



California's Subprime Mortgage Lending Crisis: Causes, Effects and Solutions

New America Foundation
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<http://www.responsiblelending.org>

Center for Responsible Lending



Promoting policies and practices that encourage fair access to credit for low-wealth families

Durham, NC Washington, DC Oakland, CA

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Self-Help



Creating and protecting ownership and economic opportunity for people of color, women, rural residents and low-wealth families and communities

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The Subprime Mortgage Crisis



- California is Ground Zero for America's Foreclosure Crisis
- The Mortgage System is Broken and the Market Alone Will Not Fix It
- Both State and Federal Action Are Needed

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What is Subprime Lending?



Higher-Cost Loans to Borrowers

- With Imperfect Credit
- Borrowing More Than They Could Otherwise Afford

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I. Causes of the Growing Foreclosure Epidemic

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Status of Foreclosures in CA



DataQuick

- Record **24,209** homes lost in Q3 2007 since 1988
- Up 39% from Q2 2007, 605% from Q3 2006
- Half of 72,571 Default Notices in 293 Zip Codes
- Fewer than half (46%) emerge from foreclosure process

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Status of Foreclosures in CA



Realty Trac: Nation's Highest Foreclosure Rates, per household, concentrated in California 3Q '07

- Stockton #1
- Riverside/San Bernardino #3
- Sacramento #6
- Bakersfield #9
- Oakland #10
- Riverside/SB and Los Angeles lead the nation in total number of foreclosure filings.

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Status of Foreclosures in CA




Center for Responsible Lending:

- **179,798** metro homes purchased with 2005-2006 subprime loans expected to be lost
- 2006 Subprime Mortgages: More than 1 in 5 (21.4%) will end in completed foreclosure
- Nearly **500,000** CA homeowners will lose their homes from 1998-2006 loans
- Subprime = 15% of all loans, but 68% of all foreclosure starts (analysis of MBA data)

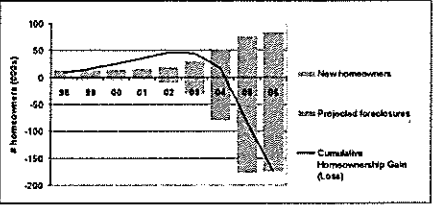
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The Effects of Foreclosures: A Drain on California Homeownership




Net Loss of 175,000 CA Homes



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Subprime Foreclosure Spillover Effects



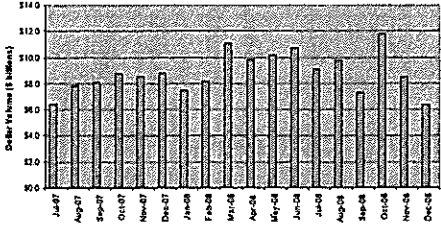
- Every Neighbor is Affected
 - CA: 8.4 million homes experiencing value declines as a result of nearby foreclosures
- Housing Value Declines
 - CA: \$67.2 Billion in loss of home value
- Economic Slowdown: Construction, Consumer Spending
- Declining State and Local Tax Revenues
- Neighborhood Decline

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The Crisis Will Worsen



CA Subprime ARM Reset Volume



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California's Communities of Color Most Likely to Get High-Rate Loans 

	Number	%
▪ African-American	47,559	44.3%
▪ Latino	241,087	42.1%
▪ White	149,678	19.4%

(2006 HMDA data)


Even after controlling for credit risk, African-American and Latino borrowers more than 30 percent more likely to receive a higher-rate loan than white borrowers with the same qualifications. (CRL, *Unfair Lending*, 2006)

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Recent Projections are Dismal 

- **HUD Secretary Jackson:** Up to 25% of resets will end in foreclosure
- **First American Core Logic:** Up to 50% of 4th quarter 2007 will end in lost homes
- **Goldman Sachs:** California home prices over-valued by 35-40% (October 21, 2007)


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II. System is Broken and Market Alone Will Not Fix It

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**My Mother's
Mortgage Market**



- **Products:** Mostly 30-year fixed; Limited ARMs
- **Underwriting:** Manual, Labor-Intensive, Lengthy
- **Lenders:** Banks and S&Ls; Hold in Portfolio
- **Profits:** Interest Spread
- **Underserved:** Redlining, high denial rates and lower homeownership rates for minorities and those with imperfect credit

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**21st Century Subprime
Mortgage Market**



- **Products:** Many options, multiple features, risk layering.
- **Underwriting:** Automated, instantaneous, heavy reliance on credit scores
- **Lenders:** Mostly non-depositories, most originated by brokers, sell loans to Wall Street
- **Profits:** Volume = Transaction fees and sales to secondary markets
- **Underserved:** "If you can fog a mirror ...," Prepayment Penalties, Flipping

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California Subprime Lending Facts



- **Refinance:** 50%, only 10% for new homeowners
- **Broker-Originated:** 80%
- **State/HUD-Regulated Lender:** 60%
- **Subprime Resets:** Up to CA 500,000 initial resets over the next 18 months.

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Risky Borrowers Get the Riskiest Loans



2006 Loans

- Exploding ARMs: 70% - 80%
- Stated incomes: 50%
- No escrows: 75%
- Piggybacks: 80%
- Prepayment penalties: 80%

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Financial Incentives Reward Risky Loans



- Broker Kickbacks for Higher Rate Loans, aka "Yield Spread Premiums"
- Prepayment Penalties
- Steering: 20-40% of subprime borrowers appear to have prime credit statistics

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Current Market Structure Lacks Accountability




- Brokers
- Lenders
- Wall Street
- Ratings Agencies
- Investors
- Servicers

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Discouraging Experience to Date




Some tightening of underwriting criteria, but

- No change in prepayment penalties
- No change in incentives or accountability
- Housing market uptick could bring back temptation for short-term profits.

Crisis Occurred Because of Inadequate Rules; New Rules are Needed to Restore Confidence, Safety and Stability

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II. State and Federal Action Are Needed to:

1. Assist Current Borrowers
2. Protect New Borrowers

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California Policy Recommendations: Help Existing Borrowers at Risk



- **Modifications: Need FDIC Systematic Approach**
 - Rhetoric vs. Reality: Only 1% of Resets Getting Modified (Moody's survey)
 - Need for Transparent Formulas
 - Accountability/Data Collection
- \$10 million for Emergency Counseling and Legal Assistance

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**California Policy Recommendations:
Prevent Future Foreclosures**



1. Return to common-sense lending practices
 - Establish borrower ability to repay at fully indexed rate
 - Verification of income
 - Escrow for taxes and insurance
2. Align incentives with borrower needs
 - Ban yield spread premiums/prepayment penalties
 - Ban steering

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**California Policy Recommendations:
Prevent Future Foreclosures**



3. **Restore Accountability Through Shared Liability, Market-Enforced Changes**
 - Brokers: Enforceable Fiduciary Duty, Bonding
 - Lenders: Liable for all loans originated.
 - Assignee Liability

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**Federal Policy Recommendations:
Help Existing Borrowers at Risk**



- Bankruptcy Fix:
- Tax Forgiveness
- Larger Role for FHA, GSEs

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Recent Federal Action



- New Federal Reserve Regulations Expected in December
- Predatory Lending Legislation:
 - HR 3915 Passed House
 - Next in Senate?
 - Passage Uncertain

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