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Preserving Homeownership

Addressing Foreclosure

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Should we close down the subprime market?... Regrettable foreclosures notwithstanding, three-quarters of new homeowners are making their payments, building wealth and participating in the American Dream.

—Edward Gramlich
Former Governor
Federal Reserve Board

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Courtesy of NeighborWorks America and the Ad Council.

Increasingly, foreclosure has become a national problem and a center of attention for Congress, regulators, the mortgage industry and consumer advocates. The residential foreclosure rate in Texas has been on the increase since late 2001, most notably concentrated in subprime adjustable rate mortgage (ARM) loans. Many efforts to prevent homeowners from facing the financial and personal disaster of foreclosure have been implemented, and many more measures are being proposed.

Research shows that about half of homeowners fail to seek help when they find themselves at risk of foreclosure and that the stress from being delinquent on their mortgage interferes with their ability to strategize and make rational decisions about how to deal with financial crises.

In June, the Federal Reserve Bank of Dallas, in partnership with the Dallas Field Office of the Department of Housing and Urban Development (HUD), hosted a conference to examine the data trends, patterns and potential impact of foreclosure as well as industry innovations being used to reach troubled borrowers and sustain homeownership. This issue of Banking and Community Perspectives *recaps the conference by highlighting a portion of the research and innovative solutions presented.*

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Preserving Homeownership

Addressing Foreclosure

The conference "Preserving Homeownership: Addressing the Foreclosure Issue," held in Dallas in June, opened with a panel of Texas researchers who addressed the impact foreclosures are having on the U.S. and Texas economies.

Framing the Issue

The first several years of this decade may prove to be the "great housing experiment of the 21st century," according to James P. Gaines, a research economist with the Real Estate Center at Texas A&M University.

Homebuyers in the U.S. have enjoyed historically low interest rates, record home price increases in selected areas, and a flood of private capital from Wall Street that led to easy credit terms and nontraditional mortgages, Gaines said. These conditions have also resulted in a surge in vacation home purchases and extraordinary investor demand for residential housing. The major impact of the housing experiment was an astounding increase in the national homeownership rate from 64 percent in 1994 to 69 percent today.

Gaines also pointed out that the current results of the experiment are record home price decreases in some areas, accompanied by high levels of foreclosures. The main factor leading to higher foreclosures was relaxed underwriting standards coupled with nontraditional loan products, according to Gaines. To quantify the subprime situation, he explained that about 65 percent of owner-occupied homes in the U.S. have a mortgage. Of those mortgages, 76 percent have fixed interest rates and 86 percent are priced at prime—the rate available to homebuyers with the best credit. Of the roughly 14 percent of mortgages considered subprime—priced at higher interest rates than prime loans—more than half are adjustable-rate mortgages (ARMs), and of those, 17 to 20 percent are interest-only loans.

In Texas, as in the U.S., foreclosure inventory rates on prime mortgages as of fourth quarter 2006 were running at historical norms—one loan foreclosure for every 200 loans, or 0.5 percent. In contrast, the subprime loan foreclosure inventory rate was much higher, at about eight foreclosures for every 200 loans, or 4 percent. Because 75 percent of all subprime loans were originated after 2003, Gaines said, this situation is expected to be compounded over the next two years as interest rates on many of these subprime loans are scheduled to increase. (See box "Quantifying the Foreclosure Issue.")

Gaines emphasized that the subprime story is not all bad. Even if the foreclosure rate climbs to 10 percent of all subprime loans, that means 90 percent of the families who financed with subprime loans are still living in their own home—a home they may not have been able to own otherwise.

Table 1

Top County Foreclosure Rankings in Texas

Rank	County	Total foreclosures 1/1/2002 to 6/30/2006	Foreclosures/ mortgages
1	Dallas	15,406	5.6%
2	Bexar	6,040	3.3%
3	Travis	3,327	3.1%
4	Harris	12,689	3.0%
5	Cameron	706	3.0%
6	El Paso	1,547	2.1%

SOURCE: Elizabeth Mueller/Texas Department of Housing and Community Affairs report, 2006.

Study of Texas Foreclosures

Elizabeth Mueller, assistant professor at the University of Texas at Austin, led an advisory committee to the Texas Department of Housing and Community Affairs (TDHCA) in a study of Texas foreclosures. Mandated by the 2005 Texas Legislature, the study examined mortgage foreclosure activity in six Texas counties: Bexar, Cameron, Dallas, El Paso, Harris and Travis (*Table 1*).

The TDHCA report included total number of foreclosures for 2002 to mid-2006 and mapped data from 2004 to mid-2006 to determine where foreclosures are concentrated.

Texas ranked sixth nationally during this period in number of foreclosures compared with number of households holding a mortgage.

Photo: Roy Lopez

Every lender will agree that foreclosure is a lose–lose situation for all involved.

Photo: Roy Lopez

Mueller explained that past studies have cited several possible causes of foreclosure. These include length of the foreclosure process, economic conditions such as job loss, family breakup and high debt load relative to income. The committee attempted to assess the importance of these factors in explaining the high rate of foreclosure in Texas.

Texas has the worst average credit score in the U.S., which could result in Texans paying higher interest rates on mortgage loans. Mueller pointed out that a loan applicant with the average Texas credit score of 648 (compared with a national average score of 675, according to Experian's National Score Index) would likely fall between being qualified for a prime ARM and a subprime fixed rate. "That really sums it up," Mueller said. "A lot of people in Texas are right on the edge between subprime and prime."

When Texas' short, nonjudicial foreclosure process was compared with other states that have longer processes involving court hearings, there was not a clear pattern of more foreclosures in states with shorter time frames. Therefore, the length of the process was not considered a factor. (See box "Texas Foreclosure Timeline.")

Mueller's committee mapped foreclosures by census tract to reveal any insight into the causes of foreclosure. The map for Dallas County, the county with the highest foreclosure rate, shows most foreclosures were concentrated in areas with incomes below 90 percent of median county income, 22 percent or more high school dropout rate and a majority minority population. In addition, at least 24 percent of the loans in these areas were made at high interest rates (high-cost loans typically have interest rates at least 3 percentage points above prime mortgages).

In summary, Mueller said, the study shows a critical need for financial education. Foreclosures are more likely in neighborhoods where the average income is below median and lack of education may put borrowers at a disadvantage in navigating the lending process. Concentrated foreclosure activity has severe consequences for residents and communities, may indicate abusive practices, and shows the need for more research to determine the causes of foreclosure and possible solutions.

One Neighborhood's Story

Assistant Professor Olivia Yu presented findings from her case study of a specific San Antonio neighborhood with a very high foreclosure rate. The project originated when a student in her class at the University of Texas at San Antonio's College of Public Policy voiced concern about a neighborhood of new homes that had already shown an alarmingly high foreclosure rate before construction was complete. Under Yu's supervision, the student conducted independent research to identify the extent and possible cause of the neighborhood's foreclosure problem.

As background, Yu explained that San Antonio has enjoyed a high rate of housing growth for more than a decade, averaging a 40 percent annual increase in single-family permits in the past 15 years.

An analysis of 2005 Home Mortgage Disclosure Act data for San Antonio showed that neighborhoods with the highest minority rate (80 percent or more) had the largest shares of high-cost mortgages, which accounted for 64.2 percent of all refinance loans and 56.7 percent of all home purchase loans. In contrast, the predominantly white neighborhoods (80 percent or more) had the lowest share of high-cost mortgages, which accounted for 23.2 percent of all refinance loans and 13.8 percent of all home purchase loans.

Yu compared the characteristics of the subdivision's census tract with the average features of all census tracts in Bexar County (*Table 2*).

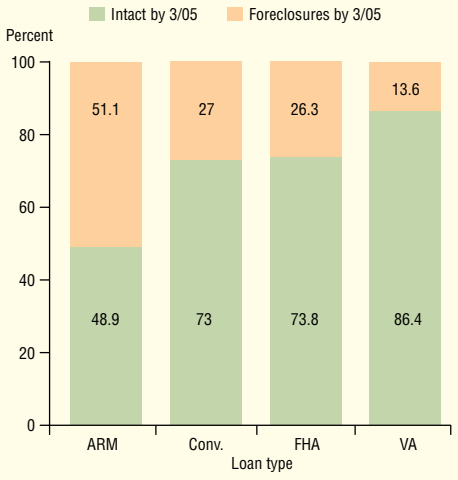
The subdivision is in a census tract with an above-average minority rate, moderate median income, more new homes and an above-average rate of owner-occupied homes. This census tract's foreclosure rate was four times the average of all census tracts in the San Antonio area. The area with the worst foreclosure record in the census tract was the subdivision Yu and her students observed. By the time the case study was completed, almost 28 percent of the homes in the subdi-

Table 2
Bexar County Census Tract Comparison

Variable	Mean of 276 census tracts	Census tract where the subdivision is located
Median income, N = 275	$44,570	$32,025
Below poverty rate, N = 275	16.9%	17.4%
Minority rate	64.8%	79.4%
Black rate	7.1%	25.2%
Hispanic rate	54.7%	49.9%
Homeownership rate	57.3%	67.0%
Median house age	29.1 years	15.0 years
Foreclosure rate, N = 275	4.1%	15.5%

SOURCE: Olivia Yu.

Figure 1
Distribution of Foreclosed Loans in One Troubled Neighborhood



SOURCE: Olivia Yu.

vision had been foreclosed. Further, and just as troubling to homeowners who remained in the neighborhood, home values had dropped by almost 13 percent.

Of the 306 loan originations in the subject neighborhood, 14.7 percent were high-cost ARMs. The distribution of foreclosed loans by loan type is illustrated in Figure 1.

More than two-thirds of the 86 foreclosures took place within three years of the loan origination. Yu said that, according to the Department of Housing and Urban Development, "foreclosures filed within two years of the loan origination are strong indicators of fraudulent and abusive lending practices."

The research team found it extremely difficult to reach families that had lost their homes to foreclosure. In the end, six families agreed to be interviewed. One experience that four families had in common was that their property taxes were not assessed as improved property at the time of closing, resulting in a shortage in their escrow account of approximately $2,500 by the end of the first year of their loan. Of these families, only one stated that the lender had mentioned that the property tax was based on the land value but had not explained why and what difference it would make.

Yu identified one obvious problem based on this study. In Texas, there does not appear to be a single, qualified guardian looking out for the borrower in the complex home mortgage process. She cited the state of New York, where buyers must pay a lawyer to represent them in the home loan transaction. "It costs about $300, but it's worth it," she said.

Mortgage Industry Response

Every lender will agree that foreclosure is a lose–lose situation for all involved. The conference included presentations from large and small mortgage lenders and servicers, the secondary market and the mortgage insurance industry. Many of these organizations are partnering with nonprofit, community-based service providers to reach troubled homeowners and raise awareness of the various alternatives to foreclosure.

Created by the federal government in 1938, Fannie Mae is now the largest buyer and guarantor of mortgages in the United States. Steve Horne, director of servicing risk strategy for Fannie Mae's Dallas office, explained that Fannie Mae is working with national and community-based nonprofits, in addition to lenders, loan servicers and mortgage insurers, on strategies to increase homeownership retention rates.

Horne echoed a statement by many presenters at the conference: "The trick is reaching the borrower earlier in the process." Fannie's new HomeStay initiative is a combination of technology (underwriting systems), alternative loan options for refinancing subprime mortgages, and outreach to loan servicers and nonprofits. According to a recent update on the HomeStay initiative by Fannie Mae President and CEO Daniel Mudd, about 70 percent of Fannie's applications for refinancing of subprime mortgages have been approved. This means over $6 billion in refinancing and approximately 33,000 homeowners served.

Republic Mortgage Insurance Co. (RMIC) is a national provider of private mortgage insurance. Michael Derstine, pricing group manager for RMIC, explained that the mortgage insurer's role is to protect lenders from financial losses due to defaults on high loan-to-value mortgages. As Derstine put it, "We feel the pain directly" when a homeowner defaults and a loan is foreclosed.

Some of the incredible boom in home mortgage lending was due to refinance activity, Derstine said, but a lot of the lending was for home purchases as borrowers took advantage of historically low interest rates and especially low short-term financing rates in 2002 and 2003. Rates began rising in 2004 and 2005, and the incentive to refinance disappeared. Home prices leveled off in 2005 and 2006, and loans began aging into "peak loss years," typically three-plus years after origination. RMIC analysis found that Texas has a high proportion of loans to borrowers with lower credit scores and higher loan-to-value ratios, which also impacts the state's foreclosure rates.

The current trend in Texas is stabilization of defaults, according to Derstine. He mentioned these positive signs: low unemployment rates, house price appreciation, moderate inventory levels, slowing of new construction, and less use of high-risk ARMS and other products. "While we are still seeing relatively high foreclosures, given these factors, we hope the market is not introducing any new problems into the mix."

RMIC is reviewing its loans, identifying those with upcoming interest rate resets and finding ways to solve problems before they occur. The company is also conducting regular reviews with lenders, providing analytical tools and guidance on portfolio risks, and encouraging prudent practices through strong credit policies.

As senior vice president of Wells Fargo Home Mortgage, Stephanie Christie is an executive for one of the largest mortgage lenders and servicers in the U.S. Despite the current controversy, Wells Fargo is committed to responsible nonprime lending, Christie said. She referenced a recent *New York Times* article that claimed an increase in minority homeownership was directly attributable to an increase in subprime lending options.

The Wells Fargo Steps To Success program offers upfront education for all nonprime borrowers—those with less-than-perfect credit or low use of credit, Christie said. The program is also provided to homeowners with loans made by Wells' joint

venture partners. Through March 2007, over 30,000 households were enrolled in Steps To Success. The program has three elements:

- Credit cleanup. Borrowers receive a free credit report, including credit score and tips on how to keep credit sharp.
- Hands on Banking, a financial education program, enhanced to include live counselors.
- Information about automatic payment enrollment and other banking services.

After one year of making payments on time through automatic payment, the borrower receives recognition and a small monetary reward. Although early in the process, Wells Fargo is seeing positive results:

- Participants in Steps To Success are significantly more likely to be enrolled in automatic mortgage payment programs.
- Visits to the Hands on Banking web site have increased 100 percent, and much of this increase can be attributed to the Steps To Success program.
- Fewer delinquencies occur among program participants than among a larger sample of nonprime customers (including 30, 60 and 90 days delinquent categories).

Josh Fuhrman is director of counseling for the national nonprofit Homeownership Preservation Foundation (HPF), which bridges the communication gap between homeowner and lender. HPF provides a toll-free consumer hotline (888-995-HOPE) with counselors available 24 hours a day, seven days a week to help homeowners with their mortgage difficulties. If face-to-face counseling is needed, the homeowner is referred to a local, nonprofit counseling agency.

HPF has worked with over 100,000 consumers since the nonprofit was founded in 2004, and almost a third of those were counseled in the first five months of 2007. The hotline's current call-in rate is 600 calls per day, compared with 200 per day last year.

HPF counseled 1,500 Texas homeowners in 2005 and 3,000 in 2006. It anticipates 6,000–8,000 calls from Texas in 2007.

Tips for Avoiding Foreclosure

- Don't ignore the letters from your lender.
- Contact your lender immediately.
- Understand your foreclosure prevention options. Go to: www.fha.gov/foreclosure/index.cfm
- Contact a HUD-approved housing counseling agency: Toll-free 800-569-4287 TTY 800-877-8339

Fuhrman suspects Texas caller volume will go even higher because of efforts in the state to promote the hotline and homeownership. For example, following a press conference organized by the Dallas HOPE partnership on June 6 in Arlington, call volume from Texas temporarily jumped from 30 calls per day to over 250 per day.

Lenders and others are supporting HPF efforts to increase awareness of the toll-free number nationwide. Because early intervention is critical and some homeowners are reluctant to make their first call for help to their lender, some lenders are printing 888-995-HOPE on their monthly mortgage statements and delinquent letters.

Not all success can be gauged by homeownership retention, Fuhrman said. Sometimes the result of a successful counseling effort is helping borrowers see that homeownership is not for them or not realistic given the circumstances. In those situations—perhaps in the case of divorce or loss of income—homeowners are encouraged to consider other options, such as a short sale, which gives them a graceful exit from the home but still avoids the devastating effect of a foreclosure on their credit record.

Modernizing the FHA

Federal Housing Commissioner Brian D. Montgomery's remarks concentrated on the Federal Housing Administration (FHA) having fallen behind the times. Without a modernized FHA product, many first-time homebuyers have been left without safe, affordable mortgage options and have instead turned to subprime loans. Even in Texas, which is the strongest FHA state in the country, FHA loan originations are down 34 percent from 2001 through 2006.

Montgomery believes that modernizing the FHA will provide sound and affordable refinance alternatives to people who have "gotten in over their heads" with more exotic loan products.

Some of the proposed FHA improvements include:

- Lowering the down payment requirement (FHA currently requires 3 percent).
- Establishing mortgage insurance premiums based on the borrower's ability to repay the loan.
- Lengthening the available loan terms from 30 to 40 years.
- Increasing loan limits.
- Eliminating the cap on the number of Home Equity Conversion Mortgages that FHA insures.

The most frequent recommendation made by speakers at the "Preserving Homeownership" conference was to increase communication channels to borrowers earlier in the delinquency process as the key to reducing foreclosures.

One national initiative to achieve earlier intervention is NeighborWorks America's new public service announcement, designed by the Ad Council. The message, "Nothing is worse than doing nothing," is accompanied by the HPF counseling hotline number. The radio and TV message has been distributed to media outlets in Texas and across the country.

With thousands of Texas homeowners facing interest rate adjustments in the coming months, the mortgage industry and consumer advocates are hoping they will heed the advice.

More information and presentations from the Federal Reserve Bank of Dallas conference "Preserving Homeownership: Addressing the Foreclosure Issue," June 12, 2007, are available at www.dallasfed.org/news/ca/2007/07home.cfm.