A Case Study: Subprime Mortgage Problems

By Congressman J. Randy Forbes
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Recently, our nation has been hit with a troubling subprime mortgage situation. Reports of homeowners in the U.S. that are going into foreclosure on their homes are on the rise. This sharp increase in foreclosure rates can mostly be attributed to subprime mortgage loans, where low introductory interest rates are ending, causing homeowners' mortgage payments to increase dramatically. Additionally, mortgage lenders are losing large amounts of money, some reporting bankruptcy, because of the number of foreclosures in their loan portfolio.

This subprime mortgage situation has an adverse effect on homeowners, mortgage lenders, and our overall economy in the United States. The U.S. housing market is already facing serious negative pressure as a result, and it faces the potential of even more.

There are many questions to consider when addressing the subprime mortgage crisis. How did we get in this situation? What is the appropriate role of Congress in this situation? What should be done to help homeowners who are in foreclosure due to bad loans? How are consumers protected from predatory lenders? How can the number of foreclosures be limited in the future? How can this situation be prevented from happening again without losing an appropriate balance of access to homeownership?

I have created this case study on subprime mortgage problems to address these important questions. I look forward to hearing from you on this issue as well. I invite you to visit my website, http://randyforbes.house.gov, and email me with your questions and concerns regarding housing issues in the United States. With kind personal regards, I am

Yours truly,

J. Randy Forbes
Member of Congress

THE BACKGROUND ON SUBPRIME MORTGAGES

A Brief Overview of Mortgage Lending

Mortgage loans are broken into the following general categories: prime loans, alternate-A loans, and subprime loans. While a variety of different characteristics can describe loans within the same category (different payment terms, interest rates, etc), the loans are broadly classified based on the amount of risk the mortgage lender thinks the borrower bears. Thus, a prime loan is a low-risk loan, an alternate-A loan is a mid-risk loan and a subprime loan is a higher-risk loan.

Mortgage lenders look at a variety of factors to determine what risk category a borrower fits. To qualify for a low-risk loan, on average a borrower needs:

- 20 percent down payment (also called a loan to value of less than 80 percent, reflecting the down payment money)
- Excellent credit (generally a FICO score of at least 680)
- Debt to income ratio of less than 33 percent
- A mortgage amount under $417,000 (called a conforming loan, as the loan falls under the Freddie Mac/Fannie Mae loan limits)
- A mortgage free of any suspicious terms (like an interest-only loan, balloon payment, or jumbo loan)
- Full documentation (borrower can prove stated income levels with W2 forms)

While a borrower does not have to meet every category to qualify for a low-risk loan, those are general guidelines that are used and certain trade-offs can apply if a borrower doesn't fit every category. For example, a borrower with excellent credit might be able to carry a higher debt to income ratio of 38 percent or a higher loan amount. There are no strict guidelines to determine loan categories, and borrowers who are slightly more risky might qualify for the alternate-A loan instead of a prime loan.

Prime loans usually have lower interest rates that are more closely matched with the Treasury Department's interest rates. If a borrower cannot qualify for either a prime or alternate-A loan, they might be offered a subprime loan.

Subprime loans usually are given to borrowers with many of the following characteristic, which mortgage lenders perceive as risky:

- Recent payment delinquencies (30-day or 60-day depending on how recently) as noted on an applicant's credit report (from credit cards, auto loans, etc)
- Judgment, foreclosure, repossession, or charge-off within prior two years
- Bankruptcy in past five years
- Relatively low credit score (FICO below 620)
- Limited ability to cover living expenses after debts (debt to income ratio of 40% or more)

A Recent History of Subprime Loans

Until the 1990s, banks primarily made loans classified as low risk based on an individual's good credit and a low debt to income ratio. At that time, individuals who did not qualify for a low-risk loan had little to no options to finance a home. In the mid-1990s, however, banks began offering a new category of loans - subprime mortgage loans - to homebuyers as a means of responding to a demand in the marketplace. Since that time, the number of subprime loans has increased dramatically. A couple of factors contributed to this rise. First, innovations in the mortgage industry have adjusted the amount of risk lenders can structure themselves to have, lowering some of the historical risk

associated with subprime loans. Second, there has been a growing emphasis on increasing the number of homeowners in the United States, which has increased the number of potential homebuyers.

The Structure of Subprime Loans

Borrowers who end up using subprime loans usually face higher costs of borrowing than prime or alternate-A borrowers, primarily in the form of higher interest rates. The following characteristics are more frequently found in subprime mortgages:

- **Adjustable Rate Mortgage or ARM** – these loans usually offer low, introductory interest rates for the first few years, and then readjust after the introductory period based on market interest rates.
- **Negative Amortizing Mortgages or NegAms** – these loans allow borrowers to pay less than the current interest due. The interest the borrower didn't pay is added onto the loan balances, which results in higher loan balances and higher future payments.
- **Interest Only Mortgages** – these loans offer an introductory period during which monthly payments cover only the loan interest. After the introductory period, the loan payments reset to a higher amount to also cover the loan's principal.

The Rising Number of Foreclosures

The recent focus on subprime mortgage loans was caused by an increase in the number of subprime borrowers who went into foreclosure. Similar to the 2000-2001 recession when subprime foreclosures increased, there has been an upward trend in the number of subprime foreclosures since 2005. Overall, three percent of subprime loans are in foreclosure. However, for borrowers with an ARM – which account for about nine percent of first-lien mortgages overall and two-thirds of all subprime loans – 11 percent are in serious delinquency (more than 90 days past due or in foreclosure), according to the Chairman of the Federal Reserve Ben Bernanke. Conversely, low-risk mortgages foreclosures have remained relatively stable at less than one percent of all mortgages in foreclosure.

According to RealtyTrac, a database of foreclosured homes, it is estimated that over 33,000 homes in Virginia have gone into foreclosure as of October 2007. In October 2007, 443 percent more homes were in foreclosure than in October 2006. However, Virginia is ranked 29th overall in the number of foreclosures in the United States and in October 2007, Virginia foreclosures only accounted for one percent of the 224,451 foreclosure filings nationwide.

Many financial experts have theorized that the number of foreclosures is rising because borrowers were given loans they cannot afford long-term. This particularly affects borrows with an ARM or Interest-Only Mortgage that are seeing their low, introductory interest rate end and cannot afford the higher payments an increased interest rate or principal payment brings. Additionally, the current housing downturn has caused the value of many homes to decline, which in turn makes it harder for borrowers in trouble to sell their home to pay off their mortgage or refinance their home because in some instances, their home is worth less than the amount of mortgage on their home.

The current foreclosure situation has attracted particular concern because of the current relatively low employment rate in the United States. At a low 4.7% in October 2007 (3.3% in Virginia), it is unusual that the foreclosure rate on home is rising while unemployment has fallen. This has given further credence to the idea that borrowers were given loans they cannot financially support.

The Issue of Predatory Lending

There has been an increasing incidence of predatory lending in the United States, which has compounded the subprime problem. Predatory lending in the mortgage industry refers to practices of deceptively convincing borrowers to agree to unfair or abusive loan terms, often by pressuring buyers to make an uninformed or hasty decision on what mortgage they select. According to the Department of Housing and Urban Development, predatory lenders and their associates (sometimes home appraisers or mortgage brokers) often use one or more of the following loan techniques:

- Sell properties for much more than they are worth using false appraisals.
- Encourage borrowers to lie about their income, expenses, or cash available for down payments in order to get a loan.
- Knowingly lend more money than a borrower can afford to repay.
- Charge high interest rates to borrowers based on their race or national origin and not on their credit history.
- Charge fees for unnecessary or nonexistent products and services.
- Pressure borrowers to accept higher-risk loans such as balloon loans, interest only payments, and steep pre-payment penalties.
- Target vulnerable borrowers to cash-out refinance offers when they know borrowers are in need of cash due to medical, unemployment or debt problems.
- "Strip" homeowners' equity from their homes by convincing them to refinance again and again when there is no benefit to the borrower.
- Use high pressure sales tactics to sell home improvements and then finance them at high interest rates.

Predatory lenders will sometimes force borrowers who would qualify for a prime loan into a subprime loan to maximize their profits, which in turn forces borrowers to incur higher payments.

THE EFFECT OF SUBPRIME MORTGAGE FORECLOSURES

The effects of an increased rate of foreclosures – whether from legitimate subprime loans or from predatory lenders - are threefold. First, the borrower is impacted because the mortgage lender repossesses their house. This has both the immediate impact of the borrower losing their home and any home equity they already paid into the home as well as the long-term impact of adverse information on their credit report. This will make it harder for them to get a loan of any type in the future.

Second, mortgage lenders are impacted. Many subprime lenders raise funds by selling their loans to investors in the secondary market (subprime lenders make money this way and investors – often some of the biggest banks and investment houses across the country – make money by assuming the interest payments the borrower makes). As foreclosures have increased, investors are losing large amounts of money and have become unwilling to purchase the same amount of subprime loans, which has forced some subprime lenders into bankruptcy. Investors lose money when a house forecloses because they lose out on the interest payments for the duration of the mortgage term, which can be up to hundreds of thousands of dollars per house. Additionally, mortgage investors have been losing money because the slow housing market makes it hard for a repossessed home to be sold at the same amount or more than the mortgage is for, which results in a financial loss for the bank. It is estimated that some banks, such as Citigroup, have lost up to $11 billion because of the subprime mortgage crisis. This loss of revenue has the potential to destabilize the banking industry as well as lead to a shortage of capital in the market, which limits the amount of money available for future loans for both individuals and businesses.

Third, communities have the potential to be destabilized across the country. Communities with large numbers of abandoned homes have more of a potential of being subject to vandalism and other acts of crime, lower home values, and a decreased sense of stability. Furthermore, the housing market, which has already been stagnant, is facing increased negative pressure as the numbers of foreclosures grow in communities across America. This has the potential to continue to push down the value of homes in many communities, as well as make it harder for homebuyers to qualify for mortgages in the future.

WHAT IS THE WHITE HOUSE INITIATIVE?

On December 6, 2007, the White House outlined steps that the Administration is taking to help American homeowners who may be feeling the impact of the subprime mortgage situation. The White House initiative is not a program that

provides an overarching government bailout to those Americans who have defaulted on their loans. It is an effort of the federal government to bring together lenders, mortgage counselors, loan servicers, and investors to develop a private-sector plan that would allow our market-based system to work out the challenges of the subprime mortgage situation on a voluntary basis.

The Department of Treasury and the Department of Housing and Urban Development have worked with those private entities to create a private-sector group called the HOPE NOW Alliance. HOPE NOW is staffed by HUD-approved credit counselor whose goal is to maximize outreach efforts to homeowners who are experiencing distress as a result of the subprime mortgage situation. For more information on HOPE NOW, you can visit www.hopenow.com. You can also call 1-888-995-HOPE or visit www.995hope.org if you need to speak with a credit counselor who is ready to help.

WHERE I STAND

America's market-based economic system has proven faithful over the years. In responding to the subprime issue, it is important that we take steps to minimize the effects of the problem on families impacted, without compromising our market-based system and without rewarding mortgage borrowers' risky behaviors. Likewise, our current patchwork of rules governing federal and state institutions have made regulating mortgage borrowing difficult and we need to see that predatory lending practices are regulated so that American consumers are protected. The following steps will help homeowners avoid foreclosure, see that consumers are protected, and help prevent these problems from happening again.

✓ Encourage Lending Companies to Make Decisions to Help Consumers

While a stable housing market and a reduced number of foreclosures are most favorable, it is not the federal government's role to bailout homeowners who can't make their mortgage payments. However, we should encourage those companies who are willing to come together and make decisions that would help consumers who may be struggling with subprime loans, especially when the companies themselves have played a large role in the subprime mortgage situation.

✓Protect Consumers Through Anti-Predatory Lending Initiatives and Financial Literacy Education

Predatory lending can result in risky mortgages and irresponsible financial practices, and many times can result in homeowners losing their homes. Predatory lending is one of the most threatening challenges to first-time home buyers, elderly homeowners, fixed-income homeowners, and minority homeowners. Public and private anti-predatory lending initiatives such as outreach programs and mortgage education programs allow consumers to become more aware of predatory lending practices, so they decrease their chances of falling prey to this form of lending and potentially losing their homes. These initiatives, when provided to new home buyers and those groups of homeowners who are often targeted by predatory lenders, will allow consumers to make more educated lending choices. I voted in favor of H.Res. 526, which declares the sense of the House that specified government action should be taken that protects buyers from unscrupulous mortgage brokers and lenders, and H.Res.273, which supports the goals and ideals of Financial Literacy Month, including raising public awareness about the importance of financial education in the United States so consumers can make more educated lending choices.

✓ Increase Resources for Housing Counselors

The role of non-profit housing counselors between borrowers and lenders is critical to helping prevent foreclosures. Counselors work on behalf of borrowers to negotiate safe and affordable loan modifications in an effort to help prevent foreclosures. These groups include community organizations like NeighborWorks, the Federal Housing

Administration (FHA), government-sponsored enterprises like Fannie Mae and Freddie Mac, and mortgage and loan servicers. Seeing that these organizations that are aimed at helping prevent foreclosures receive the resources they need will enable them to help more homeowners who are at risk for defaulting on a loan.

✓ Change Key Housing Provisions in the Federal Tax Code

Currently, when a lender and borrower negotiate a refinance of the debt and the lender forgives part of the debt, the IRS views this as income for the borrower and taxes it. Temporary relief of this tax provision will ensure that cancelled mortgage debt on a primary residence is not counted as income. I supported H.R. 3648, which would make this important change to our tax code.

✓ Require Mortgage Lenders to Meet Uniform Education and Licensing Requirements

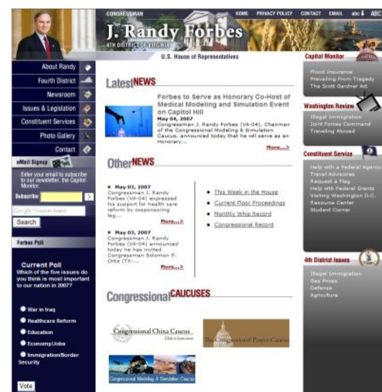
Currently, each state establishes varying degrees of licensing requirement for mortgage brokers, many with little or no oversight. Creating a uniform licensing system for lenders would require lenders to meet certain minimum standards of licensing requirements and standards of behavior. These licensing requirements will create enforceable regulatory oversight, with primary oversight responsibility at the state level, and encourage lenders to participate in fair lending practices, thus protecting consumers from predatory lending practices.

✓ Create a National Loan Tracking Database

A national loan tracking database would assign a unique number to lenders, and each loan a lender sold would be tagged with their unique number. As it is now, once loans are sold off to other financial institutions, there is no way to track where a bad loan may have originated. A national loan tracking database would change this by allowing us to track the originator of the loan, and find those lenders who may be practicing predatory lending.

FOR MORE INFORMATION

For more information on the subprime issue or for a list of resources relating to housing counselors or financial literacy initiatives, please use the links below. I would appreciate hearing your thoughts on housing issues. Please take a moment to Email me via my website http://randyforbes.house.gov, or call my Washington, D.C. office at (202) 225-6365.



The Federal Housing Administration

Center for Foreclosure Solution – NeighborWorks

All About Mortgages Guide – Freddie Mac

Financial Literacy Toolkit – U.S. Financial Literacy and Education Commission

Looking for the Best Mortgage – Federal Reserve Board

Bureau of Financial Institutions