrod Brown (D-OH) and Rep. Carolyn Maloney (D-NY), the Vice Chairman of the Joint Economic Committee. The JEC report is the first of its kind to project economic costs on a state-by-state basis from the third quarter of 2007 through 2009.

<u>Schumer</u> said, "State by state, the economic costs from the subprime debacle are shockingly high. From New York to California, we are headed for billions in lost wealth, property values, and tax revenues. The current tidal wave of foreclosures will soon turn into a tsunami of losses and debt for families and communities. The administration must act quickly to save financially-strapped families from drowning in this flood of subprime foreclosures."

The JEC report found that the subprime catastrophe is likely to accelerate the downward spiral of house prices. Based on state-level data, the report estimates that by 2009:

- 2 million foreclosures will occur by the time the riskiest subprime adjustable rate mortgages (ARMs) reset over the course of this year and next.
- Approximately $71 billion in housing wealth will be directly destroyed because each foreclosure reduces the value of a home.
- More than $32 billion dollars in housing wealth will be indirectly destroyed by the spillover effect of foreclosures, which reduce the value of neighboring properties.
- States will lose more than $917 million in property tax revenue as a result of the destruction of housing wealth caused by subprime foreclosures.
- The ten states with the greatest number of estimated foreclosures are California, Florida, Ohio, New York, Michigan, Texas, Illinois, Arizona and Pennsylvania. But there are several others that are close behind in the rankings.
- On top of the losses due to foreclosures, which this report examines, a 10 percent decline in housing prices would lead to a $2.3 trillion economic loss.

The full report can be found at www.jec.senate.gov.

"American families stand to lose over $100 billion in the value of their homes over the next two years due to subprime foreclosures, and this economic pain will also be felt by neighbors and local economies," said Maloney. "This new JEC report is a sobering look at just how much worse things could get, and fast, for American families and the economy. Democrats in Congress are working hard to help families stay in their homes and prevent another crisis like this from happening in the future."

"In the world of subprime lending, the chickens have come home to roost," said Klobuchar. "If we are to contain the economic spillover effect of the subprime lending disaster, we must act now."

"Since January, Ohio foreclosure filings were almost double what they were last year – 100,000 through September. This fall will probably be worse, and next year could be even higher. We need to act, and act now. The problems Ohio is facing are spreading across the country – from New York to Florida to California. We should apply the same attention to Main Street's problems that we do to Wall Street's," said Brown.

Nationally, house prices began to decline in 2006 and are now down approximately 3.2 percent from their peak in the second quarter of 2006. Inventories of unsold new homes have increased, and the monthly supply of new homes has risen. With housing prices no longer rising, subprime borrowers cannot refinance their homes to pay off loans before they reset to higher and often unaffordable rates. Loan delinquencies are soon followed by foreclosures.

One study on housing values in Philadelphia found that an abandoned property lowered values on homes located within 150 feet of the abandoned property by an average of 10% and lowered values on homes located within 450 feet by an average of 5%.

The JEC report outlines several policy proposals to combat additional foreclosures and prevent this crisis from happening again:

Foreclosure prevention counseling. There is a broad consensus that the role of housing counselors as intermediaries between borrowers and lenders/loan servicers is critical in helping prevent foreclosures. Housing counseling agencies across the country are helping struggling borrowers to negotiate safe and affordable loan modifications and refinancings in an effort to prevent foreclosures where possible. The Senate approved a $100 million appropriation targeted to HUD-approved foreclosure-avoidance nonprofits and $100 million in loss mitigation funding for both nonprofits and private entities. Nonprofits that specialize in foreclosure prevention have been highly effective in acting on behalf of borrowers to explore their options with their lenders, but they're inundated and more resources are needed.

Temporarily increase portfolio caps for Fannie Mae and Freddie Mac. Both of the government sponsored enterprises (GSEs) are currently constrained by portfolio limits imposed upon them by their regulator. Temporarily raising the GSE portfolio limits so they can focus on subprime ARMs could provide much needed funding to mortgage lenders who will be able to refinance struggling borrowers in safe and sustainable loan products.

Increase FHA's ability to refinance subprime borrowers. Modernizing the Federal Housing Administration (FHA) would increase their capacity and flexibility to insure subprime mortgages that can be refinanced. The proposal currently in Congress is designed to make FHA-insured loans a more attractive option to lenders and borrowers by increasing allowable loan limits and lowering down-payment requirements.

Amend the bankruptcy code to protect families from foreclosure. Bankruptcy could be a highly effective tool for helping families recover from subprime loans, but today's bankruptcy code prevents courts from providing relief on mortgage loans and many have loans that are greater than the value of their homes, meaning that foreclosure will not extinguish their debts. In fact, federal law singles out the home mortgage loan as the one debt the courts are not permitted to modify. Amending the bankruptcy code to either temporarily or permanently exclude primary home loans from the remedies that are available on other, less important debts, would allow borrowers to pay the liquidation value of their home and to keep that home, rather than seeing the home sold to a third party for its liquidation value.

Encourage more loan modifications and refinancings. The most effective way to help prevent foreclosures for hybrid ARM borrowers that cannot afford their payments after the rate reset is to modify the terms of their loan to make them affordable. The federal regulators have issued guidance to lenders and servicers to engage in loss mitigation efforts prior to pursuing foreclosures, and lawmakers must continue to pressure lenders and loan servicers to step up their efforts to help subprime ARM borrowers before their loan resets. Policymakers may also consider requiring specific loss mitigation efforts prior to any foreclosure filing by creating an affirmative duty for lenders and servicers prior to foreclosure.

Waive tax liability on forgiven debt in restructured loans. Legislation is currently pending in Congress to temporarily change the tax law to let homeowners avoid paying taxes on any forgiven debt in loans being restructured by financial institutions.

Reform mortgage lending and ban predatory lending practices. Predatory lending helped fuel the volume of risky subprime loans and was enabled by a patchwork of federal and state regulations that was all-too-easily evaded by subprime mortgage brokers and lenders. Federal laws are needed that would offer predatory lending protections to homeowners, restore common sense underwriting practices and ensure a borrower's ability to pay. The federal government should require lenders to determine that the borrower has the ability to repay a loan at the fully-indexed rate and assume fully amortized payments. Federal regulation needs to rein in lenders and originators that escape regulatory guidance requiring depository banks and their affiliates to underwrite loans at the fully indexed interest rate. Policymakers should also require lenders to verify a borrower's income using tax documents or other reasonable documentation.

Policymakers may also want to combat predatory lending practices by:

- Requiring mortgage lenders to escrow for taxes and insurance on all mortgage loans. Failing to escrow for taxes and insurance on a subprime loan is an unfair and deceptive practice that contributes to high rates of foreclosure.
- Eliminating prepayment penalties and yield-spread premiums on subprime loans.
- Regulating mortgage brokers and originators under the existing Truth in Lending Act (TILA) by establishing a fiduciary duty between brokers and their customers, and a duty of good faith and fair dealing standard for all originators.
- Making sure all borrowers understand the terms of their mortgages, requiring that all mortgage lenders disclose the basic facts about the mortgage loan that they underwrite for the borrower. This one page form should be easy to understand and should indicate the amount of the loan, the property's appraised value, the term of the loan, the payments at each reset date, and today's estimate of how much the rate will increase (the fully indexed rate), as well as the maximum possible rate on the loan. Other disclosures would include, in plain language, any prepayment fees and other estimated costs and fees due at closing.

<u>The JEC report also highlights the underlying causes of the subprime mortgage crisis:</u>

Unregulated Mortgage Companies: Most subprime loans are made by companies that specialize in mortgage lending. Because they are not deposit-taking institutions, the independent mortgage companies and bank subsidiaries are not subject to the safety and soundness regulations that govern federal or state banks. Nor are they subject to other federal regulatory regimes such as the Home Owners' Equity Protection Act (HOEPA) or the Community Reinvestment Act, leaving the door open for fraud and abuse.

Slicing and Dicing of Loans into Mortgage-Backed Securities: The lack of oversight during the lending process is exacerbated by the fact that lenders hold only a fraction of the subprime loans they make in their own portfolios. Most loans are sold, in whole or in part, to the secondary market, where they become the underlying assets for residential mortgage backed securities. Lenders sell the securities to a wide array of financial players spread throughout the world. The "slicing and dicing" of the original loans makes it difficult to value them and complicates refinancing.

Perverse Incentives for Mortgage Brokers: Lenders, such as Countrywide, sometimes pay brokers so-called "yield-spread premiums," when they sell loans with interest rates above the minimum acceptable rate for the loan. Some brokers may also receive higher fees for selling mortgages with prepayment penalties. Moreover, since mortgage brokers bear little or no risk when a borrower defaults, they have no economic incentive to originate loans that a borrower can afford in the long term. Brokers also lack strong legal incentives to act in the interest of borrowers. Under state law brokers are not fiduciaries, who must put the interest of their clients first. Nor do they have a duty to sell their clients products which are at least suitable to their circumstances, as registered securities brokers do.

Predatory Lending by Lenders and Brokers: Given the financial incentives for brokers and lenders to provide an increasing volume of high yield mortgages, it is no surprise that tactics were invented to meet the demand.

Common practices included:

- Expansion of 2/28 and 3/27 hybrid adjustable rate mortgages in which mortgages reset to a higher rate after the second or third year, making it more likely that a subprime borrower will need to sell, refinance, or default.
- Imposition of prepayment penalties, which are frequently imposed on all types of subprime loans at a very high relative and absolute rate, have the potential to strip the housing equity from subprime borrowers and increase the likelihood of default
- Rapid rise in "no document" loans that appear affordable even when they are not
- Deliberate targeting of the most vulnerable segments of society, including but not limited to, Hispanics and the elderly.

The Joint Economic Committee, established under the Employment Act of 1946, was created by Congress to review economic conditions and to analyze the effectiveness of economic policy.

www.jec.senate.gov

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