Randall S Kroszner: Mitigating the impact of foreclosures on neighborhoods

Speech by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the NeighborWorks America Symposium on Stabilizing Communities in the Wake of Foreclosure, Cincinnati, Ohio, 7 May 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Good morning. I would like to thank NeighborWorks America for inviting me to be with you today to continue the very important discussion of community stabilization in the wake of rising foreclosures in neighborhoods across the country. As a member of the board of directors of NeighborWorks America for the last two years, I am impressed that attendance at these training institutes continues to grow – a strong testament to the importance of the subject matter being discussed as well as the quality of the curriculum and instruction. Today's discussion of the impact of foreclosures on neighborhoods and what can be done to mitigate those impacts is not only timely, it is essential to promoting local and regional economic recovery and growth.

This morning, I will provide an overview of current conditions in the mortgage market and discuss how the disruption in this market is affecting neighborhoods. I will also outline the steps that the Federal Reserve System is taking to address these challenges and assist communities struggling with the impact of foreclosures.

Foreclosures continue to affect the housing market

The mortgage market continues to face challenges, especially in the subprime segment, which serves consumers who have imperfect or limited credit histories. The delinquency rate on subprime mortgages has continued to climb and has about doubled in the past year and, as of February, one in four subprime adjustable-rate mortgages was seriously delinquent, meaning the borrower was either in foreclosure or ninety days or more past due on a payment. Delinquency rates have risen on most other types of mortgages as well, but these increases have been more recent and less dramatic than those in the subprime segment. Foreclosures have also risen appreciably. Lenders initiated roughly one-and-a-half million foreclosures last year, up 53 percent from the previous year. On the basis of preliminary estimates published by the Hope Now Alliance, foreclosures are likely to have risen further in the first quarter of 2008.

Homeowners may become delinquent on their mortgage for a variety of reasons. Historically, an adverse life event, such as a job loss, was often the reason a homeowner fell behind on his or her mortgage payments. And in the current economic environment, job losses have continued to contribute to the rise in mortgage delinquencies and foreclosures, particularly in areas of the Midwest, such as here in Ohio. Yet, other factors also explain the recent rise in mortgage delinquencies and foreclosures. Mortgage underwriting standards slipped in the middle of this decade, resulting in greater numbers of mortgages that had high combined loan-to-value ratios or for which incomplete documentation was provided. More than 40 percent of the subprime loans originated in 2006 had combined loan-to-value ratios in excess of 90 percent, a considerably higher share than earlier in the decade. In some cases, lenders originated mortgages that had multiple risk factors – a practice often referred to as risk-layering. Taken individually, these risk factors may not have significantly raised the likelihood that a homeowner would fall behind on payments; taken together, however, these risks materially increased this likelihood.

High loan-to-value ratios at origination, combined with stagnant and eventually declining home prices, are a key aspect of the recent rise in delinquencies and foreclosures. After rising rapidly during the early part of this decade, home prices began to decelerate in 2006 and are now declining appreciably in some areas. As home prices declined, homeowners who had little or no equity at the time of their mortgage origination saw their home equity disappear – and with it their ability to refinance into a more-sustainable mortgage. Declining home equity may also reduce a stressed borrower's incentive to stay current on his or her mortgage or remain in a home. Recent research conducted by the Federal Reserve Bank of Boston suggests that homeowners who have experienced a 20 percent or greater fall in house prices are about 14 times more likely to default on a mortgage compared with homeowners who have experienced a 20 percent increase in the price of their home.[1] Some types of mortgage borrowers appear to be particularly sensitive to home-price declines; at least 18 percent of foreclosures started in the third quarter of 2007 involved non-owner-occupied properties.

The Federal Reserve's response to the challenges resulting from foreclosures

The Federal Reserve views the current high rate of mortgage foreclosures as an urgent problem, and we are addressing the issue on many fronts: we are contributing to initiatives already underway at the local and national level, as well as collaborating with other regulators, community groups, policy organizations, financial institutions, and public officials in an effort to identify ways to prevent unnecessary foreclosures and the associated negative effects on local communities. We are also leveraging the decentralized structure of the Federal Reserve System, which consists of the Board of Governors in Washington, D.C., and the twelve Federal Reserve Banks that each represent a distinct region of the country. This structure enables us to gather information and tailor responses to foreclosure issues at the local level, while using our collective experience to address regional and national policy issues. In addition, the Federal Reserve uses its considerable analytic resources to conduct research at the national level, which the Reserve Banks can disseminate to local community groups, counseling agencies, financial institutions, and others who are working to help troubled borrowers and communities.

Timely analysis of data and other available information is critical to crafting appropriate remedies to any problem. To that end, the Federal Reserve recently helped NeighborWorks America identify those regions and neighborhoods throughout the country that are most at risk for higher rates of foreclosure and would therefore benefit from an increased capacity to provide mortgage counseling. Using this analysis, NeighborWorks America in February awarded $130 million in newly granted funds from Congress to thirty-two state housing finance agencies, eighty-two community-based NeighborWorks organizations, and sixteen counseling intermediaries approved by the Department of Housing and Urban Development (HUD).

The Federal Reserve has recently made available on its public website detailed reports identifying neighborhoods that have especially high concentrations of foreclosures. These data – in the form of dynamic maps and other data – illustrate the regional variation in the condition of securitized, owner-occupied subprime and alt-A mortgage loans across the United States.[2] Local leaders can access these reports and work with community affairs staff at the local Reserve Banks to more effectively address foreclosure problems.

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1 Kristopher Gerardi, Adam Hale Shapiro, and Paul Willen (2008), "Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures," Federal Reserve Bank of Boston.

2 "Dynamic Maps of Nonprime Mortgage Conditions in the United States."

For example, a user can choose to view key foreclosure measures such as "Foreclosures per 1000 housing units," "Share ARMs," and other factors. The maps drill down from national-level data to zip code level. They also depict factors such as "Share of low FICO and high LTV" and "Share late payment in last 12 months" that may help to predict which areas are most likely to experience higher rates of foreclosures. Finally, the Federal Reserve is providing, via downloadable files, the data supporting the maps, as well as data for scores of other loan-performance variables at the state, metropolitan area, and county levels. By making more data and information on emerging trends available to key local leaders, financial institutions, and community organizations, our aim is to improve the efficiency of their efforts to rebuild neighborhoods.

The Federal Reserve System has also established a working group of economists and community development experts in order to coordinate System research efforts. This working group will monitor developments in the mortgage markets and study how these developments may affect individual borrowers and neighborhoods. Currently, the group is assessing existing research on house prices, mortgages, and foreclosures, with the goal of identifying important analytical gaps.

The Federal Reserve System conducts outreach and education efforts through its regular contact with financial institutions and market intermediaries, as well as through its network of Community Affairs staff members who work with communities to identify trends and issues affecting low- and moderate-income neighborhoods. This communication with both financial markets and communities allows the Federal Reserve to act as a bridge between the two groups and between local communities and the organizations that provide community resources, such as credit counselors.

For many borrowers who are behind on their mortgage payments, refinancing their loan is not an option. Therefore, the Federal Reserve is engaged in a number of efforts to encourage the use of loss-mitigation tools by lenders, servicers, and not-for-profit organizations that help individual borrowers resolve delinquency issues. The cost of foreclosure is high for everyone involved; estimates of the direct losses resulting from a foreclosure range from one-fifth to one-half the principal balance of a mortgage loan.[3] With these costs in mind, the Federal Reserve, together with the other federal banking agencies, has issued guidance urging lenders and servicers to pursue workout arrangements, when feasible and prudent, as an alternative to foreclosure. In some cases, temporary adjustments to payments may not be sufficient, and more-permanent reductions in interest rates or an extension of the loan term may be required to help a borrower. In some situations, lenders and servicers may want to consider using principal writedowns as a way to reduce re-default risk or to facilitate a refinancing.

The Federal Reserve's outreach efforts inform its policymaking. We recently hosted focus groups to evaluate regulatory proposals on credit disclosures and held a series of informative hearings on the Home Ownership and Equity Protection Act (HOEPA) regulations. The Board then issued a regulatory proposal under HOEPA that called for stricter regulations to prohibit unfair and deceptive practices in the mortgage market. By targeting protections to borrowers who face the most risk of experiencing unfair or deceptive practices, the proposal seeks to protect consumers and preserve consumer choice in mortgage products. We have also sought to provide lenders with clear standards that, without being overly prescriptive, preserve access to responsible credit for qualified borrowers. The proposal covers the entire subprime market, not just lenders supervised by the federal banking agencies, and focuses attention on the areas of greatest risk – while preserving consumers' access to responsible credit. The proposal addresses the extension of credit without consideration of a borrower's

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[3] Liz Laderman (March 2008), "The Efficacy of Mortgage Loan Workouts," Unpublished, Federal Reserve Bank of San Francisco.

ability to repay, verification of income and assets relied upon to make a loan, prepayment penalties, and escrow accounts for taxes and insurance. The comment period ended on April 8, and we are currently reviewing the more than 4,000 comment letters received.

Legislative initiatives that would allow the Federal Housing Administration to increase its scale to reach a wider range of borrowers and develop appropriate underwriting and pricing methodologies to deal with any increased risk and another that would strengthen the oversight of Fannie Mae and Freddie Mac are important compliments to our regulatory efforts to strengthen the housing markets.

Another major outreach effort involves gathering information on the best practices for addressing community development issues and then disseminating that information through publications, meetings, and forums. Since January 2007, Community Affairs offices across the Federal Reserve System have sponsored or cosponsored more than 75 events related to foreclosures, reaching more than 5,800 lenders, counselors, community development specialists, policymakers, and others. Beginning next month, the Community Affairs function will host a series of System-wide forums in order to further examine the impact foreclosures have on neighborhoods in both weak and strong housing markets, as well as the tools available to address the impacts of foreclosures.

The Federal Reserve continues to provide educational resources to help consumers make informed personal financial decisions, such as choosing the right mortgage. We provide a variety of materials and other resources, including websites, to help consumers understand mortgage- and foreclosure-related issues, and to help lenders educate borrowers. The Federal Reserve Banks, through their Community Affairs offices, are working to establish foreclosure-mitigation resources on their websites for use by municipalities, housing counselors, and community groups.

The Federal Reserve System's partnership with NeighborWorks America

The Federal Reserve's most recent undertaking to address foreclosure issues is the partnership we are announcing today with NeighborWorks America. Specifically, this partnership will focus on efforts to stabilize neighborhoods that have experienced high rates of foreclosures. This new partnership not only leverages our ability to conduct data analysis, research, and outreach, it builds on our existing working relationship as one of the federal agencies represented on the NeighborWorks America board of directors. Together, the Federal Reserve and NeighborWorks America will develop and deploy resources, tools, strategies, and best practices for mitigating the impact of foreclosures across the country.

The cost of foreclosures is not limited to individual homeowners. Communities in which a high number of foreclosures have occurred are increasingly faced with large numbers of properties held by lenders or servicers as "real estate owned," or "REO." REO is costly to hold, and many lenders are not well equipped to handle large REO inventories. As a result, the number of vacant homes in some neighborhoods has increased markedly. After averaging about 1.7 percent starting in 1990 through 2006, the home-vacancy rate rose sharply in 2006 and hit 2.9 percent in the first quarter of 2008, according to the U.S. Census Bureau.

Properties left vacant for long periods have many negative effects on a community. Research indicates that foreclosures tend to reduce the value of nearby properties; the magnitude of these price declines appears to differ, depending on the presence of variables such as the strength of the local housing market or the distance between a foreclosed home and other surrounding homes.[4] Moreover, neighborhoods that have significant concentrations of vacant

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4 Dan Immergluck and Geoff Smith (June 2005), "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values," Woodstock Institute; William C. Apgar and Mark Duda,

properties are not attractive to potential buyers, further challenging community-stabilization efforts.

Vacant homes also drain the coffers of municipalities, who must secure the homes from crime, keep them clear of trash, or in extreme cases, demolish them in order to maintain stability in the broader community.[5] For example, the chief of regional development for the City of Cleveland estimates that the city will spend $65 million each year for five years to address costs related to abandoned properties.[6] Not only are these costs high, they come at a time when tax revenues are generally decreasing because of declining home values.

As state and local governments face diminished resources for dealing with vacant properties, many nonprofit organizations are likewise struggling with capacity issues. We have heard from many nonprofit community development organizations that foreclosures, and the impact on the neighborhoods affected by them, limit the organizations' ability to proactively engage in their previous development activities. As a member of the board of NeighborWorks America, I am keenly aware of the resources needed to deal with community stabilization in the wake of foreclosures.

I am also aware of some promising examples of programs that NeighborWorks affiliates have developed to address problems associated with vacant and abandoned homes. In Chicago, the Neighborhood Housing Services Redevelopment Corporation, in cooperation with the city, has acquired hundreds of abandoned properties from several sources, such as HUD, REO from financial institutions, and private owners. The properties are then rehabilitated and sold to owner-occupants, frequently with appraisal-gap subsidies provided by the city and federal resources. In other highly depressed housing markets across the country, municipalities often demolish the worst-quality units in order to mitigate safety hazards, reduce the total number of vacant homes, and restore the quality of life in the community.

The purpose of our partnership with NeighborWorks America is to support local communities as they assess local housing conditions and evaluate responses to the challenges before them. The partnership will develop and deliver training designed to help local communities acquire, rehabilitate, and manage foreclosed REO. Working with NeighborWorks America, the Federal Reserve will develop training resources for nonprofits and local governments to foster their understanding of the foreclosure and REO process and to help them develop specific strategies for the sale and effective use of REO in individual markets. The ultimate goal is to return REO to productive use, for example, to provide affordable rental housing or to supply new, sustainable homeownership opportunities in low- and moderate-income communities.

Research and analysis will play a key role in the success of local efforts. The Federal Reserve System is committed to providing NeighborWorks and others with timely reports and information so that foreclosure-mitigation resources can be effectively targeted to local areas. For example, the Federal Reserve may map mortgage-delinquency rates in specific metropolitan areas, to help local governments and nonprofits develop and prioritize their strategies for stabilizing communities.

As demonstrated by our partnership with NeighborWorks America, the Federal Reserve System is committed to supporting sustainable, healthy communities. Bringing nonprofits, local government representatives, and financial market participants together to share

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"Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom," Minneapolis, Homeownership Preservation Foundation.

5 William C. Apgar and Duda, Mark, "Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom," Minneapolis, Homeownership Preservation Foundation.

6 Chris Warren (March 5, 2008), "Presentation to Consumer Advisory Council of the Federal Reserve Board," City of Cleveland.

information and develop best practices for addressing the negative impacts of foreclosures on neighborhoods is the next phase of this commitment. Leveraging the System's unique structure of Banks and Branches and NeighborWorks America's broad local presence will allow us to make our research and outreach broadly available to nonprofits and community leaders.

Conclusion

As the Federal Reserve builds on its consumer protection efforts in order to mitigate foreclosures for current homeowners, we are also concerned about the impact current mortgage market problems are having on individual communities. The challenges of rising foreclosures are significant at the state and local level and the nature of the problem varies by location. Through its structure, the Federal Reserve System is attuned to local issues, which both informs its national policymaking and allows for responses tailored to local conditions. We are committed to continuing to strengthen our relationships with local stakeholders. Our partnership with NeighborWorks America is an important part of that commitment. A unified effort is essential to mitigating and offsetting the negative impact of foreclosures.