

## **Randall S Kroszner: The challenges facing subprime mortgage borrowers**

Speech by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Consumer Bankers Association 2007 Fair Lending Conference, Washington DC, 5 November 2007.

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

\* \* \*

I am delighted to have been invited to speak to you about the important and pressing problems in the subprime mortgage market. My remarks today will address those problems, with particular focus on how they are affecting borrowers. The sharp increases in subprime mortgage loan delinquencies and foreclosures this year have created personal, economic, and social distress for many homeowners and communities. I will discuss first the forces that caused that distress and then turn to the prospects for troubled borrowers. Finally, I will address the critical question of what can be done to keep the affected families in their homes and alleviate the other difficulties they and their communities will face.

### **Background on the subprime mortgage market**

Subprime loans are associated with high credit risk because the borrower lacks a strong or lengthy credit history or has other characteristics that are associated with high probabilities of default. The expansion of subprime lending since the mid-1990s has been quite substantial, with the number of subprime mortgage loans now totaling 7-3/4 million, or 14 percent of the overall mortgage market. Technological advances and financial innovations that reduced the costs of lending to higher-risk households contributed importantly to the expansion of the subprime market. In particular, improvements in information processing allowed lenders to standardize their underwriting techniques and to better manage risks by adjusting the terms of loans to reflect the expected probability of default. Ongoing growth in the secondary market for mortgage loans also contributed to the growth of subprime lending by lowering transactions costs for investors and by spreading risk more broadly, especially through the process of securitization. That process allows intermediaries to pool large numbers of mortgages and sell the resulting cash flows to investors, often as components of structured securities.

Despite the positive aspects of the longer-term expansion of access to mortgage credit, it came with features that increased risks to households, the financial system, and the broader economy. Not surprisingly, subprime loans are more likely to default; for the borrower, this can mean the loss of a home and reduced access to future credit. Such outcomes can be even more likely if loan products have complex repayment terms that are not fully understood, or if the borrowers have unrealistic expectations of their future income or house prices. On the lender side, the originate-to-distribute model can leave lenders with weaker incentives to maintain strong underwriting standards. In particular, originators who securitize may inadequately screen potential borrowers unless investors provide oversight and insist on practices that align originator incentives with the underlying risk. The originate-to-distribute system is thus not only a potential source of risk to the financial system but also raises concerns regarding consumer protection.

### **Sources of the recent problem**

With this background in mind, let me turn now to the recent problems in the subprime mortgage market. As is widely known, delinquency rates on subprime mortgages have

increased sharply over the past year. The distress has been concentrated among the two-thirds of subprime borrowers who have variable-rate mortgages; more than 17 percent of those mortgages are in serious delinquency, about a tripling of the share since mid-2005.<sup>1</sup> Near-prime loans are showing a rise in serious delinquencies as well, although it is much smaller than for subprime. Serious delinquencies encompass foreclosures, and those are also up sharply – lenders initiated foreclosure proceedings for an average of 320,000 mortgage loans per quarter in the first half of this year, up from 240,000 loans per quarter over the preceding two years.<sup>2</sup> This increase in foreclosures has been largely associated with subprime mortgages.

Many factors contributed to the sharp increases in subprime delinquencies and foreclosures, both separately and in combination. First, the unemployment rate in an area can significantly undermine the ability of people in that area to repay their mortgages. States in the Midwest hit hardest by job cuts in the auto industry, such as Michigan and Ohio, are among the states with the highest rates of new foreclosures.

A second key factor has been the slowing of house prices: One national index, which rose at close to a double-digit pace from 2000 through 2005, has slowed to show only small gains for the past several quarters, and some areas are seeing outright price declines. By damping the growth of home equity, sluggish house-price appreciation makes it harder for homeowners struggling with payments to obtain better terms through refinancing or to withdraw accumulated equity to finance their obligations. In addition, borrowers with mortgages "under water" – that is, the house is worth less than the mortgage balance – may be tempted to walk away from their loans. That outcome may be particularly likely for those who purchased properties purely for investment purposes; indeed, the Mortgage Bankers Association has found that a disproportionate share of serious delinquencies are associated with non-owner-occupied properties in some of the states that have seen the largest increases in delinquencies.

A third factor that contributed to the sharp rise in payment problems among subprime mortgages appears to have been a loosening of underwriting standards for such mortgages in late 2005 and 2006. Investors, having seen several years in which mortgages showed extremely strong performance, apparently did not demand sufficient information from sellers of mortgages and related products during this later period.<sup>3</sup> As I already noted, inadequate monitoring can leave originators with weak incentives to maintain strong underwriting standards under the originate-to-distribute model.

Many subprime originators, for example, engaged in so-called risk-layering – in which they made loans to borrowers not only with weak or short credit histories but also with other risk factors. More than one-third of subprime mortgages originated in the second half of 2005 and 2006, for instance, carried a second lien, up from an average of only about 10 percent over the preceding three years.<sup>4</sup> The greater prevalence of such "piggyback loans" contributed to higher initial cumulative loan-to-value ratios. In addition, the share of subprime mortgages with full documentation fell to about 60 percent in late 2005 and 2006 from about 70 percent

---

<sup>1</sup> Seriously delinquent mortgages are more than ninety days in arrears or in foreclosure. Estimates are based on data from First American LoanPerformance.

<sup>2</sup> Foreclosure estimates are based on data from the Mortgage Bankers Association, adjusted to reflect the limited coverage of the association's sample.

<sup>3</sup> For a more comprehensive treatment of the causes and results of the failure of investors to exercise due diligence, refer to my recent speech to the Institute of International Bankers, in which I noted that the episode underscores the importance of the Russian proverb: "Trust but verify" (Randall S. Kroszner, 2007, "Recent Events in Financial Markets," speech delivered at the Institute of International Bankers Annual Breakfast Dialogue, October 22).

<sup>4</sup> The estimates in this paragraph are based on analysis of loan-level data from LoanPerformance by Federal Reserve Board staff.

over the preceding three years. Another underwriting practice in the subprime mortgage market that can add to risk is the failure to escrow taxes and insurance, which can result in payment shock to the borrower if the borrower did not fully anticipate the costs of taxes and insurances on the property.

These and other shifts in underwriting standards, coupled with slowing house price appreciation or even depreciation, are the most likely explanation for the pronounced rise we have seen in defaults occurring within a few months of origination – before most borrowers would have experienced significant changes in their payment obligations or in their financial situations.

Finally, another factor that could affect subprime delinquencies is the substantial payment increase often experienced at the first interest rate reset. For the most common type of subprime variable-rate loan, the so-called "2/28" loan, this reset occurs after two years, before which payments are typically based on a fixed below-market rate. In early 2007, the typical subprime mortgage experiencing a first reset had its rate increase from 7 percent to 9-1/2 percent, producing an increase of 25 percent to 30 percent in the monthly payment. This increase translates into an additional monthly debt obligation of \$350 per month for the average subprime variable-rate mortgage.

In the past, many subprime borrowers have avoided such payment increases by refinancing; for example, about two-thirds of subprime 2/28s originated in 2003 and 2004 were terminated through a refinancing or home sale by the time of the first scheduled reset. Prepayments on subprime variable-rate loans originated in late 2005 and 2006, however, have occurred at a slower pace, likely in part because the combination of sluggish house price appreciation and high initial cumulative loan-to-value ratios has left some borrowers with too little equity to qualify for new loans.

### **Prospects for subprime borrowers**

Looking ahead, two considerations suggest that conditions for subprime borrowers have the potential to get worse before they get better. First, all indications are that housing activity is continuing to weaken. Incoming data in recent weeks show that sales and new residential construction have declined further. In such an environment, house prices in the aggregate are likely to remain sluggish for some time. Second, the bulk of resets is yet to come: On average, in each quarter from now until the end of next year, monthly payments for more than 400,000 subprime mortgages are scheduled to undergo their first interest rate reset. That number is up from roughly 200,000 per quarter during the first half of 2007. Delinquencies and foreclosures are therefore likely to continue to rise for a number of quarters.

Many of the borrowers facing resets will still have solid payment records and enough home equity to refinance. But others will face challenges from not only low levels of home equity but also from considerably tighter credit conditions. The Federal Reserve's recent surveys of senior loan officers at banks have showed a significant tightening of standards on subprime loans. In addition, many lenders that dealt only in subprime loans have gone out of business, and other large lenders have cancelled some subprime lending programs. The issuance of new securitized pools of subprime loans has dwindled in the past couple of months, and judging from the few deals that are being placed, spreads are extremely wide. The supply of funds for subprime loans is likely to remain low for some time as investors gather information and reevaluate the risks.

### **Helping borrowers and mitigating losses**

These circumstances call for a high degree of collaboration and innovation to identify solutions that can keep borrowers confronting foreclosure in their homes. The loss of a home

to foreclosure is distressing to families and communities and can cause significant financial and social difficulties. We should also pay particular attention to communities that may face more challenges than others, such as African-American families, who, according to data collected under the Home Mortgage Disclosure Act, account for a disproportionate share of higher-price (and thus more likely to be subprime) loans.<sup>5</sup>

It is imperative that we work together as a financial services community to look for ways to help borrowers address their mortgage challenges, particularly those who may have fewer alternatives, such as lower-income families. Toward this end, the Federal Reserve's Community Affairs Offices have been convening lenders, community leaders, and government officials around the country over the past two years to help identify strategies to provide resources to assist borrowers confronting foreclosure. Most recently, the Federal Reserve Bank of Chicago sponsored symposiums in Chicago, Indianapolis, and Detroit to discuss factors contributing to increasing foreclosure rates and to highlight innovative intervention programs. Another meeting will be held in Waukesha, Wisconsin, in December.

In addition, the Federal Reserve and other banking supervisory agencies have issued statements in recent months urging both lenders and servicers to look for ways to work with borrowers having difficulty in meeting their mortgage loan obligations.<sup>6</sup> These statements note that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term interests of both the financial institution and the borrower. The September statement identifies prudent strategies for loss mitigation for servicers, including loan modifications, deferral of payments, extension of loan maturities, capitalization of delinquent amounts, and conversion of adjustable-rate mortgages into fixed-rate mortgages or fully indexed, fully amortizing adjustable-rate mortgages.

Lenders and servicers generally would want to work with borrowers to avoid foreclosure, which, according to industry estimates, can lead to a loss of as much as 40 percent to 50 percent of the unpaid mortgage balance. Loss mitigation techniques that preserve homeownership are typically less costly than foreclosure, particularly when applied before default. Borrowers who have been current in their payments but could default after reset may be able to work with their lender or servicer to adjust their payments or otherwise change their loans to make them more manageable.

Comprehensive data about how many loan workouts and modifications have actually occurred are not available, but some reports suggest that the numbers may be limited thus far. One possible contributing factor is that many borrowers are not seeking help or advice from their lenders because they believe that lenders cannot or are not willing to help them. Industry and consumer advocates who testified at our hearings on the home equity lending market last year told us that the greatest barrier to working with troubled borrowers is in simply making contact with them. These witnesses told us that lenders can reach troubled borrowers through trusted community advocates and that partnerships between community groups and lenders can reduce the number of homes lost to foreclosure. In addition, the analysis necessary to identify the best sustainable workout solutions that take into account the specific circumstances of individual borrowers can require a great deal of time and resources. Trusted counselors can also help here.

---

<sup>5</sup> Robert B. Avery, Kenneth P. Brevoort, and Glenn B. Canner (2007), "The 2006 HMDA Data," *Federal Reserve Bulletin*, vol. 93.

<sup>6</sup> Board of Governors of the Federal Reserve System (2007), "Working with Mortgage Borrowers," Division of Banking Supervision and Regulation, Supervision and Regulation Letter SR 07-6 (April 17); and "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," Supervision and Regulation Letter SR 07-16 (September 5).

One national nonprofit organization, NeighborWorks America (NeighborWorks), is making important strides in helping facilitate loan workouts and modifications.<sup>7</sup> As a member of the board of NeighborWorks, I have the privilege of seeing firsthand how this organization has mobilized its national network of affiliates and partners to respond to the threat of foreclosures in various communities throughout the country. Through its Center for Foreclosure Solutions, NeighborWorks has partnered with mortgage and insurance companies to help train and develop foreclosure counselors, conduct outreach to borrowers in trouble, and promote research to help inform strategic solutions for families and communities. A primary tool of the center is a hotline – 1-888-995-HOPE (4673) – that borrowers in financial distress can contact any time – twenty-four hours a day, seven days a week – to seek assistance from a mortgage counselor.

So far this year, the hotline has received more than 100,000 calls, with more than half of those calls received in the third quarter alone. As more subprime ARMs reset over the course of coming quarters, services aimed at preventing foreclosures will continue to be strained, and all stakeholders will need to be innovative in identifying strategies to help preserve sustainable homeownership.

A recent collaborative initiative that may help to alleviate some of the resource challenge is the Hope Now alliance. This collaboration among counselors, servicers, investors, and other mortgage market participants aims to increase outreach efforts to contact at-risk borrowers through a national direct-mail campaign, encouraging them to either call their lender or a credit counselor. The alliance will work to expand the capacity of an existing national network to counsel, refer, and connect borrowers to servicers. Participating servicers have agreed to work toward cross-industry technology solutions to more effectively link servicers and counselors to better serve the homeowner.

A promising effort started by the states is the new Foreclosure Prevention Working Group. Consisting of eleven state attorneys general plus the Conference of State Bank Supervisors and the state bank regulatory agencies, the Working Group has held conversations with mortgage servicers and will continue to pursue opportunities for preventing foreclosures and encouraging increased loan modifications.

All these efforts are important, but there is more to be done to deal with the significant challenges ahead. First, at this point, we are hearing that many modifications are done on a case-by-case basis. That is understandable given the complexity of the products and the unique circumstances of each borrower. Given the substantial number of resets from now through the end of 2008, however, I believe it would behoove the industry to join together and explore collaborative, creative efforts to develop prudent loan modification programs and other assistance to help large groups of borrowers systematically.

Second, I believe that modernization of programs administered by the Federal Housing Administration, which has considerable experience helping low- and moderate-income households obtain home financing, could also help avoid foreclosures. FHA modernization could give the agency the flexibility to work with private-sector lenders to expedite the refinancing of creditworthy subprime borrowers and to design products that improve affordability through such features as variable maturities or shared appreciation.

Third, we must pursue initiatives to prevent these problems from recurring, and the Federal Reserve is making strides in this direction. We are engaged in a rigorous review of the mortgage-related rules under Regulation Z, which implements the Truth in Lending Act (TILA), and we intend to issue proposals before the end of the year to ban several deceptive advertising practices and require important consumer disclosures earlier in the mortgage process to better enable consumers to compare and shop among loan products.

---

<sup>7</sup> NeighborWorks America is a registered service mark.

We also plan to issue proposed regulations under the Home Ownership and Equity Protection Act to address unfair or deceptive mortgage lending practices that would apply to subprime loans offered by all mortgage lenders. We will address some practices associated with subprime lending, such as prepayment penalties, failure to offer escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the failure to give adequate consideration to a borrower's ability to repay. For example, as I mentioned earlier, failure to escrow for taxes and insurance can lead to a situation akin to payment shock for borrowers. It is a common practice for these payments to be escrowed in the prime markets, and I see no reason that escrows should not be standard practice in the subprime markets too.

All told, the spirit of innovation is essential to addressing the issue that is before us now as lenders, investors, regulators, community leaders, and borrowers. As stakeholders and beneficiaries of the mortgage market, we all share an interest in working together to implement solutions that maintain a robust, transparent credit environment that promotes access to responsible mortgage lending.