Updated Projections of Subprime Foreclosures in the United States and Their Impact on Home Values and Communities

CRL Issue Brief *Rev. August 2008*

Background

In our December 2006 *Losing Ground* study, the Center for Responsible Lending (CRL) predicted that 1.1 million households holding subprime mortgages originated in 2005 through third-quarter 2006 would lose their homes, and that 2.2 million subprime loans made since 1998 would end in failure.[1] In our *Subprime Spillover* report issued in January 2008, we estimated that these foreclosures would cause a $202 billion decline in home values in their communities.[2]

While some in the mortgage industry previously asserted that CRL foreclosure estimates were "wildly pessimistic",[3] the number of troubled loans has now reached historic levels—the Mortgage Bankers Association reported that 16 percent of subprime loans (and 24 percent of subprime ARMs) were seriously delinquent or in foreclosure at the end of first quarter 2008.[4] Today, foreclosure rates continue to climb above record levels, spurred by the trifecta of unaffordable loans, declining home values, and general economic instability. Accordingly, **CRL has revised our original foreclosure projections to reflect the ongoing decline of the market and the resulting impact on homeowners and communities.**

New Foreclosure and Spillover Projections

We now project that almost 2.2 million subprime foreclosures will occur primarily in late 2008 through the end of 2009, up from our original 1.1 million estimate made in 2006. Additionally we estimate that 40.6 million homes in neighborhoods surrounding those foreclosures will suffer price declines averaging over $8,667 per home and resulting in a $352 billion total decline in property values. These new projections—representing only property value declines caused by nearby foreclosures, not other price drops associated with the slowdown in local housing markets—are based on CRL research combined with data from Merrill Lynch, Moody's Economy.com, and the Mortgage Bankers Association, as described in the Appendix.[5]

Table 1: Projected Subprime Foreclosure Impact in U.S.
UPDATED AUGUST 2008

Subprime foreclosures expected to occur (primarily in late 2008 through end of 2009)	2,164,000 homes lost
Spillover impact:	
Surrounding homes suffering price declines caused by nearby subprime foreclosures	40.6 million homes
Decrease in home values	$352 billion
Average decrease in home value per unit affected	$8,667

Related state statistics are outlined in Table 2.

Table 2: Projected Foreclosures and Spillover Impact by State
(ranked by number of foreclosures)
UPDATED AUGUST 2008

	Number of projected Foreclosures (primarily in 2008-2009)	Number of surrounding homes suffering price declines caused by nearby foreclosures	Decrease in home value ($ million)	Average decrease in home value per unit affected ($)
California	336,967	7,505,584	$105,922	$14,112
Florida	198,828	3,667,230	$35,430	$9,661
Texas	143,091	2,283,390	$4,865	$2,131
New York	122,192	3,552,642	$64,362	$18,117
Georgia	85,198	630,218	$1,796	$2,849
Illinois	84,158	2,536,938	$26,973	$10,632
Ohio	81,039	1,392,990	$2,817	$2,022
Arizona	80,850	1,201,327	$8,584	$7,145
Michigan	76,892	1,414,411	$3,753	$2,653
Pennsylvania	72,689	1,684,475	$6,504	$3,861
Virginia	58,067	1,035,979	$6,871	$6,632
New Jersey	56,919	1,781,424	$19,340	$10,857
Maryland	52,480	1,220,574	$11,989	$9,823
North Carolina	50,979	332,375	$851	$2,561
Nevada	49,605	557,286	$6,459	$11,591
Colorado	46,252	748,652	$3,145	$4,201
Indiana	44,982	544,991	$948	$1,739
Tennessee	42,663	441,703	$956	$2,164
Missouri	40,114	705,446	$1,771	$2,510
Washington	38,675	846,526	$4,835	$5,711
Minnesota	36,740	545,773	$2,227	$4,080
Massachusetts	31,818	1,013,548	$7,897	$7,791
South Carolina	26,840	179,309	$471	$2,629
Louisiana	26,007	400,306	$1,020	$2,547
Oregon	25,771	466,877	$2,518	$5,394
Wisconsin	24,661	557,251	$1,878	$3,369
Utah	20,850	310,442	$1,302	$4,193
Alabama	20,200	209,052	$401	$1,917
Kentucky	19,841	249,727	$492	$1,970
Oklahoma	18,702	256,261	$422	$1,645
Connecticut	17,677	441,018	$2,015	$4,569
Mississippi	14,209	77,449	$142	$1,838
Kansas	13,081	200,403	$378	$1,886
Arkansas	11,123	71,351	$130	$1,816
Iowa	10,592	178,166	$340	$1,907
Idaho	9,263	97,029	$301	$3,098
New Mexico	8,650	151,430	$507	$3,349
Hawaii	8,200	167,942	$4,110	$24,474
Rhode Island	7,611	244,424	$1,693	$6,925
New Hampshire	6,866	57,628	$201	$3,482
Nebraska	6,806	132,896	$247	$1,862
West Virginia	6,441	40,886	$79	$1,936

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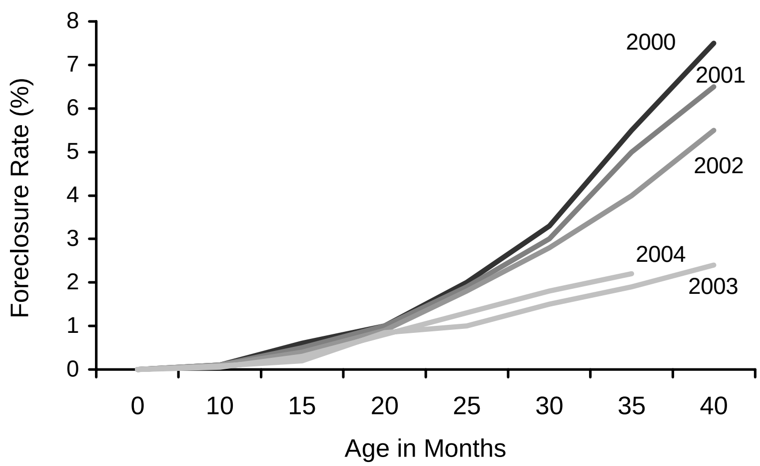
UPDATED AUGUST 2008

	Number of projected Foreclosures (primarily in 2008-2009)	Number of surrounding homes suffering price declines caused by nearby foreclosures	Decrease in home value ($ million)	Average decrease in home value per unit affected ($)
Maine	6,208	42,127	$133	$3,151
Delaware	5,294	90,615	$385	$4,249
District of Columbia	4,091	223,797	$4,236	$18,930
Alaska	3,631	47,404	$188	$3,965
Montana	3,092	16,790	$42	$2,496
Wyoming	2,110	18,630	$45	$2,441
Vermont	2,080	6,460	$21	$3,325
South Dakota	1,849	18,982	$38	$1,976
North Dakota	1,078	23,761	$51	$2,140

Unsafe Loans and Weaker House Prices Fuel Higher Foreclosures

In *Losing Ground,* CRL found that high housing price growth had masked a high "failure rate" on subprime loans made since 1998, because it enabled many delinquent borrowers to use their increased home equity to refinance their loans despite being behind on monthly payments. We also noted that subprime loans made during 1998-2004 had performed quite similarly,especially in their early years. For example, after 20 months of aging, subprime loans typically showed a foreclosure rate of 1% or less, even for the worst performing loans originated in 2000. (Each line in Figure 1 represents the proportion of loans originated in a given year that have foreclosed at a given age.)

Figure 1: Cumulative Default Rates on 2000-2004 Subprime Loan Cohorts

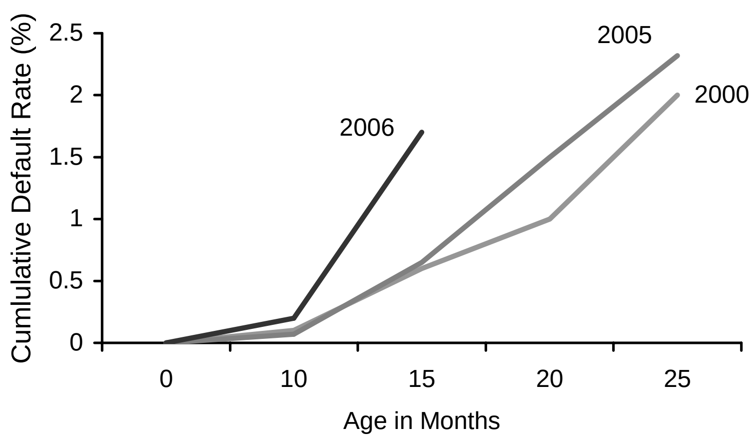


Source: CRL and Freddie Mac[6]

Based on further analysis, CRL conservatively estimated that one in five (19.4 percent) subprime loans originated in 2005-2006 would fail. This projection considered the demonstrated performance of subprime loans in the past, coupled with the impact of lower housing price growth forecast for 2007 and beyond. We also pointed to factors that—while not quantified in our analysis—would likely cause foreclosure rates to be even higher than our estimate. These factors included the proliferation of risky loan products and looser underwriting standards for qualifying borrowers, a market structure and incentives that encouraged originators to make loans with little regard for how those loans would perform, and insufficient legal and regulatory standards to ensure that loans were sustainable.

Sadly, the impact of these risk factors has been greater than imagined and 2005 and 2006 loan vintages are performing poorly compared to prior year vintages, even the heretofore worst-performing loans made in 2000. For example, after 15 months of aging, the default rate for 2006 subprime loans is three-times higher than the default rate on 2000 loans. (see Figure 2).

Figure 2:



***Source: CRL and Freddie Mac*[7]**

This poor performance supports CRL's new higher projections of subprime foreclosures and spillover impact. We note too that other analysts have predicted similarly disastrous foreclosure rates.[8]

Appendix: CRL Methodology for State Subprime Foreclosure and Spillover Impact Statistics – August 2008 update

Note: CRL's analysis for the "Losing Ground" and "Subprime Spillover" studies considered only originated conventional home loans to owner-occupants, in a Metropolitan Statistical Area or Metropolitan Division, secured by a first-lien on a 1- to 4-unit home, as disclosed under HMDA.

In January 2008 Congressional testimony, Mark Zandi, Chief Economist at Moody's Economy.com projected that 2 million subprime homeowners would be foreclosed upon in 2008 and 2009.[9] The previous month, Merrill Lynch published a report that projected losses on subprime mortgage loans could reach \$250B on \$1.4 trillion of outstanding loans.[10] Using an estimated severity rate of 50%, we calculated an incidence rate for the Merrill Lynch projections of 35.7%. We applied this incidence rate to the number of outstanding subprime loans at the end of 1st quarter 2008 as reported by the Mortgage Bankers Association, grossed up to reflect the entire subprime market of 6.5 million loans.[11] This resulted in an estimated 2.3 million foreclosures expected to occur in the next two years. We then calculated the average of this estimate and the Moody's Economy.com projection (2 million) to project 2.16 million homes foreclosed upon in 2008 and 2009. We then used the proportionate distributions by state originally established using census tract level HMDA data in our *Losing Ground* paper to determine the impact at the state level.

We were restricted to calculating the spillover impact of these foreclosures on a national and state basis only, since we did not have updated data on a census tract level as we did in our original *Subprime Spillover* study. Using the 6.5 million outstanding subprime loans figure, we revised our Losing Ground "baseline" estimate of 1.1 million foreclosures on 2005-2006 loans to 1.24 million. We then calculated the percent increase from this baseline to 2,164,020 – 74.7%. We then applied the same 74.7% increase in projected foreclosures to the original estimated dollar amount of spillover impact for the nation and each state. As a result, the U.S. figure increased from $202 billion to $352 billion. [12]

Notes

[1] Ellen Schloemer, Wei Li, Keith Ernst, and Kathleen Keest , *Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners*, (December 2006) at http://www.responsiblelending.org/issues/mortgage/reports/page.jsp?itemID=31214551.

[2] *Subprime Spillover*. Center for Responsible Lending. (November 2007) available at http://www.responsiblelending.org/issues/mortgage/research/subprime-spillover.html

[3] Statement by Michael Fratantoni, senior economist with Mortgage Bankers Association, MBA as quoted by Kirstin Downey in *Dim Forecast for Risky Mortgages*, Washington Post, December 20, 2006. Available at http://www.washingtonpost.com/wp-dyn/content/article/2006/12/19/AR2006121901491.html

[4] *National Delinquency Survey Q1 2008*. Mortgage Bankers Association. (Published June 5, 2008.)

[5] CRL's *Subprime Spillover* analysis utilized research by Immergluck and Smith (2006) that showed an average 0.9 percent decline in home values for properties within 1/8 mile of a foreclosure. (Dan Immergluck and Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values, Housing Policy Debate (17:1)* Fannie Mae Foundation (2006) at http://www.fanniemaefoundation.org/programs/hpd/pdf/hpd_1701_immergluck.pdf) We are currently evaluating the methods and results of a more recent study that estimates a slightly lower impact on home prices (John Harding, Eric Rosenblatt, and Vincent Yao. *The Contagion Effect of Foreclosed Properties*. July 2008) and may revise our analysis once this review is complete.

[6] Claims curved described by CRL (Schloemer et al, see note 1) and Amy Crews Cutts, Freddie Mac Office of Chief Economist, *Housing and Mortgage Market Outlook* (May 2007).

[7] Ibid.

[8] Fitch Ratings estimates total losses of 25.8% of original balance in Q4 2006 loans placed in MBS they rated, and that loss severity will be at 60%, which means that 43% of the loans are projected to be lost to foreclosure (25.8/60); lack of home price appreciation said to increase defaults. Glenn Costello, Update on U.S. RMBS: Performance, Expectations, Criteria, Fitch Ratings, p. 17-18 (not dated, distributed week of February 25, 2008). According to Michael Bykhovsky, president of Applied Analytics, an estimated 40% of outstanding subprime mortgage loans could go into default over the next three years; the dire outlook due to declining home values (press briefing at the Mortgage Bankers Association's National Mortgage Servicing Conference, February 27, 2008).

[9] Mark Zandi. *Written Testimony Before the House Subcommittee on Commercial and Administrative Law Hearing on "The Growing Mortgage Foreclosure Crisis: Identifying Solutions and Dispelling Myths"*

(January 29, 2008). Available at http://judiciary.house.gov/media/pdfs/Zandi080129.pdf

[10] Merrill Lynch. *The Market Economist*. (December 14, 2007)

[11] The Mortgage Bankers Association reported 5,542,954 outstanding subprime mortgage loans in their *National Deliquency Survey 3Q 2007*. The MBA estimates their report represents approximately 85% of the market, so the total number of outstanding subprime loans would be 6,521,122

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[12] We did not increase the number of homes affected by these additional foreclosures – we conservatively estimated that these were similarly distributed across a census tract and therefore would impact the same homes as originally projected.