The Subprime Lending and Foreclosure Crisis

Frank Ford, Sr. Vice President For Research and Development
Neighborhood Progress, Inc.

The following is intended as a briefing for community development practitioners on the subjects of subprime lending, foreclosure and property abandonment. Using Cleveland, Ohio as a backdrop, this briefing will provide an introduction to the following:

- Defining The Problem
- The Causes – How Did We Get Here?
- Major Fixes Required
- Role of Neighborhood Progress, Inc. (NPI)
- Proposed Role for NPI Going Forward

Defining The Problem

For the past 12 years lenders specializing in high risk and high cost "subprime" lending have made loans to people who had little prospect of repaying those loans. As a result, beginning in the mid to late 1990s, rates of ***loan default and foreclosure*** increased – and are continuing to increase - dramatically.

However, the problem is not that easily defined – it has additional manifestations and ripple effects. In some cases, subprime lending has set the stage for additional subcultures of fraud and criminal activity.

Two types of fraud are now flourishing and have been greatly enabled by subprime lending. The lax underwriting standards of subprime lending – where almost anyone could get a loan – have been a dream come true for ***dishonest flippers, mortgage brokers and appraisers.*** And, ***foreclosure "rescue" scams*** now prey upon the tens of thousands of foreclosure victims in Cuyahoga County.

The unprecedented escalation in annual mortgage foreclosure – from 2,000 in Cuyahoga County in 1995 to a projected 16,000 in 2007 – has created ***an inventory of abandoned property*** and ***blight***, that is beyond the capacity of local government, or the local community development system, to rectify. Streets that once may have had 1 or 2 vacant properties, now have 10 or 15. Strong market areas that rarely if ever saw a vacant property now count them by the dozens or the hundreds.

As grave as these foreclosure rates are, they are predicted to go even higher. Apart from the problem of lax underwriting applied by mortgage lenders, many lenders aggressively promoted adjustable rate mortgages (ARMs) and financial analysts predict that a high share of these ARMs are going to have their rates re-set over the next 16 months – adding to the number of foreclosure "time bombs" waiting to go off. News reports are already noting examples of monthly payments jumping – for example – from $800 to $1,200.

The abandoned property that follows these foreclosures ***reduces the property values*** of adjacent and nearby homeowners; two studies in the past 5 years found market value drops of $5,000 to $7,000 on average for properties within 100 feet of an abandoned home. Community Development Corporations (CDCs) and private developers find they ***cannot sell their new or redeveloped homes***, or must do so at a loss.

These problems influence the housing choices of ***homeowners and homebuyers*** in Greater Cleveland, leading many to ***choose to leave the City*** and inner-ring suburbs. Those choices further exasperate the problem by decreasing the value of property.

The problem, therefore, is not one-dimensional. It has many faces. And, its newest face may only now just be taking shape. As lenders, investors, regulators and legislators scramble to tighten up lending standards, there could be an over-reaction that could result in a ***denial of access to credit*** to those who should receive it. This could result in a return to a form of "red-lining" that would undermine the efforts of the community development industry. Fair access to credit is essential to the redevelopment of Cleveland's neighborhood and suburban markets.

The foregoing has described some of the more prominent <u>local</u> manifestations. As daily news reports now tell us, the damage from the subprime lending crisis has now spread to impact national and global economic markets.

<u>The Causes – How Did We Get Here?</u>

The causes of and the contributing factors to the subprime lending and foreclosure crisis are as complex as its outcomes. To fully understand how we got to this point, it's important to understand some of the major shifts in banking regulation that have taken place over the past century.

Until the economic depression of the 1930s the banking and lending industry was subject to minimal regulation. The depression brought the collapse of depository banks and savings and loans, and the loss of life savings for millions of people. Congress and states responded with laws and regulations built around a theme of "safe and sound lending" designed to protect depositors assets. This continued for 40 years, with regulation generally favoring the rights of depositors over borrowers. By the 1970s many housing and community development advocates felt that this imbalance led to a denial of credit ("red-lining") for people of color specifically, and urban neighborhoods in general. Congress responded by passing the Home Mortgage Disclosure Act (HMDA) in 1974 and the Community Reinvestment Act (CRA) in 1977 in an effort to protect people of color and other minorities from being shut out of the credit marketplace. It is significant to note that the Community Reinvestment Act required fair access to credit – but mandated that it be done "***consistent with safe and sound lending practices***". These laws achieved a balance between protecting the rights of borrowers, and protecting the interests of depositors.

The fundamental problem today is that much of the lending industry seems to have recklessly abandoned the core principles of "safe and sound" lending.

The following are among the factors that may have contributed to a shift away from the core principles of “safe and sound” lending.

The Creation of a Secondary Mortgage Market. As early as the 1930s housing advocates realized that if mortgage lenders held and serviced their loans for a full 30 year term, lenders would have to wait during that period for the loans to be repaid before funds could be re-loaned to other borrowers. However, if a “secondary” market were created that could buy mortgages soon after they were made, money could be re-cycled and re-loaned faster, making the dream of homeownership available for more people. The Federal government created three quasi-public institutions to fill this need: Fannie Mae (the Federal National Mortgage Association), Freddie Mac (the Federal Home Loan Mortgage Corporation) and Ginnie Mae (the Government National Mortgage Association). In the 1990s Wall Street investment firms followed the lead of Fannie, Ginnie and Freddie and began purchasing mortgages as an investment.

One of the most common questions asked by people trying to understand predatory and subprime lending is “Why would they make a loan knowing it has a high probability of going into default?” One obvious answer is – they’re selling the loans on the secondary market within days or weeks after making them. There simply isn’t the same incentive to insure “safe and sound lending” when you don’t have to hold onto the mortgage for 30 years. In fact, once it’s clear that there are investors waiting to buy pools of loans by the hundreds or thousands at a time, it becomes highly profitable for subprime lenders to churn out loans as fast as they can make them. ***The original idea behind a secondary market is sound – but there is a need at the national level for regulation that would require secondary market investors to exercise greater due diligence before purchasing unsafe loans.*** When loan originators cannot “dump” their products easily, they will exercise greater care in making the loans.

Some may argue that there is no need for regulation since Wall Street investors have, since February 2007, begun to react to the high rates of foreclosure and appear to be exercising greater caution. It’s worth noting that communities such as Cleveland suffered 12 years of damage before they reacted. We could also question whether, without stronger regulatory guidelines for the secondary market, the same cycle could repeat in 15 or 20 years.

Increased Mergers and Acquisitions. The past 20 years have seen a dramatic increase in the number of acquisitions and mergers of banks and savings and loans. As a result, the majority of subprime loans are issued by lenders operating out of state. Forty years ago a Clevelander seeking a mortgage loan would have typically gone to a Cleveland-based bank, savings and loan or mortgage company. The loan review would have taken place in Cleveland and the loan decision would have been made in Cleveland – most likely by someone who knew the neighborhood in question. Finally, as noted above, prior to the rise of the secondary market the loan would have been serviced by the local institution and its personnel for the life of the loan. Today almost every lending institution in Cleveland has its home base out of state. The review, decisions, and servicing may also be done out of state. The opportunity for reckless lending, or outright fraud, is greatly increased when the decisions are made by people who have little or no knowledge of the local neighborhood.

The Rise of the Mortgage Broker Industry. As a result of this long-distance lending, a new industry evolved around the role of the “mortgage broker”, someone who serves as an intermediary to arrange a loan, and earns their fee based on the size of the loan. A mortgage broker is not the “loan originator” – as Federal regulations define the entity that actually makes the loan decision and issues the loan. The broker earns a fee for packaging the loan and forwarding the paperwork to the lender. The mortgage broker makes their profit from the size of the loan, and their success is not tied to the success of the loan. Not only are brokers not harmed by high rates of foreclosure, they may actually contribute to default. To enhance their fee, a broker may be inclined to encourage a borrower to borrow more money than they can afford, increasing the risk of default.

The Declining Market Share of Prime Lenders. Since 1995 the market share of high-cost subprime loans has increased while prime loans have decreased. A study by the Housing Research and Advocacy Center in Cleveland found that 48% of all loans made in Cleveland in 2005 were high-cost subprime loans. While this does not necessarily suggest that a withdrawal of lending by prime lenders is a cause of the foreclosure problem, it does suggest that a re-engagement in mortgage lending by prime lenders may be an important part of the solution. This view is supported by a Fannie Mae study that found that 50% of all borrowers who obtained a high-cost subprime loan would have qualified for a prime loan. This finding suggests that there are market opportunities for prime lenders that are not being taken advantage of. ***Municipal, County and State governments should use the billions of dollars they place on deposit at banks to encourage greater participation by prime lenders.***

Overselling The Goal of Homeownership. For 40 years it has been a goal of community development to increase homeownership opportunities, a goal supported by local, state and Federal government and the community development industry. While this has had generally positive results, a legitimate question can be asked whether the zeal with which homeownership was pursued inadvertently led some to fail to see the lending abuses that were rising over the past decade. Some argue that homeownership has been pushed in underserved markets without sufficient commitment to prevent abuses and provide adequate counseling and homebuyer education.

Major Fixes Required

There are four broad remedies that are needed, and they can be categorized according to four categories of people directly affected. The table on the following page provides a summary of these remedies.

	People Affected	Fix
1	**Borrowers who have a subprime loan and are still occupying their homes.** *-in foreclosure, still occupying the home.* *-in default, but soon to be in foreclosure.* *-not in default, but at risk.*	**Increase Opportunities for Borrower Refinancing** *-Develop the NEO CANDO early warning system to identify borrowers at risk (see attached map).* *-Encourage lender loan workouts & loan re-structuring, e.g. modeled after East Side Organizing Project (ESOP) lender agreements.* *-Encourage more alternative re-financing products, e.g. modeled after Third Federal Savings and Loan.*
2	**Neighborhoods and communities faced with the abandoned property that follows foreclosure.**	**Reclaim and Redevelop Abandoned Property for New Housing, Retail or Green Space** *-Increased funding for blight removal & demolition* *-Increased funding from state and local government, and from private sources, for reclaiming and rehabbing vacant homes*. *-Lender donation (to CDCs) of vacant property in their REO inventory.*
3	**Borrowers still at risk of being victimized.**	**Insure a Return to Safe and Sound Lending Practices** *–Aggressive prosecution of fraud* *-Stricter policing of mortgage brokers and appraisers by the Ohio Dept. of Commerce* *-Aggressive enforcement of Ohio's new Predatory Lending Law.* *-Greater investment in financial literacy education for homebuyers.* *-Require secondary market investors to exercise greater due diligence before purchasing unsafe loans*.
4	**The next generation of borrowers who will need home mortgage credit in the next 1 – 5 years.**	**Insure Access to Fair Credit Consistent With Safe and Sound Lending Practices** *-Encourage lawmakers and regulators, as they work to eliminate irresponsible lending practices, to maintain the fundamental balance of CRA: access to fair credit, consistent with safe and sound lending practices.* *-Leverage Municipal, County and State funds to encourage prime banks and prime lenders to recapture mortgage markets hard hit by subprime lending.*

NPI's Role To Date

For four years NPI's Land Assembly and Vacant Property Initiative has studied the causes and impact of vacant property, and developed practical tools and programming for the acquisition and redevelopment of vacant property.

- We were one of the first organizations to look comprehensively at both foreclosure on the front end of the problem, and reclamation of vacant property on the back end. Until recently, most advocates for foreclosure prevention limited their focus to individual victims of lending abuse, and not to the broader impact on neighborhoods. Conversely, most advocates concerned with vacant property limited their focus to reclamation – not addressing the cause of the problem.
- We have been a leader in connecting reforms and lessons learned to "on the ground" practice in neighborhoods, which we do through our "Land Assembly Team". Two notable examples:
    - The Team aided an investigation into fraudulent lending in Slavic Village which uncovered a complex flipping and loan fraud scam. The Ohio Attorney General's Cleveland office is now actively investigating.
    - The Team developed a model for an "early warning" foreclosure intervention program that is being tested in 6 Strategic Investment Initiative neighborhoods over the next 4 months. (See the attached sample map for the Slavic Village Model Block area.)
- We were one of the first organizations to look at the problems of subprime lending, foreclosure and vacant property in the context of a bigger picture - market recovery for Cleveland.
- We are the leading financial sponsor and advocate for Case Western Reserve University's NEO CANDO property data system and provide the bulk of the subject matter for "beta-testing" new components of the system. NEO CANDO is one of only a few such systems in the country and it is now relied upon by City and County officials, suburban municipalities, CDCs, and local foundations.
- We are one of the founding members, and the chief financial sponsor, of Rebuild Ohio, the state's leading organization addressing statewide policy reform on vacant property issues.
- NPI, jointly with the Cleveland Neighborhood Development Coalition, is the convener of the Vacant and Abandoned Property Action Council, perhaps the only forum that regularly brings together representatives from Cleveland City Council, the Mayor's Administration, Cleveland Housing Court, Cuyahoga County, inner-ring suburbs, and Enterprise Community Partners to address issues related to vacant and abandoned property.
- NPI has recently been exploring a relationship with Wall Street Without Walls, a Wall Street-based organization whose mission is to link financial market resources with local community development issues and efforts. Two specific initiatives are being considered: financing for catalytic real estate projects and alternative loan work out products for borrowers with subprime loans.

Proposed Role for NPI Going Forward

NPI's unique strength is its connection to "on the ground" community development practice in target neighborhoods and its ability to connect that practical work to larger systems reform. With this in mind, NPI will direct its resources to the following initiatives in this next period:

- Continue to develop the Early Warning Foreclosure Intervention Pilot Project with ESOP and Case Western Reserve University's NEO CANDO data system in six Strategic Investment Initiative Neighborhoods.
- Continue to fine tune the NEO CANDO vacant property data system and related technology.
- Continue to work with ESOP and Cleveland Neighborhood Development Coalition to develop a program facilitating donation of lender REO property to CDCs and other non-profit housing developers.
- Work with State and Local officials to develop a pilot project to finance the rehab of vacant homes.
- Join with others to encourage regulatory corrections to the lending industry that insure access to fair credit for creditworthy homebuyers.
- Continue to explore the potential for one or more pilot projects with Wall Street Without Walls.
- Continue to support the work of Rebuild Ohio to advance legislative and regulatory campaigns that facilitate the reclamation and redevelopment of abandoned property.
- Continue to support the work of the Vacant and Abandoned Property Action Council to explore solutions at the neighborhood, City and County level.