



Not long after making the final mortgage payment on the house she bought in 1970 for \$15,500, Mary Kelly needed another, even larger, loan.

The home, filled with a lifetime of comforts and 30 years of memories, where she raised her three children, where her grandchildren and great-grandchildren come to visit and where she hosts her fellow community group members, also has a shifting foundation needing \$20,000 in repairs.

Eighty years old, long retired from nursing and living on a fixed income, Mary went to a mortgage broker to get a loan.

The broker told Mary it would be easier for her to get approved for a larger loan than a smaller one, recommending \$40,000. At first she was told her interest rate would be around 6 percent, but when it came time to sign, it was in the double digits. Then she and her daughter, Ann, a teacher, had trouble understanding the other terms and conditions of the contract, but neither could get clarification.

“They were rushing us,” says Ann, 47, who lives with her mother in Kansas City, Mo. “(The broker) told us we had to sign that day.”

They did.



Repairing *the* Damage

A combination of factors led to the nationwide foreclosure surge



Mary Kelly, right, and her daughter, Ann, walked away from a predatory loan that ultimately could have caused them to lose their home. They received another loan for the expensive repairs.

Feeling uneasy, Mary remembered a seminar on predatory lending she had attended at church. She knew help was available and took the contract to a local nonprofit, where a lawyer reviewed it.

“Legal Aid (of Western Missouri) told us this was a bad loan,” Ann says.

“I was outraged,” Mary remembers.

Because the contract had a three-day walk-out period, Mary was able to go to her credit union for a new loan. Eventually, her pension would not have been enough to make the monthly payments on the first loan.

“We would’ve lost our home,” Ann says.

Unfortunately, many homeowners across the country already have and others will—some estimates predict 3 million homeowners will default on their mortgages by mid-2009, with two-thirds of those resulting in foreclosure.

Mary Kelly’s experience is just one of many scenarios leading to foreclosure. A variety of other causes—including declining home values, resetting interest rates on adjustable-rate mortgages (ARMs) and more loans issued

to higher-risk applicants—combined to result in a dramatic increase in foreclosure rates. As of mid-2007, the share of mortgages entering into foreclosure reached an all-time high.

“This unprecedented foreclosure surge was created by a perfect storm of events,” says Kelly Edmiston, senior economist at the Federal Reserve Bank of Kansas City.

Edmiston and Roger Zalneraitis, a research associate also at the Kansas City Fed, recently examined the foreclosure rise in both the United States and the Tenth Federal Reserve District, which is western Missouri, Nebraska, Oklahoma, Kansas, Wyoming, Colorado and northern New Mexico.

They researched current trends in foreclosure rates; foreclosure circumstances and its process; the relationship of factors that resulted in the current spike; and likely outcomes in the next few years.

In the District, the foreclosure situation is mixed—overall rates are slightly lower than the national average, but those on ARMs are higher than the national average. Many low- and

What happens during

FORECLOSURE

Some homeowners just walk away from their home and mortgages when faced with negative net equity. But generally a foreclosure is the result of an inability to make mortgage payments without equity to be able to sell the home.

Foreclosure is a two-step process. First, the homeowner defaults on his or her mortgage, usually from a combination of low or no equity and a trigger event, such as a job loss or serious illness.

Then, the lender forecloses on the home.

Laws governing mortgage foreclosures can differ from state to state. Foreclosure costs and rates can be affected by whether a state has statutory redemption (time after foreclosure when the borrower can redeem the property by paying balances, interests and fees) and whether it allows deficiency judgments, which allow the lender to recover funds that remain unpaid after the foreclosure sale.

Those involved:

Borrowers

Subprime borrowers don’t qualify for prime loans because of weak credit history.

Mortgage Brokers

Originated most subprime loans; assess borrowers’ creditworthiness and submit approved loan applications.

Lenders

Fund the loans; often sell loans through a trust to an underwriter.

Underwriters

Often Freddie Mac, Fannie Mae or private; package loans into securities and sell to investors.

moderate-income communities seem to be in significant foreclosure distress.

Edmiston and Zalneraitis' research shows the current and looming situation is the result of three merging factors:

- The share of subprime mortgages (loans made to borrowers with weak credit) increased substantially in recent years;
- Foreclosure rates for ARMs, especially subprime ARMs, increased considerably;
- High loan-to-value originations coupled with stagnant or falling home prices.

This means borrowers who obtained a subprime mortgage and couldn't make the payments when the initial rate increased, in many cases, couldn't sell their home at a price that exceeded what they owed.

"Any one condition would cause an

each quarter has been at unprecedented levels, and the foreclosure inventory is near its all-time high," Zalneraitis says.

At 1.7 percent, the U.S. foreclosure rate is high but has not affected all areas of the country equally. The highest foreclosure rates are in hurricane-stricken Louisiana and Mississippi, and the upper Midwest. Michigan, Ohio and Indiana have suffered economic difficulties in the manufacturing sector in addition to the same basic foreclosure issues as the rest of the country, where overall the economy is strong and unemployment is low.

In contrast, the Pacific Northwest has foreclosure rates of less than half the national average, and rates generally are below the national average in the Southwest and Northeast.

“ **These nontraditional loans, many of which are subprime, will continue to reset through 2009, so the worst of the foreclosure problem may be yet to come.** ”

increase in the foreclosure rate,” Edmiston says. “The confluence of these three factors, however, has caught a large number of homeowners in unsustainable financial situations with few options other than defaulting on their mortgages. Unfortunately, this is likely to continue, and worsen, before it gets better.”

Background

“The foreclosure rate has a natural ebb and flow,” Zalneraitis says, “depending largely on economic conditions and the state of the housing market.”

Before 2002, foreclosure rates hadn't really declined for any extended period of time. Heightened foreclosure rates in the 1980s likely were the result of high interest rates, weak real estate markets and regional energy gluts.

After leveling off, foreclosures started to rise again in 1995, spiking to a record high in 2002 as a result of the 2001 recession. Rates settled back to levels seen in the mid-90s until the current surge began in early 2006.

“Since then, the number of new foreclosures

The increase in foreclosures has been concentrated largely among ARMs, and especially subprime ARMs. Both 2005 and 2006 were record years for subprime lending and the origination of nontraditional mortgages, such as ARMs, Alt-A mortgages (made to borrowers with nontraditional circumstances) and Option ARMs (borrower sets payment terms; usually results in negative amortization).

“These nontraditional loans, many of which are subprime, will continue to reset through 2009, so the worst of the foreclosure problem may be yet to come,” Zalneraitis says.

The confluence

Soaring foreclosure rates usually result from poor economic conditions, such as recessions, which drive up unemployment and reduce personal income, making mortgage payments more difficult. These periods of especially high foreclosures also are associated with stagnant or declining home prices.

The dramatic spike in foreclosures that began in 2006 is unusual because the country's



Assistance

Consumer education is the key to prevention, but help is available for those in need, says Ariel Cisneros, senior community affairs advisor at the Kansas City Fed's Denver Branch.

As part of its mission to spur economic growth through community development, which includes financial education, asset building and entrepreneurship, the Fed dedicates its resources to foreclosure prevention and consumer assistance, Cisneros says. In addition to economic research, the Kansas City Fed hosts events to initiate community collaboration and is part of a Colorado taskforce and statewide hotline, which was formed by 25 counseling agencies to work with individual homeowners and resolve foreclosure issues.

There is a nationwide hotline (888-995-HOPE) that can put homeowners in touch with local resources.

Not only can foreclosure be detrimental for the homeowner and family, the neighborhood and community also can be affected if homes become abandoned and deteriorate—crime can increase, property values may fall, tax revenues can decrease and lenders might shy away from urban lending, Cisneros says.

"It's a domino effect and it keeps going," says MaryEllen De los Santos, a housing counseling coordinator with the Adams County (Colo.) Housing Authority. "It's going to affect the whole community."

The organization's No. 1 goal is to prevent homelessness, followed by preventing foreclosure either through selling the home or working with the lender to refinance or prepay, if possible. Staff is working now to get information to those who will have their rates reset in the coming months.

"If we get them early enough, and get the ball rolling," De los Santos says, "a lot of people can be saved."

economy overall had been strong—income growth was solid and unemployment rates were low, Edmiston says.

Edmiston and Zalneraitis explain the three factors that combined to lead to this sharp increase in foreclosure rates.

Subprime borrowers: Federal legislation in 1980 eliminated interest rate ceilings and made subprime lending possible. This allowed lenders to raise interest rates to compensate for the risk posed by borrowers who don't qualify for prime mortgages. But it wasn't until the 1990s when subprime lending became common. Developments in securitization allowed lenders to pool the loans and allocate risks to investors willing to bear them.

Meanwhile, from 2000 to 2003, average interest rates on conventional loans fell dramatically and mortgage originations skyrocketed. But as interest rates started to regain ground in 2004, many mortgage brokers moved aggressively into the still-untapped subprime market in an effort to maintain business.

"With real estate markets booming, these brokers found many willing customers who formerly had little or no access to mortgage financing," Zalneraitis says. "There also were many investors starved for the high yields subprime mortgages could bring. A major market quickly developed."

Subprime mortgages swelled from \$335 billion in 2003 to \$600 billion in 2006; more than one-third of all mortgages were nonprime.

Because subprime loans have higher foreclosure rates than prime loans, this increase alone would lead to an increase in foreclosures.

Nontraditional mortgages: "Given the run-up in home prices in the early part of the decade, an increasingly larger share of mortgages originated during the last few years have been nontraditional mortgages," Edmiston says.

These types of loans often reset to significantly higher payments within a few years, after initially hooking borrowers with teaser rates.

ARMs usually have lower interest rates than fixed-rate mortgages and are attractive to homeowners intending to stay in their homes for only five to seven years—the length of time the borrower can get a low fixed rate before it becomes variable. If the loan isn't repaid in that initial fixed-rate time period, the monthly payments can increase substantially, especially in a time of rising interest rates as seen in 2003 to 2006.

Edmiston and Zalneraitis estimate payments on traditional, prime ARMs for a \$200,000 mortgage could have increased nearly 40 percent during this period. For subprime ARMs, payments could jump as much as 120 percent, depending on the type of ARM.

Not surprisingly, subprime mortgages are more likely to default than prime mortgages. For instance, data from mid-2007 show 6.9 percent of subprime mortgages were in foreclosure compared to less than 1 percent of prime mortgages, according to Edmiston and Zalneraitis' research. Even more dramatic, they say, the foreclosure rate for subprime ARMs in particular increased from 4.7 percent in mid-2006 to 10.4 percent in mid-2007.

"Increases in short-term interest rates and payment resets on nontraditional mortgages likely are responsible for much of the increase in the foreclosure rates of ARMs," Edmiston says. "However, many subprime ARMs also have defaulted before they reset."

Underwriting standards, especially for state-regulated mortgage brokers, have been lenient until recently, which added to the foreclosure problem. Even if underwriting standards had been stricter, many of these loans likely would have been foreclosed upon after the payment reset.

Home prices: Beginning in 2001 through 2005 (when prices stagnated), homes appreciated drastically—53 percent—but personal income increased by only 20 percent.

"Homeownership became less affordable," Zalneraitis says. "Many would-be homeowners found themselves priced out of the housing market."

This prompted some borrowers to turn to nontraditional mortgage products to achieve "the American dream."

If borrowers could sell their homes or refinance mortgages when unable to make payments, the foreclosure problem would not be as severe as it has become, Edmiston says.

But the high loan-to-value mortgages, coupled with stagnant or falling home prices, have meant homeowners may not have enough equity to sell or refinance their homes when unable to pay higher mortgage payments. This can be attributed to high loan-to-value ratios (in some cases, no money down), equity extraction, and a stabilization or decline in home prices, which has occurred in the last two years, according to the National Association of Realtors and the Office of Federal Housing Enterprise Oversight.

Effects in the District

When the Rucker family defaulted on their mortgage, the interest rate had reset, again, and Michael Rucker had just received bad news from the doctors, again.

A second tumor was discovered in Michael's brain. Seizures have long prevented him from holding a job, and his radiation and chemotherapy treatments often keep his wife and sole household earner, Angela, away from work. This time she was out for nearly three weeks.

The family had purchased their Thornton, Colo., home in 2003. It was their first—Michael's disability payments covered the down payment, but with each rate reset, Angela's paycheck couldn't stretch quite far enough.

"If I would've known they were going to reset as much as they did, we would've done something different," Angela says. The lender "said, 'Can't you catch up?' I said, 'No. I can't.' It's not that easy."

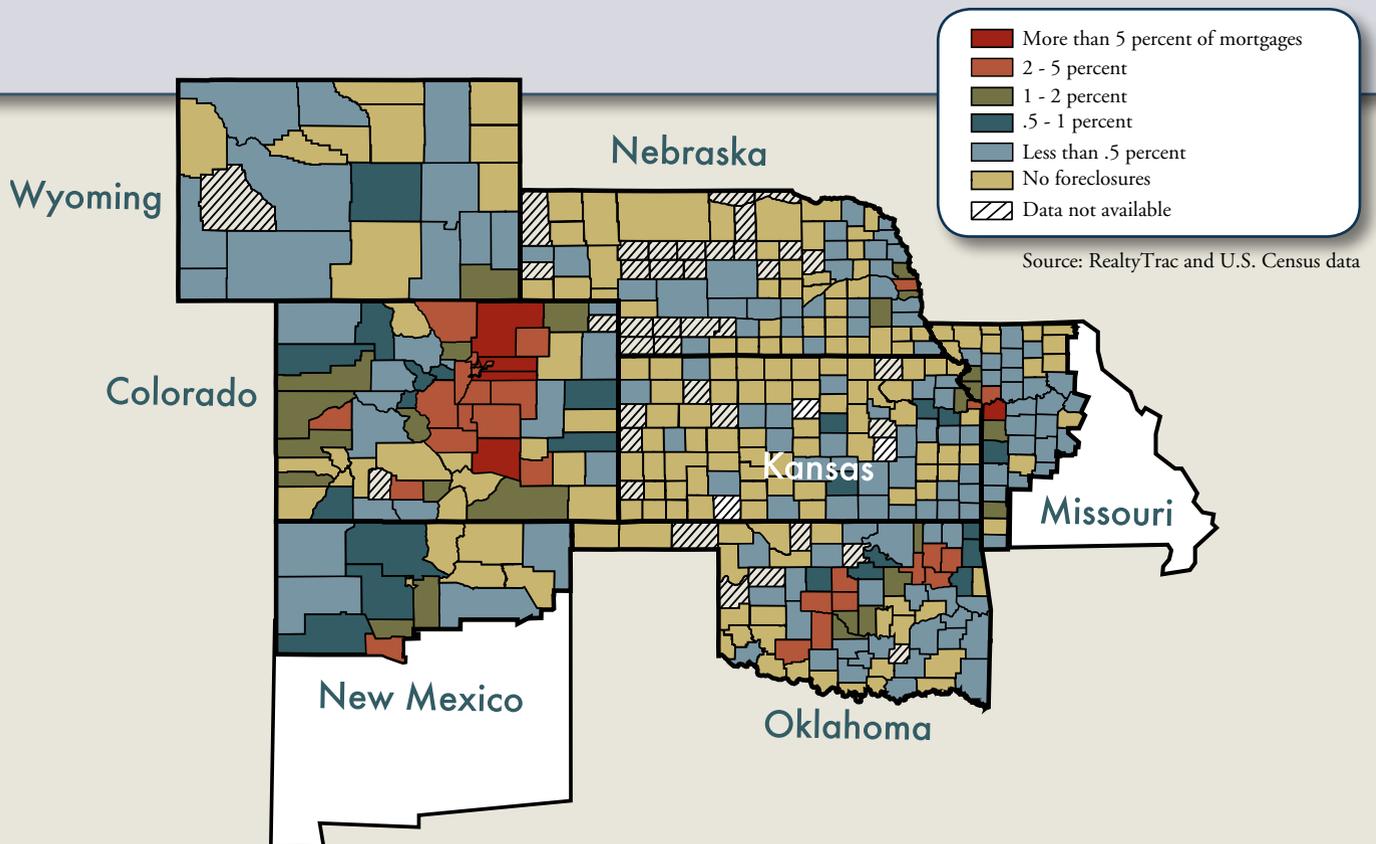
Their mortgage company suggested the family sell the home. But the couple, their two children and infant grandson had nowhere else to go. In danger of entering foreclosure, Angela contacted the Adams County Housing

Foreclosures in the District

As is the case nationally, foreclosures in the Tenth Federal Reserve District—western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico—increased significantly from 2006 to 2007, from about 1.2 percent to 1.5 percent of all outstanding mortgages. Nationwide, the rate has increased from 1.1 percent to 1.7 percent.

The relatively modest foreclosure rates in most District states can be attributed to the smaller share of adjustable-rate and subprime mortgages than the nation. In this region, housing prices are generally affordable.

Subprime loans make up roughly 12 percent of all outstanding mortgages in the District, compared to more than 13 percent nationally.



Oklahoma and Colorado show higher rates than the country (likely because of high nontraditional loans and high homes prices).

Wyoming has one of the lowest rates nationwide, likely from the energy sector boom there.

New Mexico had declining rates, likely due to a strong real estate market, but foreclosures are rising now.

Kansas rates have remained unchanged.

Oklahoma, Kansas and Nebraska are among the 10 most affordable states to live in.

Missouri foreclosure rates are rising rapidly after a period of low rates.

Nebraska and Kansas rural economies have fared well, which has a positive impact on housing.

Authority, which helps distressed homeowners work with their lender, offers financial education and often provides financial assistance to those in the county, which also includes part of Denver.

The Ruckers now have a fixed-rate mortgage of 6.625 percent, are caught up on their payments and not likely to default again, Angela says.

“It been a learning experience,” she says.

Edmiston and Zalneraitis identify two areas particularly affected by the foreclosure problem: markets where housing is unaffordable, and low- and moderate-income communities.

In low- and moderate-income communities, many borrowers have low credit scores or unsteady employment and are therefore high-risk and only eligible for subprime loans. Most often, foreclosure rates in the District are

in bedroom communities of large metros such as Denver. New Mexico, though, has a good balance of supply and demand for both new and existing housing. There also is less subprime activity as a result of stiffer licensing requirements, Stanford says.

He is optimistic for Colorado’s recovery because of strong job and industry growth there.

Oklahoma’s foreclosure rate also has been above the national average, according to Edmiston and Zalneraitis’ research, which can negatively impact housing-related businesses, such as construction.

P.B. Odom III, principal of P.B. Odom III Land Development Companies in Oklahoma City, saw a 17 percent decrease in new residential construction in 2007 from the year prior. He knows there’s been a larger impact on

“ In our business, we know these times are coming. We don’t like it. But we weather the storm. ”

highest in cities and suburban counties rather than rural areas. Low- and moderate-income areas are being hit the hardest.

In areas where homes prices are high, buyers who thought purchasing a home was a “sure thing” often resorted to ARMs and nontraditional mortgages in hopes that home prices would continue rising indefinitely, or long enough to sell or refinance if needed. For example, home prices in California increased more than 20 percent per year from 2004 to early 2006, but by mid-2007 had decreased 1.4 percent. Foreclosures there have increased almost four-fold since the beginning of 2006.

Mike Stanford has seen among the best and the worst in the District. First State Bancorporation, of which he is president and CEO, is based in Albuquerque, where the state’s foreclosure rates are actually declining, and has branches in Colorado, where foreclosures rates are higher than the national average.

Colorado, Stanford says, was ripe for an inordinate amount of subprime lending. Cheap housing was enticing and ample, especially

others. Still, Odom thinks Oklahoma is fairing well compared to the East and West Coasts.

“I think it’s going to get worse” through 2009 or 2010, Odom says. “In our business, we know these times are coming. We don’t like it. But we weather the storm.”



BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

“RISING FORECLOSURES IN THE UNITED STATES: A PERFECT STORM”

By Kelly D. Edmiston and Roger Zalneraitis
www.KansasCityFed.org/TEN

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