Mortgage Market Transformation and Foreclosure

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EXECUTIVE SUMMARY

Policy makers at all government levels support increasing homeownership as a means to build wealth and stabilize neighborhoods. However, recent increases in foreclosures nationally suggest that many homeowners are not building wealth in their homes and their neighborhoods are becoming less rather than more stabile. To learn more about foreclosure and how it affects communities, we considered several important questions:

- How substantial is the foreclosure problem and who does it affect the most?
- Is there a relationship between subprime lending and foreclosures?
- Is there a relationship between nontraditional mortgages and foreclosures?
- Why does foreclosure happen?
- What policies will best help borrowers in low-income and minority markets avoid foreclosure?

The New Jersey Institute for Social Justice (NJISJ) sponsored our work. NJISJ is a Newark-based urban research and advocacy organization dedicated to the advancement of New Jersey's urban areas and residents. The institute has been long active in issues of foreclosures and predatory lending.

Foreclosures

Measuring the extent and impact of foreclosures is complicated since foreclose is a process that begins with a mortgage foreclosure filing (MFF) and may end with a sheriff sale.

Anywhere through that process, homeowners may sell their properties or repay their loans. Measuring foreclosure using MFFs likely overestimates the extent of the problem but measuring using sheriff sales underestimates it. To further complicate matters, each of the data sets includes different information. Sheriff sales provide information on the location of the home and time of sale and are fairly easily accessible from the state. MFFs provide a considerable amount of information about the loan such as originating lender, interest rate, and loan duration presenting opportunities for rich analysis to explore the reasons for foreclosure but are extremely difficult to gather.

Sheriff's Sales

A sheriff's sale, the public auction of a property, represents the last step of the foreclosure process. We found that between 1991 and 2002:

- Sheriff's sales were overwhelmingly concentrated in the poor, urban, majority minority cities of Newark, Irvington, and East Orange. These three municipalities had 70 percent of the Essex county's sheriff's sales, even though they have only 27 percent of the owner-occupied housing units.
- Within these municipalities, sheriff's sales were concentrated in neighborhoods having high subprime market share, older homes, and relatively high homeownership rates. Foreclosures in Essex County stripped equity and assets from the more stable urban neighborhoods.
- FHA loans make up an unusually high percentage of sheriff's sales in Essex County. Between 1991 and 2002, 1,444 or 16 percent of all sheriffs' sales in Essex County were for properties with FHA loans. FHA loans accounted for 23 percent of foreclosures in Irvington, 21 percent in East Orange, and 19 percent Newark. The number of FHA foreclosures increased through 2002 even though sheriff's sales decreased after 2001. We do not know why foreclosures increased or make up such a considerable percentage of sheriff sales.

Mortgage Foreclosures Filings

We examined all the residential mortgage foreclosure filings for January and February of 2004, which represent approximately one-fifth of all filings in 2004. We found:

- Sixty percent of MFFs were concentrated in East Orange, Newark, and Irvington. Richer suburbs, with fewer minorities, did not suffer as many foreclosures.
- The MFFs had substantially higher interest rates than other mortgages originated during the same period, based on national interest rate data.
- MFFs had a very short time between loan origination and foreclosure. If loans default for the reasons cited by many experts—divorce, health problems, and job loss—the origination year of foreclosed mortgages should be evenly distributed over a fifteen- to thirty-year period. However, the MFF data reveal that a majority (56 percent) of mortgages that began the foreclosure process in January and February of 2004 originated between 2001 and 2003.
- Subprime lenders originated nearly half (47 percent) of the loans in the MFFs. We were only able to identify 7 percent of the filings as originated by prime lenders. We classified the remaining 41 percent as "unknown" since they were not in HUD's subprime list or the New Jersey state licensed lender list. Most of these lenders appear to be small companies regulated by other states. While the "unknown" lenders limits our ability to talk about the type of lenders that offered financing to these borrowers who eventually defaulted, we anticipate that a majority of loans were made by subprime lenders.

Impacts of Foreclosures: the Case of Vailsburg

Foreclosures affect both individuals and neighborhoods. Families who lose their homes are also cut off from their neighbors and sometimes from members of their own families. The social capital—the bonds that tie people together—built over decades are severed if many long-time residents lose their homes. We examined the effects of foreclosures on Vailsburg, a Newark neighborhood. Vailsburg has higher-than-average incomes and home ownership rates than elsewhere in the city. We found:

- Between 1991 and 2002, 20 percent (1,727) of the sheriff's sales in Newark were for homes in Vailsburg.
- Vailsburg is the target of aggressive subprime loan marketing and subprime lending has made significant inroads into Vailsburg since 1996. The number of subprime loans nearly doubled between 2002 and 2004. In 2004, subprime lenders made 32 percent of home purchase loans, 44 percent of home improvement loans, and 43 percent of home refinance loans.

The high level of subprime lending appears to be linked to high foreclosure levels and is a threat to the stability of the neighborhood. This phenomenon is particularly problematic because Vailsburg is the kind of neighborhood that community development organizations are trying to build—ones with considerable amounts of homeownership and stability. However, the stability of Vailsburg and similar areas are being threatened by these practices.

Explaining Why Foreclosures Happen

There are several reasons for foreclosures. Most importantly, life style changes—divorce, illness, or job loss—can bring on financial crises. These life crises are more difficult for some homeowners to weather than others. Additionally, individuals with poor credit histories or minimal financial skills are more likely to lose their homes than other borrowers. Recent transformations in the credit and mortgage industries, which have expanded the types of loans available, have also made it difficult for mortgage borrowers to understand and navigate the borrowing and repayment process. There are more potential pitfalls for borrowers and fewer risks for lenders. In addition, the growth of predatory lending and aggressive ("push") marketing, particularly in low-income and minority neighborhoods, causes individuals to secure loans that are not beneficial to them and that are often set up to fail.

Nontraditional Mortgages

In addition, mortgage lenders developed a variety of nontraditional products aimed to help borrowers better afford monthly payments. These products are departures from the long-time gold standard of lending, the 30-year fixed-rate mortgage. While there are some now well-recognized alternative mortgages such as adjustable rate mortgages, the past several years have witnessed an explosion of new and more complicated nontraditional mortgages including interest-only loans, option-only loans, and other instruments. Initially used by higher income borrowers for creative financing, NTMs are used increasingly to enable even low- and middle-income borrowers to afford housing.

The terms and conditions contained in these agreements are often confusing and sometimes not beneficial to the mass-market consumer. Less-sophisticated borrowers are led to believe that they can afford houses that are, in fact, beyond their reach. The spread of NTMs presents problems, ranging from negative amortization and payment shocks on the borrower (when the monthly payment unexpectedly jumps when the reset takes effect and interest rates rise). While NTMs allow experienced investors with a generally beneficial short-term loan option, much care needs to be given to their use in the broader markets, where consumers are easily confused by flashy dialogue such as “exotic” and loan terms that are impressive on their face, but only last a short time. Often, low initial monthly payments—a metric that borrowers often focus on—jump precipitously after “teaser” rates end and mortgage payments reset to reflect the long-term demands of the mortgagors.

The expanded use of NTMs by low- and moderate- income borrowers who may not fully understand the implications especially in a context of rising interest rates suggests that NTMs are going to result in waves of foreclosures in the near future. Because information about loan type is not recorded in public data sets including the Home Mortgage Disclosure Act or mortgage foreclosure filings, the impact of NTM foreclosures will be felt in the marketplace, by homeowners, and in neighborhoods before anyone is able to calculate the impact. Now is the time to consider the impact of these loan products.

Recommendations

Several recommendations flow from this study.

1. Data needed to examine foreclosures are not readily available to either regulators or researchers. We exerted great effort collecting and analyzing data that were only partially digitized and not in a useful format. If state regulators are to better understand foreclosure and take action about predatory lending, they will need information that allows them to find patterns of abuse and to take action against repeated offenders. The state Administrative Office of the Courts should require consistent reporting of key information in digital form and make it accessible to other state agencies and others. The state should also require adequate information about prepayment and penalties, balloon payments, and the type of loan (i.e. interest only, payment option, ARM, fixed rate) other components of NTM and other mortgages.
2. Borrowers need better education about the vast array of available options through consumer education. Consumers should be better educated about their credit scores and the intricacies of credit options and the risks associated with various kinds of mortgages. There are self-help and organized education programs, some available through the Internet and those sponsored by community organizations. We recommend the creation of a tool that would allow borrowers to compare alternatives among standard and NTM options. Lenders would also benefit from workshops, including those run by the New Jersey Financial Literacy Network.
3. Borrowers need more loan counseling at the time of the loan and continues as payments come due. Consumers need information about reputable (and unreputable) lenders, the best ways to budget and make timely payments, and related issues. Borrowers also require advice about home repairs since dishonest contractors abound.
4. People faced with 30-day foreclosure notices, should be required to undergo loan counseling. If they do so, they will be less likely to lose their homes. New Jersey should require counseling, since this will likely result in fewer foreclosures.

5. New Jersey should strengthen the disclosure requirements of nontraditional mortgages in order to reduce the confusion over these complicated instruments.

6. A foreclosure roundtable of policy makers, lenders, and advocates that would share information about foreclosures and consider policies to reduce the incidence of foreclosures should be convened that includes representatives from the Governor's Office, the New Jersey Housing Mortgage Finance Agency, New Jersey Division of Banking and Insurance, the Philadelphia Federal Reserve, Citizen Action, foreclosure attorneys from the Administrative Office of the Courts, advocates, and lending industry groups such as the New Jersey Mortgage Bankers Association. Each of these parties holds a considerable amount of information. Bringing them together to discuss the issue is likely to facilitate discussion to share data and consider policy strategies to reduce foreclosures.

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INTRODUCTION

Americans have long seen homeownership as a path to building wealth and for many families, the home represents all or most of a household's assets. Homeownership has increased in the last two decades due to targeted public policy, community advocates who pressed for increased access to capital in underserved communities, and mortgage market changes; these latter alterations include mortgage securitization, the growth of the secondary mortgage market, and the emergence of subprime lending (which provides access to capital for those with less than perfect credit), and finally federal monetary policy that pushed interest rates to their lowest levels in 40 years. Therefore, housing credit was both more readily available and extraordinarily cheap. As a result, homeownership increased, even for minority and poor families. Currently 70 percent of families own homes. Unfortunately, homeownership does not always result in the intended wealth building. Increasingly, many low- and moderate-income families are finding themselves faced with foreclosure, which hurts them and their communities.

Foreclosure occurs for many reasons. A sudden illness, divorce, or an unexpected job loss can threaten families' financial stability and leave them unable to pay mortgages. Foreclosures resulting from personal hardship are unlikely to disappear and are difficult to mitigate. Some foreclosures, however, result from poor loan quality and or a poor match between loan and borrower. In short, a cottage industry has emerged that consists of lenders and brokers that extend credit to people with less than perfect credit but they often do so in a way that strips borrowers of equity through excess fees, points, and excessively high interest rates. Some borrowers face outright fraud such as discovering too late that their written interest rate is several percentage points higher than the orally agreed-upon rate. Some loans are made with little attention to whether a borrower can afford to maintain the monthly payments over time. The practice of providing inappropriate loans with egregious terms is called predatory lending. Moreover, recent mortgage market changes are enabling a dangerous phenomenon: unprepared borrowers end up with loans that do not suit their circumstances. For example, many buyers take out nontraditional mortgages (NTMs), such as interest-only loans, but are financially unprepared for the payment reset—when the monthly payment suddenly rises. In the end, many borrowers are stuck with mortgage terms that endanger their ability to retain their home and strip them of the ability to build a "housing asset."

The Project

Despite a recent increase in the number of homeowners statewide and nationally, homeownership rates have been declining in many New Jersey municipalities. Jersey City, Irvington, East Orange, Belleville, Bloomfield, Livingston, Maplewood, and Trenton saw a decrease in homeownership during the 1990s (HUD USER 2005). Considering the importance of promoting homeownership for individual and neighborhood wealth and stability, New Jersey's urban centers can least afford to lose homeowners. Preliminary studies and anecdotal evidence from community groups suggest that recent declines in homeownership result in part from the increasing susceptibility of urban homeowners to foreclosure. These families appear increasingly vulnerable to abusive market practices that lead them to accumulate high debt and foreclosure of their homes.

The New Jersey Institute for Social Justice (NJISJ), a Newark-based non-profit, is concerned with the issue of predatory lending, nontraditional mortgage products and foreclosures.[1] NJISJ was interested in documenting the extent of the foreclosure problem and determining policies that could better avoid foreclosure and abusive lending in Essex County communities. We conducted an analysis of nontraditional mortgages and foreclosure in Essex County, New Jersey. We focused on several research questions:

- What is the extent of the foreclosure problem?
- Which Essex County communities were most affected by foreclosure?

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[1] Created in 1999, NJISJ focuses on multiple social justice issues including ex-offender re-integration and regionalism as well as predatory lending. NJISJ was instrumental in getting New Jersey's anti-predatory lending legislation, the New Jersey Homeownership Security Act, passed in 2002.

- Is there a relationship between foreclosure rates and community characteristics such as race, income, age, and housing stock?
- Is there a relationship between subprime lending and mortgage foreclosure?
- Why do individuals lose their houses through foreclosure?
- What role do nontraditional mortgages play in the current mortgage market?
- To what extent do nontraditional mortgages present financial risks that increase the threat of foreclosure?

To better understand the decline in homeownership, the reported increase in mortgage foreclosure rates, and the emergence of NTMs, we gathered foreclosure data, mapped foreclosures, census data, subprime lending share, and the location of alternative and mainstream financial institutions[2]. We reviewed academic literature and newspaper articles on predatory lending, home mortgage trends, subprime lending, NTMs, and foreclosure. We interviewed eleven people involved in many aspects of the mortgage market and the foreclosure process, including community organizers, loan counselors, consumer fraud attorneys, mortgage banking representatives, the former Director of the New Jersey Division of Banking, and a Special Agent for fraud investigation with the U.S. Department of Housing and Urban Development (HUD).

We begin this report with a discussion of mortgage market changes including the expansion of the subprime market and the emergence of NTMs. We present an analysis of foreclosure patterns in Essex County and discuss the cost of foreclosure to individuals, neighborhoods, cities, and the public. Next, we discuss the reasons for foreclosures and consider the growth of nontraditional mortgage products. Finally, we summarize the report findings and provide policy recommendations intended to mitigate the negative impacts of foreclosures.

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[2] Home Mortgage Data Act (HMDA) data, 1993-2004: Subprime and prime home loan mortgage originations; Sheriff Sales, 1991-2002: Homes sold through public auction after foreclosure in Essex County; Residential Mortgage Foreclosure Filings (MFF), January and February, 2004: Essex County home mortgage loan files submitted to the New Jersey Administrative Office of the Courts for judicial foreclosure; U.S. Bureau of the Census, 2000: Demographic and housing data for Essex County.

MORTGAGE MARKET CHANGES

Public Policy

In the 1970s, community organizations successfully pushed for access to capital for low- and moderate-income neighborhoods. Historically, spatially concentrated low-income communities were capital starved because of widespread redlining. Community advocates fought to expand access by opening up financial opportunities. Because of their efforts, the Home Mortgage Disclosure Act (HMDA), first enacted in 1975 and expanded many times since, requires that lenders make data about their lending available. The Community Reinvestment Act (CRA) of 1977 required that regulators rate lenders on their lending patterns; federal regulators consider these ratings when banks and thrifts apply for permission to merge (Engel and McCoy 2002). Both acts made the mortgage lending industry more transparent by identifying racial disparities in access to and approval of loans; these policies enabled regulators and community organizations to prod banks to increase lending activity in minority and underserved communities. Community organizers have also successfully pressed HUD to set affordable housing lending goals for Freddie Mac and Fannie Mae, the government-sponsored entities (GSEs). The 1996-2000 lending goals required that 42 percent of loan purchases come from low- and moderate-income households. In 2001, the GSE's goal increased to 50 percent. In addition, HUD's Federal Housing Administration (FHA) loans provide insurance to reimburse lenders for foreclosure costs and other expenses related to the sale of covered property. This insurance decreases the risk to lenders that results when a borrower defaults on a loan and increases their willingness to provide risky loans (Engel and McCoy 2002).

Changes within the home mortgage industry have further increased access to capital for underserved communities. Technology, such as automated underwriting and credit scoring, enabled the lending industry to quickly assess risk and process mortgage applications. Securitization, the process of converting packages of home loans into securities backed with collateral, has spurred the growth of the trillion-dollar mortgage market by increasing lender liquidity (Harvard Joint Center 2006).

Subprime Lending

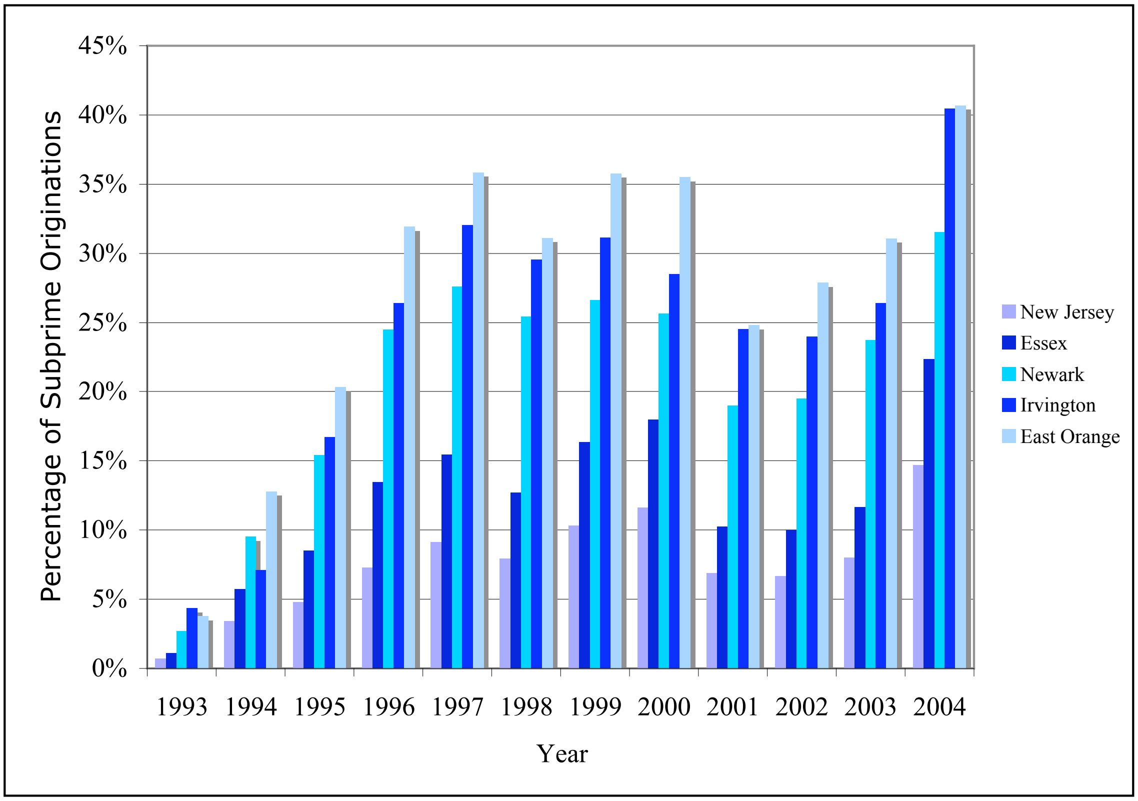
The growth of the subprime market increased access to capital for many people lacking good credit. Subprime mortgages carry higher interest rates and may have higher points and fees to compensate for the increased lending risk associated with borrowers with weak credit histories (Azny and Reiss 2004).[3] Former Federal Reserve Board Governor Edward M. Gramlich (2003) and others see this expansion of credit as "a true democratization of credit markets." Clearly, subprime lending has increased access to capital among previously underserved populations unable to participate in primary markets. However, the concentration of subprime lending in poor and minority communities and the prevalence of abusive practices and unfair loan terms, is cause for concern. There are large racial disparities in subprime lending. Approximately 50 percent of all loans in African American neighborhoods are subprime, compared to only nine percent in white neighborhoods (Azmy and Reiss 2004). Between 35 and 50 percent of borrowers, securing subprime loans may actually qualify for prime credit. This means that a significant number of borrowers are paying higher interest rates and unnecessary fees. Immergluck and others have found that delinquency rates for subprime loans are higher than those for prime loans and are increasing at a faster pace (Immergluck and Smith 2005). Researchers have also found higher rates of foreclosure for subprime loans (Immergluck 2004). This is particularly alarming in neighborhoods with high concentrations of subprime loans.

In New Jersey, subprime lenders increased their market share of all lending, as they did nationally. In 1993, less than one percent of mortgage organizations were subprime; by 2004, 15 percent of mortgage originations in New Jersey and 22 percent in Essex County were subprime. Figure 2 suggests the concentration in particular municipalities and neighborhoods. High rates of subprime mortgage origination are clustered in Newark, Irvington, and East Orange and in

[3] Traditional banks and mortgage companies make subprime loans, but mortgage brokers originated approximately 55 percent of all subprime mortgages in 2000 (Immergluck and Smith 2005).

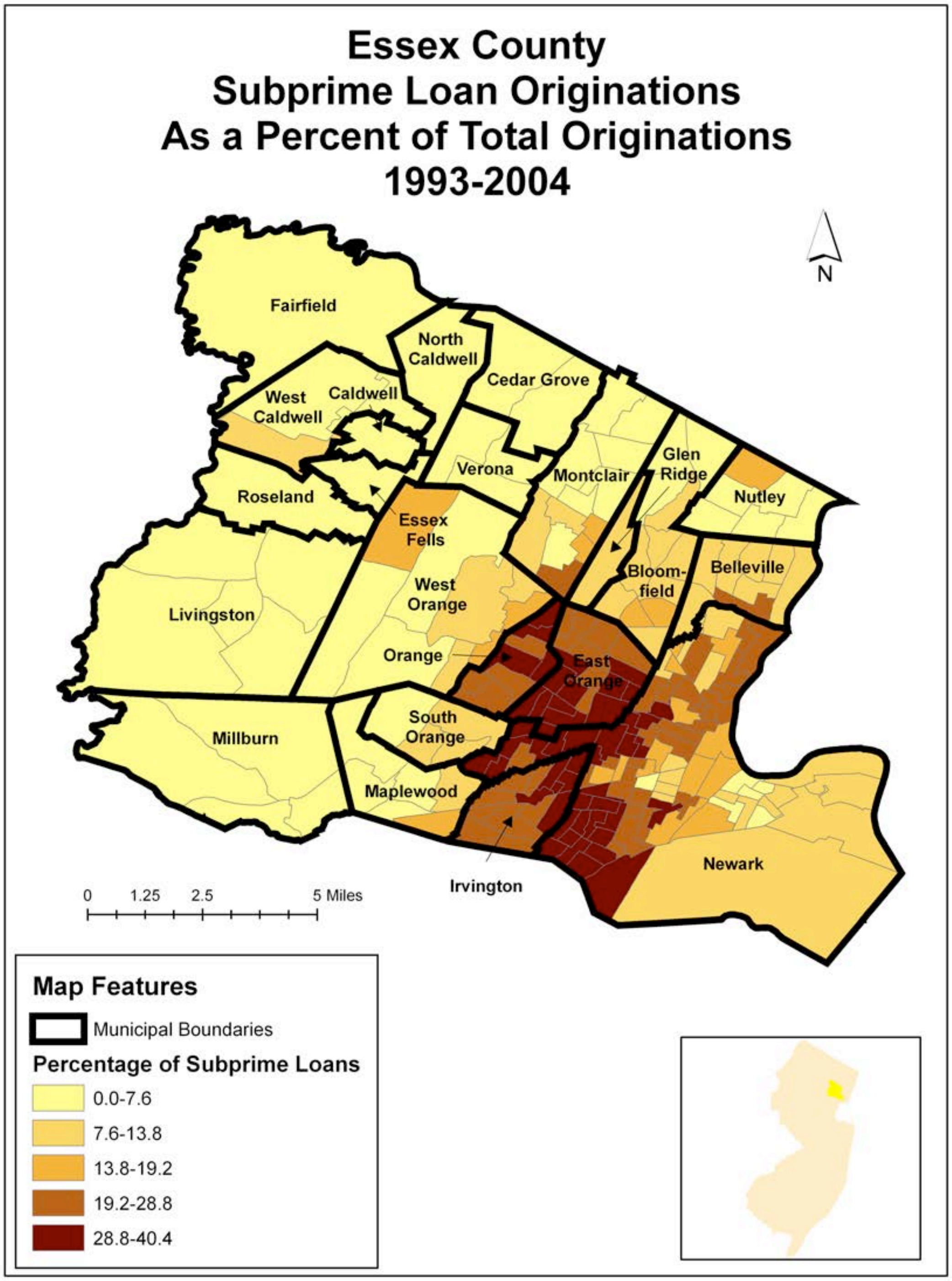
particular neighborhoods within these cities. After a brief decline between 2001 and 2003, subprime market share increased enormously in 2004. In Irvington and East Orange, subprime market share exceeded 40 percent; in Newark, it was more than 30 percent (See figure 1).

Figure 1. Percent of Subprime Loans Originated 1993-2004



Source: HMDA 1993-2004

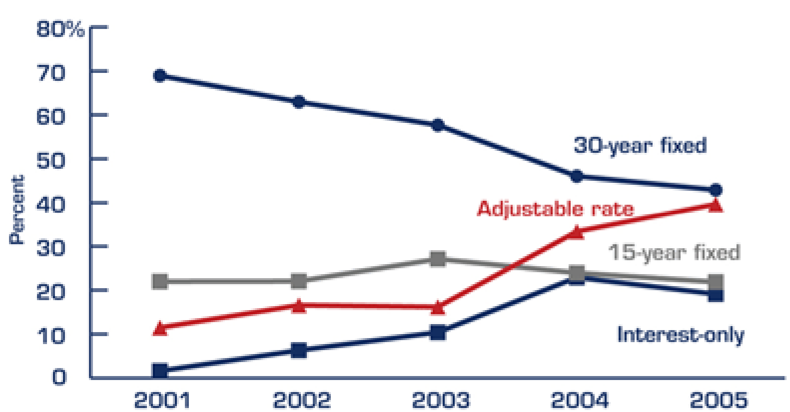
Figure 2. Essex County Subprime Loan Originations 1993-2004



Nontraditional Mortgages

The mortgage market has developed new mortgage products to help borrowers unable to afford monthly mortgage payments but lack the upfront costs—the down payment and closing costs—to buy a home. These products, known as nontraditional mortgages (NTMs), offer adjustable rates, low teaser rates, interest only loans, and optional monthly payments. Initially used by higher income borrowers for creative financing, NTMs are used increasingly to enable low- and middle-income borrowers to afford housing. NTMs also help to inflate housing prices because they allow borrowers to bid on higher priced units than they previously could afford. Unfortunately, NTMs may enable borrowers to borrow more than they can repay. Moreover, as interest rates rise, lenders and brokers use NTMs to prop up their lending volume through teaser rates that encourage borrowing. As Figure 3 illustrates, over the last four years, the number of 30-year fixed rate mortgages declined as the share of financially riskier mortgages grew. Specifically, increases in adjustable rate mortgages (ARMs), whose interest rate shifts with market conditions, and interest-only loans, where initial mortgage payments do not include payment on the principal, are growing at the expense of the 30-year fixed rate mortgage.

Figure 3. Types of Mortgages Issued, 2001 – 2005



Source: Insurance Information Institute

Inherent in the broader discussion of mortgage market transformation, is the constant tension between broadening access to capital and yet, protecting borrowers from disadvantageous capital. As Immergluck puts it, the challenge has shifted "From fair access to credit to access to fair credit" (Immergluck 2004, 109). Described by a community organizer as "a loan that is set up to fail," predatory lending brings more harm to the borrower than benefit (Interview 2006). Examples of predatory practices include: high-pressure sales and marketing tactics, repeated refinancing that does not benefit the borrower, excessive fees (including high points and origination fees), negative amortization, and fraud such as inflating housing appraisals and borrower income. Other abusive terms include yield spread premiums, balloon payments, unnecessary mandatory insurance, and mandatory arbitration (Center for Responsible Lending 2006).[4] Predatory lending often takes place within the subprime market but it also occurs within the prime market. In a recent report on foreclosures TRF (2005) found a high rate of subprime foreclosures suggesting that subprime lending in and of itself may be harmful.

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[4] The following definitions of common predatory lending practices are from the Center for Responsible Lending: *Negative Amortization*: monthly payments do not cover the full amount of interest due. Unpaid interest is added to the principal balance, causing it to increase overtime and strip equity from the home. *Yield Spread Premium*: payment to the mortgage broker that results when a loan is made with an interest rate higher than the minimum rate the lender would accept for that loan. This creates an incentive for brokers to push higher-cost loans. *Balloon Payments*: result when all monthly installments do not cover the entire repayment amount. Payment amounts are high and may result in refinancing or foreclosure. For further information, see http://www.responsiblelending.org/glossary.cfm?cat=General

FORECLOSURE

Only a small percentage of loans go into foreclosure leading some to suggest that the problem does not warrant attention. However, as one interviewee suggested:

> I suggest that foreclosures are a major deal. This year, with $4 trillion with mortgage lending, 5 to 10 percent of $4 trillion is a big deal when you talk about urban planning and neighborhood stability you have to think carefully about the impact neighborhood foreclosures have when it could be targeted to a particular geographic area (2006).

Measuring foreclosures is analytically complicated because the foreclosure process is long. Borrowers may sell their property or resolve their debt at any point during the process. Measuring foreclosures at the start of the process will produce a higher estimate of foreclosure than if it is measured at the end of the process. The foreclosure process begins with a notice of *lis pendens*—a statement that a lender plans to foreclose. Because New Jersey has a judicial foreclosure process, notice of foreclosure along with supporting legal documents is filed at the state court house as a mortgage foreclosure filing (MFF). The foreclosure process may result in a sheriff's sale. However, such a sale does not reflect the full extent of foreclosure because it is a transaction of last resort. Homeowners often sell their homes after notice of foreclosure, but before the sheriff's auction; such is often true in hot real estate markets.

We measured foreclosures using sheriff's sales and MFFs. We acquired a database of sheriff's sales for Essex County for 1991 through 2002 that includes property location, titleholder, and year of sale. Sheriff sale data is relatively accessible from the state over long periods of time but it provides little information about the loan such as loan originator, interest rate, and duration. It does however allow us to identify FHA loans. To learn more about the loans themselves, we gathered MFFs from January and February of 2004 for all of Essex County.[5] In New Jersey, MFFs include: loan originator, interest rate, loan duration, loan origination date, original mortgage amount, and monthly payment. This information adds valuable information about the type, size, and quality of the loans falling into foreclosure and allows us to explore the relationship between subprime lending and foreclosure because we know the loan originators. It is difficult to determine how many MFFs do not go to sheriff's sale, but based on records from both data sources, it appears significant. Because we could not obtain sheriff's sales data for 2004 or MFFs from 2001, it was impossible to calculate the actual percentage of foreclosures that end in sheriff's sale. Based on trends revealed in the 1991 to 2002 sheriff's sales data, we estimated that a majority of MFFs is settled before reaching the sales phase. Therefore, examining only sheriff's sales significantly underestimates the foreclosure problem.

Sheriff's Sales

Between 1991 and 2002, 8,763 homes in Essex County went to sheriff's sale. The number of sheriff's sales increased from 1991 until 2000 and dipped between 2000 and 2002 (See figure 4).[6] Sheriff's sales are overwhelmingly concentrated in the urban, majority minority cities of Newark, Irvington, and East Orange. The inner ring cities of Orange, West Orange, Bloomfield and Belleville, which are less poor and minority than Newark, Irvington and East Orange, but are still inner ring suburban cities with substantial minority populations also experienced hundreds of sheriff's sales (See table 1 and figure 7). The wealthiest cities in the county, Essex Fells, Millburn, and North Caldwell had the smallest numbers of sheriff's sales.

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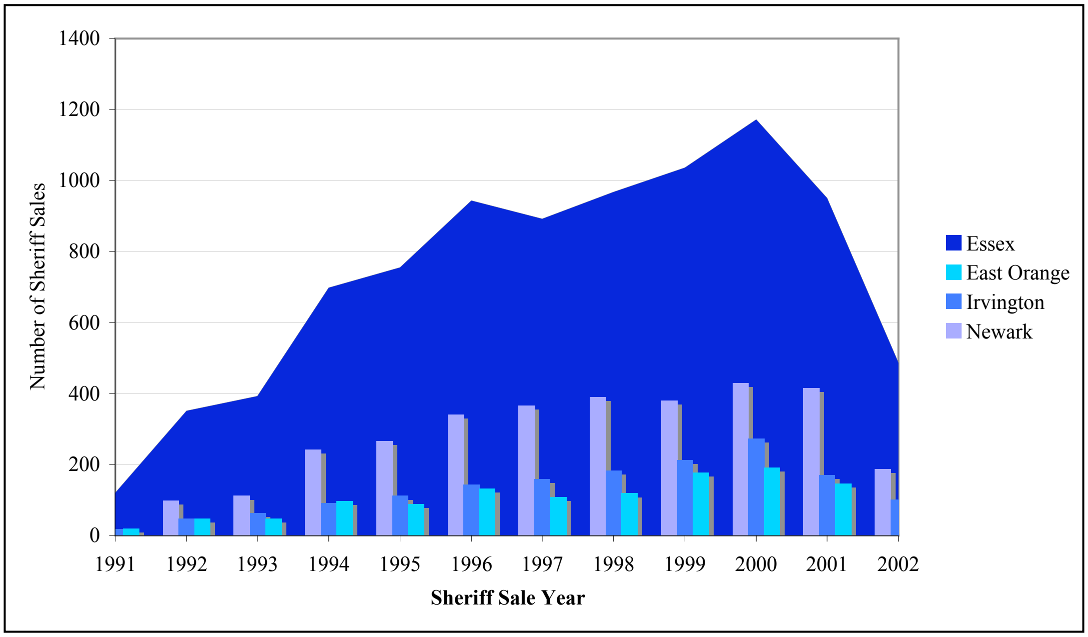
[5] There are multiple types of foreclosures. The most common are tax foreclosures filed by the municipality and bank foreclosures filed by the lender that currently holds the note. We only examined residential bank foreclosures and omitted all other foreclosures filed for other reasons. Initially, we attempted to collect an entire year of MFFs but that would have been impossible given the laborious process involved (see data recommendations).

[6] Since the decline is similar to a decline in subprime lending during the same time period, it may be attributed to community and regulatory activities that restricted some of the most abusive predatory lending practices used by lenders during the late 1990s.

Figure 4. Sheriff's Sales per Year: Essex County, Newark, Irvington, and East Orange



Source: Sheriff's Sales, Essex County 1991-2002

We calculated foreclosure rates by dividing sheriff's sales by owner occupied housing units for the census tracts in the three municipalities most heavily hit by foreclosure in Essex County—Newark, Irvington and East Orange. In Newark, more than half of the census tracts had a foreclosure rate greater than 10 percent. The foreclosure rate was more than one-fifth in nearly a quarter of the Census tracts and half in 4 percent of the census tracts. More than 65 percent of the Census tracts in Irvington had a foreclosure rate greater than 10 percent. In Newark, East Orange, and Irvington, sheriff's sales are clustered in majority minority neighborhoods with older housing stocks, higher homeownership rates, high subprime lending rates, and often slightly higher average median income (See figures 5 through 9). In Newark, sheriff's sales are concentrated in Vailsburg, Clinton Hill, Lower Broadway, Northeast Newark, and the Weequahic section. Foreclosure rates in Vailsburg's main census tracts exceed 30 percent, those in Clinton Hill and the Lower Broadway corridor area (to the East of the Southern portion of Branch Brook Park) are more than 20 percent; rates in the Weequahic section range from 12 to 35 percent (See figure 5).

Table 1. Sheriff's Sales per Municipality, 1991-2002

Municipality	Sheriff's Sales 1991-2002
Newark	3,255
Irvington	1,573
East Orange	1,268
City of Orange	618
West Orange	313
Bloomfield	304
Bellville	295
Montclair	273
Maplewood	185
South Orange	180
Livingston	88
Nutley	82
Verona	55
Millburn	48
Glen Ridge	45
Fairfield	41
Cedar Grove	36
West Caldwell	31
Caldwell	29
North Caldwell	26
Roseland	14
Essex Fells	4

Source: Sheriff Sale Data 1991-2002

Figure 5. Foreclosure Rates: Newark, Irvington, East Orange 1991-2002

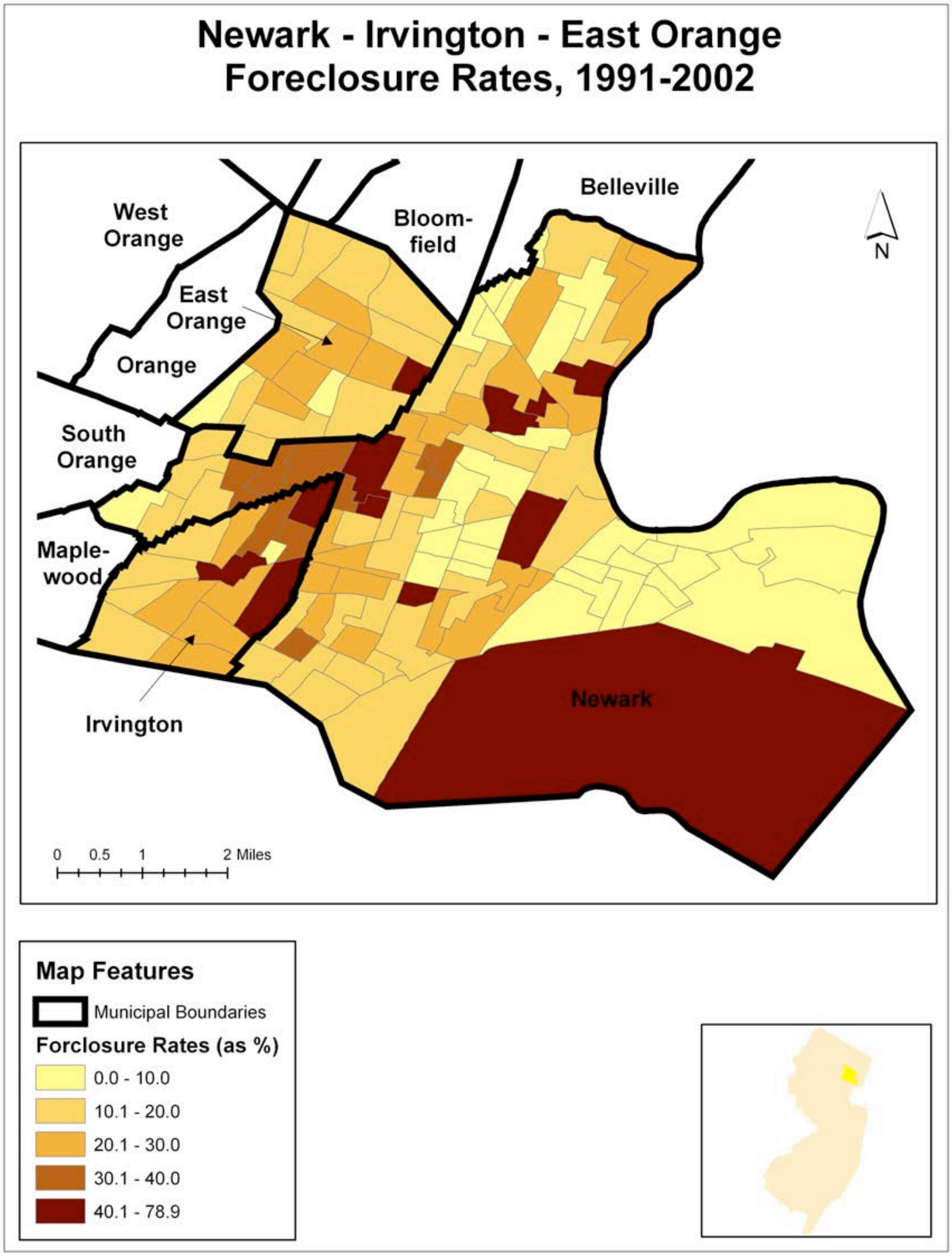


Figure 6. Subprime Loan Origination Market Share:
Newark, Irvington, and East Orange 1993-2004

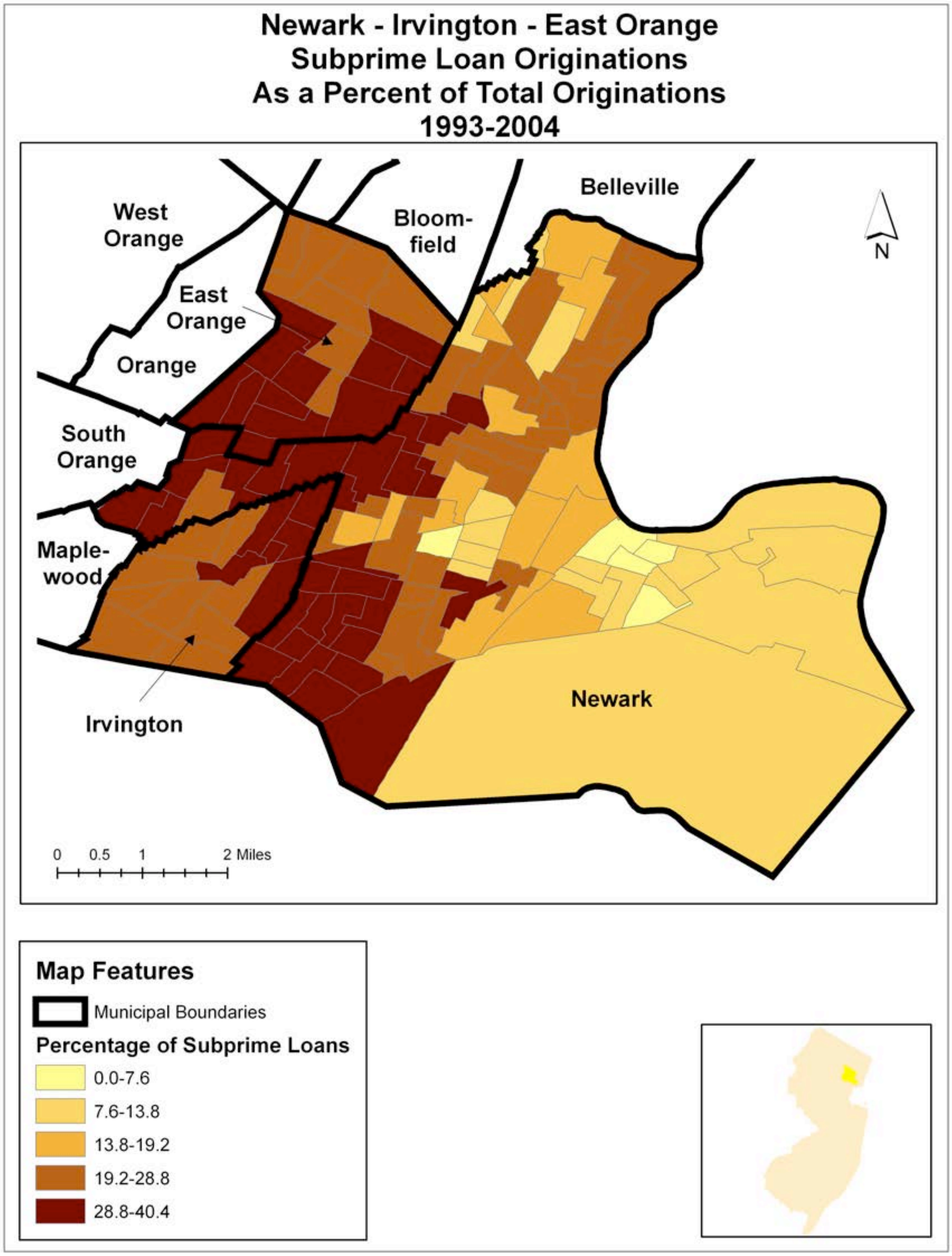


Figure 7. Black Population as a Percent of Total 2000

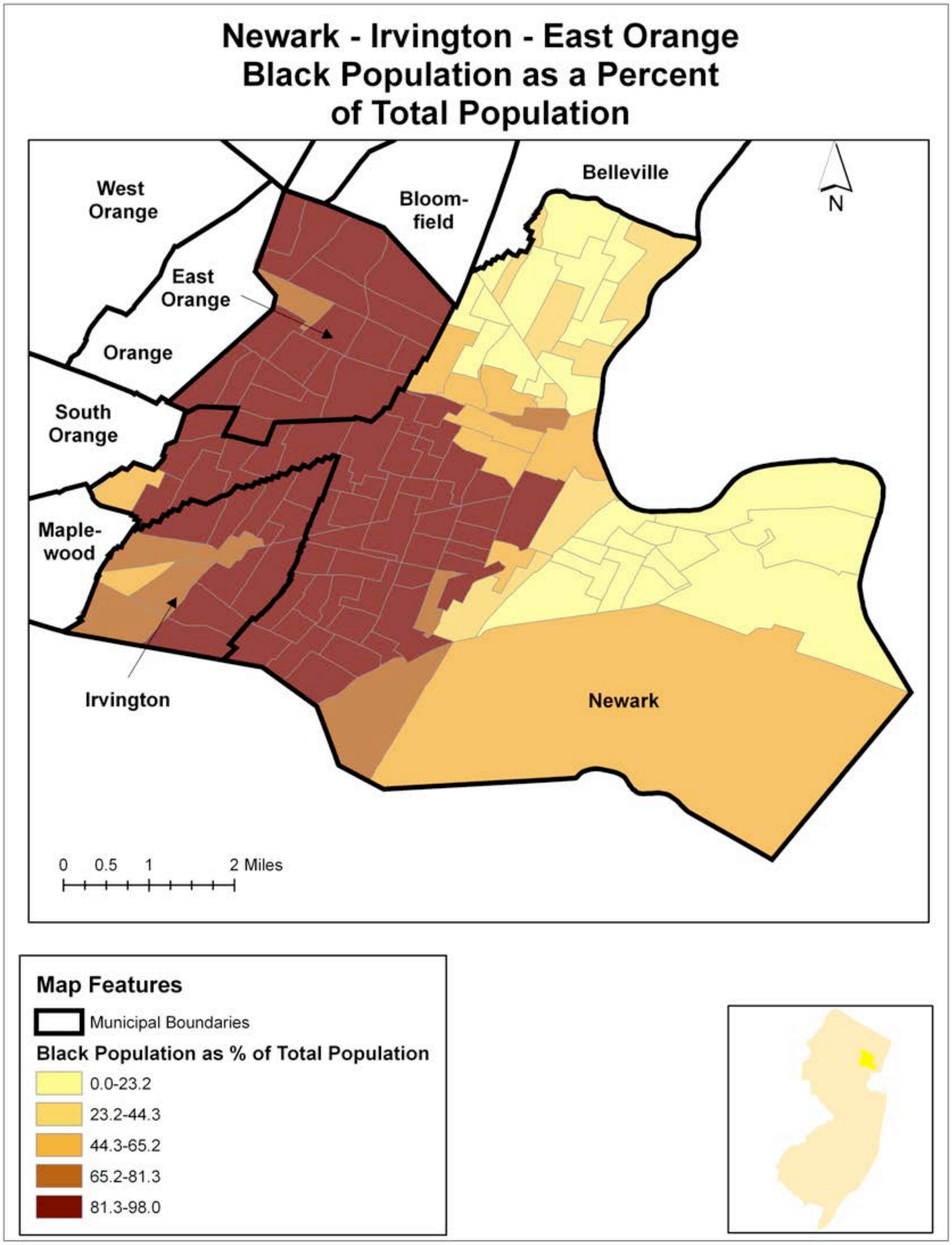


Figure 8. Latino Population as a Percent of Total 2000

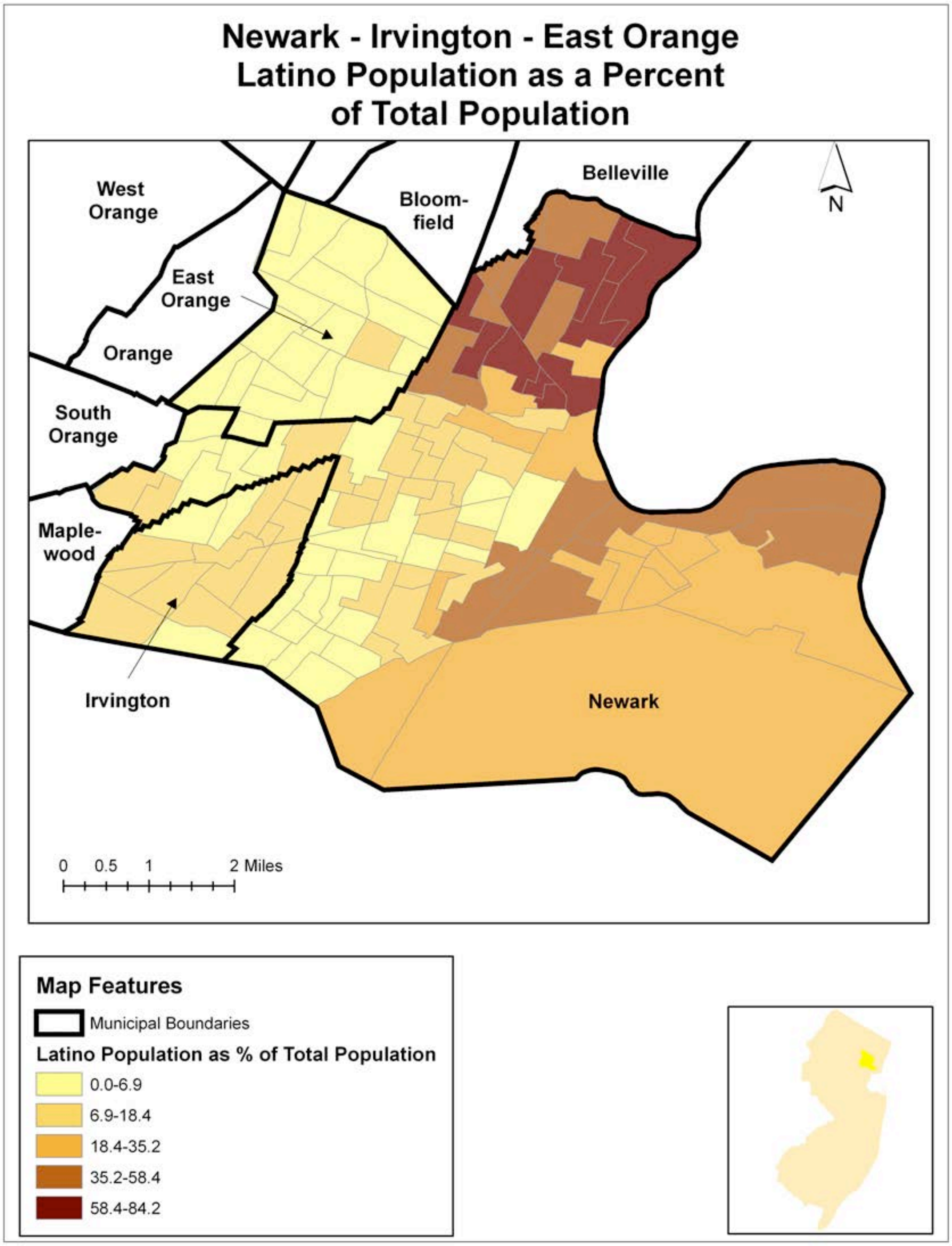
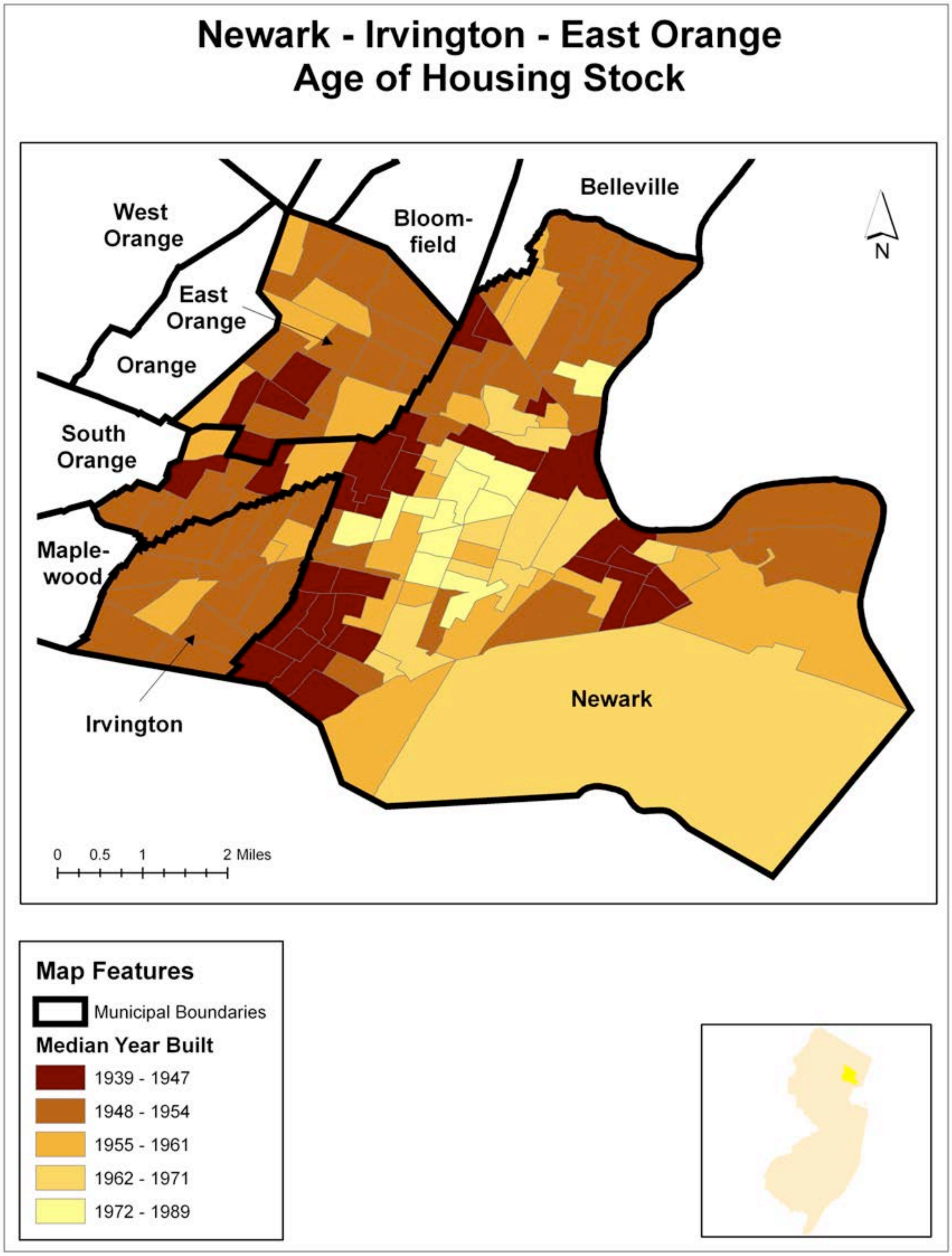


Figure 9. Age of Housing Stock 2000



Neighborhood Impact

To illustrate the effect of concentrated foreclosures on communities, we selected the Vailsburg section of Newark for closer examination. Vailsburg is a predominantly black (81 percent) neighborhood, located on Newark's western edge. The neighborhood contains many large, older, stately homes; more than one-third are owner occupied, more than the city's 24 percent average (U.S. Bureau of the Census 2000) (See table 2). Between 1991 and 2002, 20 percent (1,727) of the sheriff's sales in Newark were for homes in Vailsburg (See figure 10).[7]

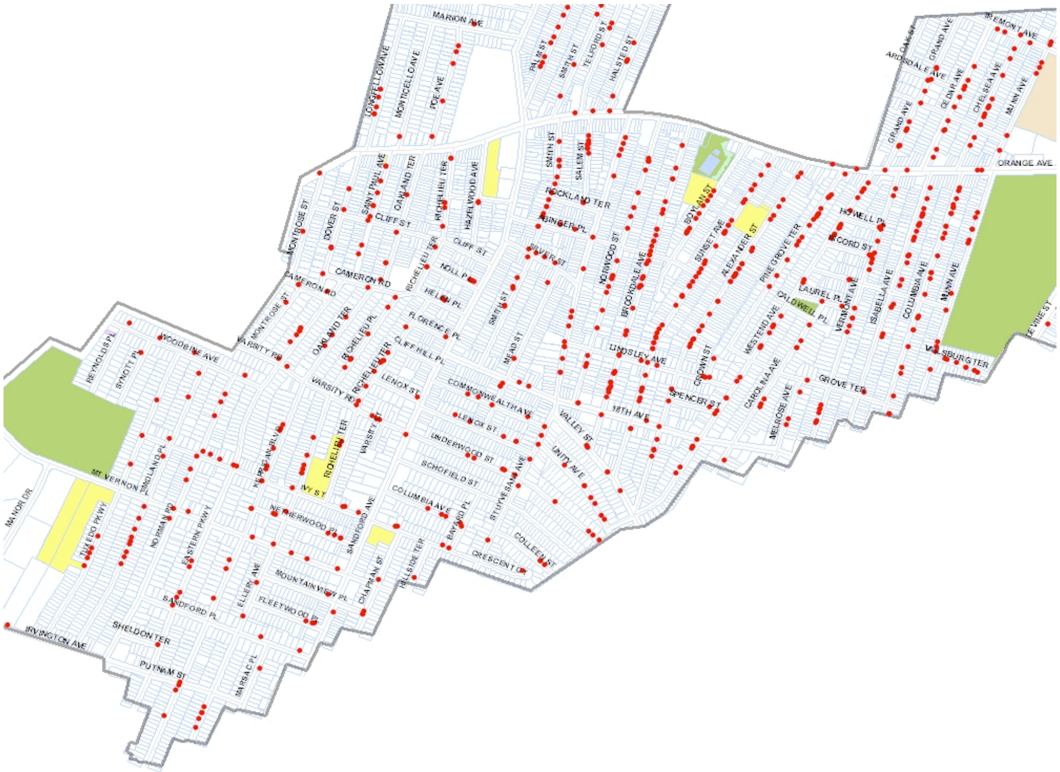
TABLE 2. Sheriff Sales and Vailsburg Neighborhood Characteristics

Census Tract	*Number of Sheriff Sales (1991-2002) (No FHA)*	*Home-Ownership*	*Foreclosure Rate (Owner Occupied Units/Non FHA Sheriff Sales)*	*Percentage of Population that is Black*	*Median Household Income (in 1999)*
Tract 1900	49	24%	27.84%	88%	$20,602
Tract 2000	66	27%	14.29%	89%	$27,202
Tract 2100	85	58%	13.98%	92%	$46,927
Tract 2201	28	16%	6.32%	51%	$28,029
Tract 2202	57	52%	10.54%	83%	$37,313
Tract 2300	82	46%	11.25%	86%	$45,841
Tract 2400	123	39%	26.57%	92%	$35,050
Tract 2500	111	37%	22.56%	92%	$36,534
Vailsburg	601	34%	16.67%	81%	$34,687
Newark	2,638	24%	9.68%	53%	$26,913

Source: U.S. Census, Sheriff Sale Data 1991-2002

[7] Foreclosures are concentrated in the middle census tracts—in tracts that have the "stable" neighborhood characteristics of higher home-ownership and income levels. The census tracts on the far west and east sides of the neighborhoods have few sheriff's sales. This is due to lower income and lower homeownership, the presence of a large park that covers much of that area and a very large apartment building on the west side.

Figure 10. Sheriff's Sales 1991-2002 in Vailsburg, Newark



Vailsburg may seem an unlikely neighborhood to experience so many foreclosures, but the neighborhood's relatively higher home ownership rates, higher incomes, aging housing stock, and mostly black residents make it a target for abusive lending practices. A "dual mortgage market" exists in Vailsburg. A dual mortgage market is characterized as one in which some communities receive prime credit, while others receive subprime credit even though they may be similarly qualified for a loan. Apgar explains, "African Americans are shown to be less likely to receive a prime conventional loan…the higher the share of African Americans living in a neighborhood, the lower the odds that a borrower of any race or ethnicity will receive a prime loan" (Apgar 2004, 53-55). Subprime lending has made significant inroads into Vailsburg since 1996 and the number of subprime loans nearly doubled between 2002 and 2004. In 2004, subprime lenders made 32 percent of home purchase loans, 44 percent of home improvement loans, and 43 percent of home refinance loans (See Table 3).

Table 3. Vailsburg Subprime Mortgage Originations

Home Purchase				
Year	*Subprime*	*Market %*	*All Others*	*Total*
1993	1	1.10%	91	92
1994	0	0.00%	115	115
1995	8	7.10%	105	113
1996	5	4.70%	101	106
1997	10	6.40%	146	156
1998	41	21.80%	147	188
1999	37	19.10%	157	194
2000	53	28.80%	131	184
2001	19	9.50%	180	199
2002	35	17.30%	167	202
2003	54	19.40%	225	279
2004	100	31.70%	215	315
Total	363	16.90%	1,780	2,143

Home Improvement				
Year	*Subprime*	*Market %*	*All Others*	*Total*
1993	3	15.80%	16	19
1994	8	11.00%	65	73
1995	35	51.50%	33	68
1996	53	58.90%	37	90
1997	37	46.80%	42	79
1998	21	22.10%	74	95
1999	17	28.80%	42	59
2000	20	35.70%	36	56
2001	29	56.90%	22	51
2002	20	30.80%	45	65
2003	12	28.60%	30	42
2004	32	43.80%	41	73
Total	287	37.30%	483	770

Refinance				
Year	*Subprime*	*Market %*	*All Others*	*Total*
1993	5	4.00%	121	126
1994	20	16.00%	105	125
1995	14	18.70%	61	75
1996	46	42.20%	63	109
1997	74	45.70%	88	162
1998	93	42.30%	127	220
1999	102	42.90%	136	238
2000	54	48.20%	58	112
2001	61	29.50%	146	207
2002	101	29.20%	245	346
2003	191	38.10%	310	501
2004	178	42.50%	241	419
Total	939	35.60%	1,701	2,640

Brokers aggressively market subprime loans in Vailsburg by phone, in person, and through mailings and flyers. This, combined with many consumers' limited access to mainstream financial institutions, has contributed to a situation in which high cost loans have become the norm. The effect is harmful to the neighborhood and to individual residents. Frequent resident turnover decreases neighborhood stability and disrupts critical social and civic networks that enable people to work and care for their families. Housing loss counters the public policy agenda of increasing homeownership as a wealth generating enterprise. Families lose equity, find themselves increasingly in debt with narrow housing choices, and intergenerational networks can be broken. Increasing foreclosure rates reduce homeownership rates.

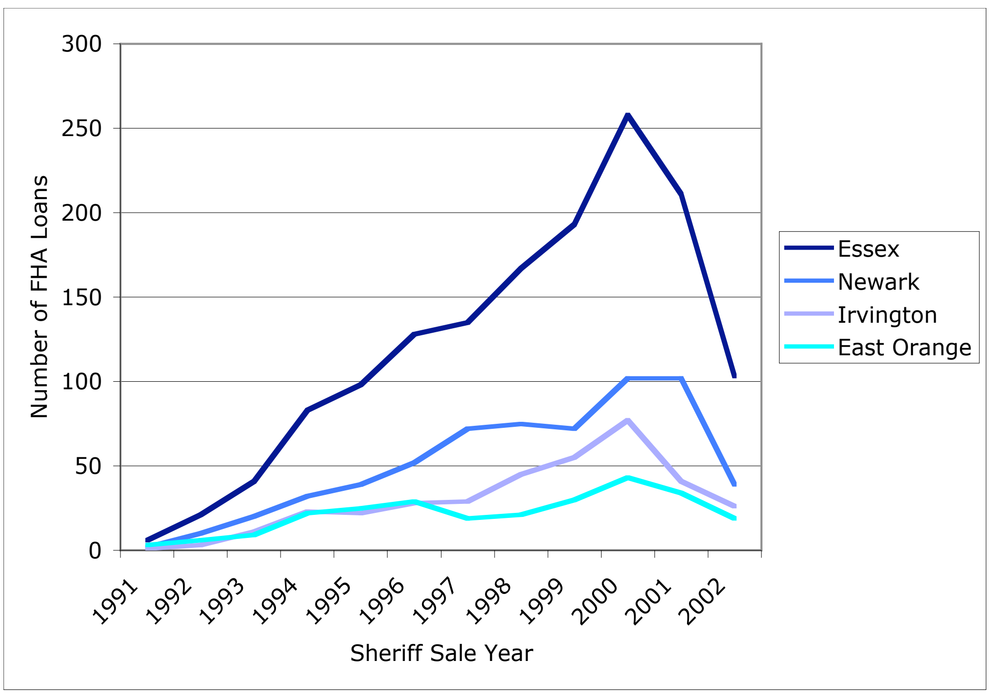
Besides the toll on families, foreclosure also undermines neighborhood stability. When long-term residents lose their homes and have to move, social networks—their relationships to their neighbors, churches, and other institutions—are disrupted. Since these are exactly the types of characteristics that community development actors seek to reproduce when rebuilding severely disinvested neighborhoods, foreclosure hinders community development efforts. Even as non-profit and public resources are invested in building new housing in devastated neighborhoods, the high concentration of foreclosures in these more stable, slightly higher income neighborhoods exacts a heavy toll on communities and individual residents.

The extent of foreclosures in Vailsburg and neighborhoods like it suggest a need to further explore the role of subprime lending in these communities and the impact of high cost mortgage lending on residents. What is viewed as an opportunity to obtain credit appears to be negatively affecting people in the neighborhoods. The current policy agenda strongly supports homeownership to increase neighborhood stability, revive failing urban neighborhoods and cities, improve civic engagement, and build individual and community wealth. HUD's Section 8 vouchers can now be used for homeownership and HUD's HOPE VI program strongly encourages home ownership as a "sustainable" outcome. City, state, and federal governments support the homeownership strategy. Nevertheless, foreclosures have considerable neighborhood and individual costs.

FHA Loans

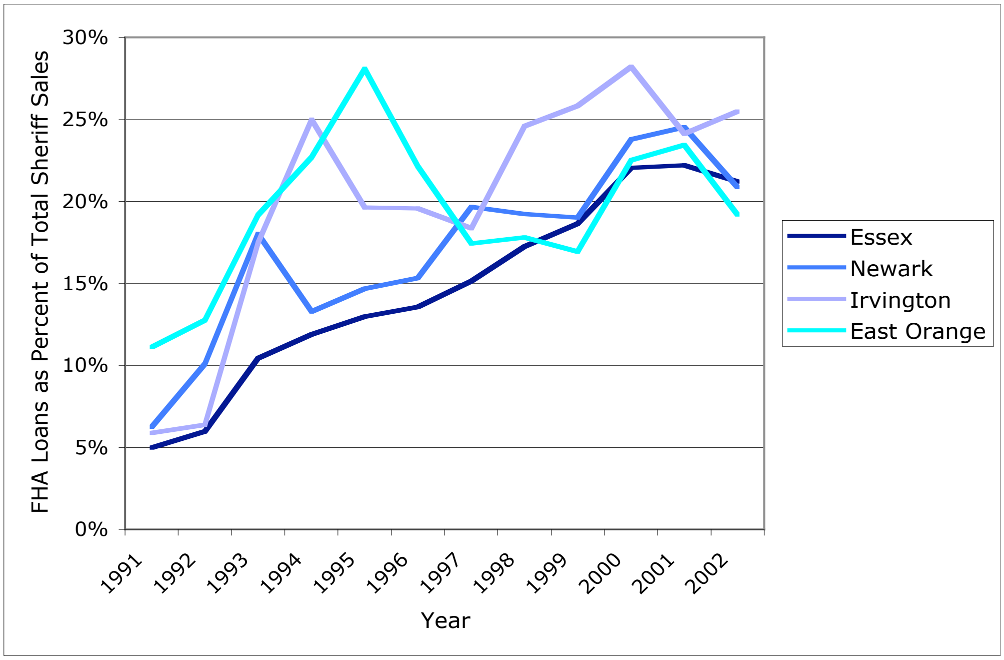
FHA loans make up an unusually high percentage of sheriff's sales in Essex County. Between 1991 and 2002, 1,444 or 16 percent of all sheriff's sales in Essex County were for properties with FHA loans. FHA loans accounted for 23 percent of foreclosures in Irvington, 21 percent in East Orange, and 19 percent in Newark (See figures 11 and 12). The number of FHA foreclosures increased through 2002 even though sheriff's sales decreased after 2001. We do not know why foreclosures increased or made up such a considerable percentage of sheriff sales. HUD has stepped up efforts to reduce fraudulent FHA lending and recently won a fraud case against a group of individuals that inflated house prices and persuaded people to buy the homes with FHA loans in Essex County.

Figure 11. Number of FHA Properties at Sheriff's Sale 1991-2002



Source: Sheriff's Sale data 1991-2002

Figure 12. FHA Loans as a Percentage of Total Sheriff's Sales 1991-2002



Source: Sheriff's Sale data 1991-2002

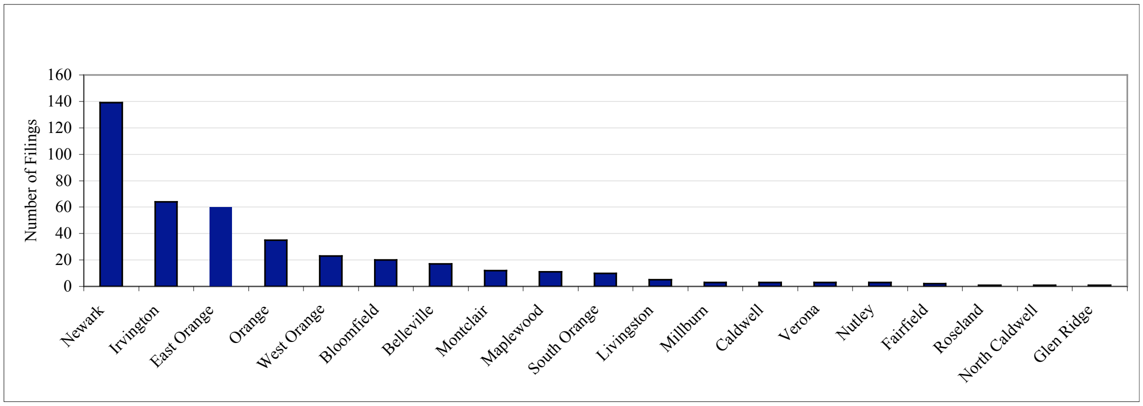
Mortgage Foreclosure Filings

Sheriff's sales provide a proximate indication of foreclosures, but they underestimate the extent of housing problems because many foreclosed properties are sold before they reach sheriff's sale. Examining foreclosures in the initial phase of the process, when lenders file their intent to foreclose, provides a better indicator of the total number of housing units entering foreclosure. To learn more about foreclosures we recorded data on 582 mortgage foreclosure filings (MFF) filed in January and February 2004 or slightly less than one fifth (19 percent) of the total 3,019 mortgage foreclosure filings (MFF) for Essex County in 2004.[8] We found that MFFs are predominantly concentrated in a few municipalities. Newark, East Orange, and Irvington accounted for more than 60 percent of MFFs. Orange, West Orange, Bloomfield, and

[8] Approximately 70 percent (412) of the mortgage foreclosures resulted from individuals defaulting on residential mortgages. The remaining 30 percent resulted from the other five types of foreclosures, predominantly municipal tax foreclosures. For this analysis, we use MFFs from residential bank foreclosures only. Projecting from these two months of data, we estimate that 2,142 of the mortgage foreclosure filings derive from residential mortgage defaults in 2004.

Belleville comprised another 23 percent. The remaining Essex County suburbs had less than 15 percent[9] (See figure 13).

Figure 13. Percent of County Mortgage Foreclosure Filings by Municipality



Source: Mortgage Foreclosure Filings January and February 2004

To better understand this phenomenon, we calculated foreclosure rates for each community by projecting the number of MFFs from the January and February data[10] and dividing those figures by the number of owner occupied housing units[11] in each municipality.[12] We found that Orange and Irvington experienced the greatest foreclosure rates. Newark and East Orange also encountered significant foreclosure rates. Among the municipalities grouped within the "other suburbs" category, only South Orange had a foreclosure rate above one percent (See figure 14).

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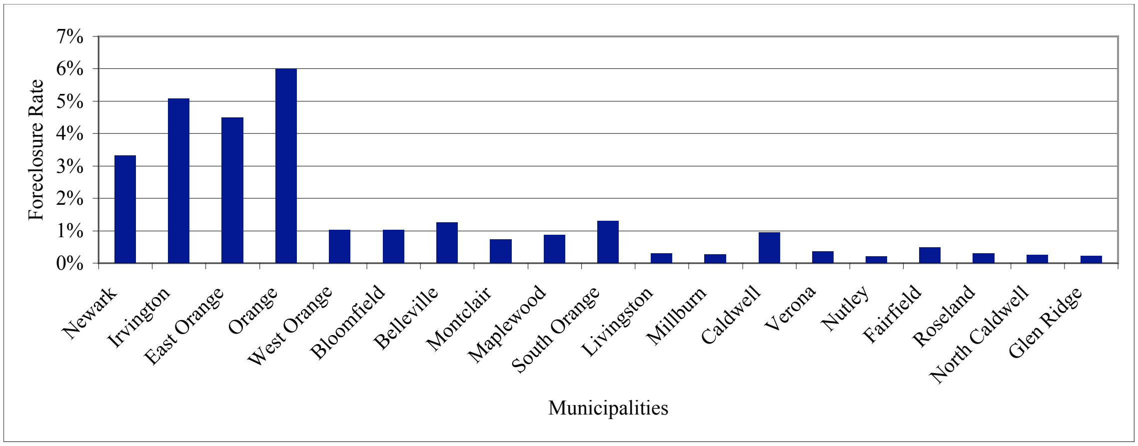
[9] "Other suburbs" include: Caldwell, North Caldwell, West Caldwell, Cedar Grove, Essex Fells, Fairfield, Glen Ridge, Livingston, Maplewood, Millburn, Montclair, Nutley, South Orange, Roseland and Verona. These municipalities were combined because they have few MFFs and are more affluent communities.

[10] Although the January and February data cannot be extracted as a random sample, we made projections based on these figures because these were the only MFF we were able to obtain. Projections were determined by taking the percent of MFF for each municipality and multiplying that number by the total number of projected residential lender foreclosures (2137). The actual 3019 files may reveal very different information.

[11] Figures represent 2000 Census numbers.

[12] While using this method has flaws, there is no perfect or standardized process for deriving foreclosure rates using MFF data. Flaws of this method include: Rental properties entering foreclosure and housing counts that change each year.

Figure 14. Foreclosure Rate: Mortgage Foreclosure Filings Divided by Total Owner Occupied Housing Units

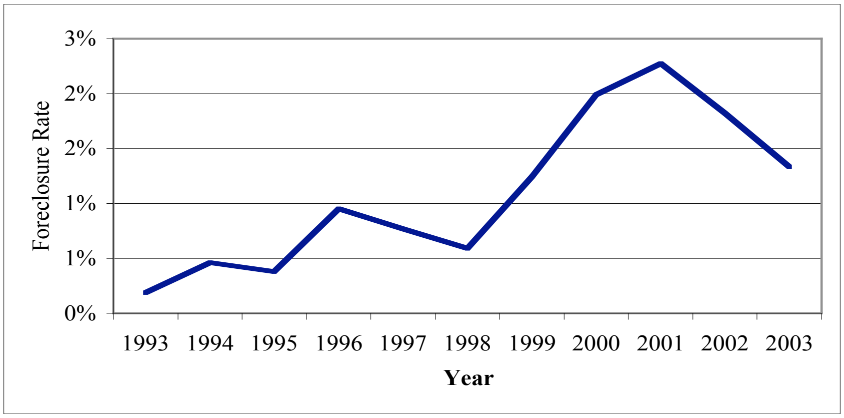


Source: Mortgage Foreclosure Filings 2004; U.S. Census 2000

Second, we combined total mortgage originations for each year (from HMDA) with the MFF data (MFF data includes loan origination year) and estimated the percentage of mortgages that entered foreclosure in 2004 for each loan origination year. While this foreclosure rate yields significant insights into the problem, it fails to convey a complete picture because it only captures information from loans that went into foreclosure in 2004. A number of loans originated during the 1990s and early 2000s likely foreclosed in previous years suggesting that this measure underestimates the problem. This analysis yielded low foreclosure rates for that reason but is valuable when we look at foreclosure rates over time. As figure 15 shows, the foreclosure rate climbs dramatically in 1999 and remained close to 2 percent between 2000 and 2002.[13]

[13] The projections made are based solely on the January and February data. Because these months are at the beginning of 2004, it is highly possible that they underestimate the percent of 2003 loans that will enter foreclosure in 2004.

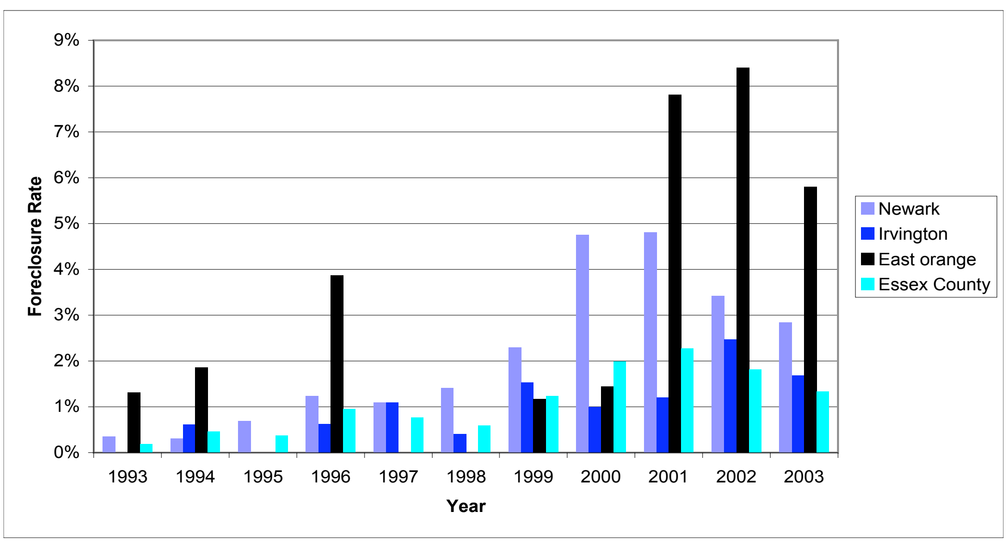
Figure 15. MFF Foreclosure Rate



Source: Mortgage Foreclosure Filings 2004; HMDA 1993-2003

The projected foreclosure rate is significantly higher in Newark, East Orange, and Irvington. Figure 16 shows the foreclosure rate rising in these cities since 1999, especially for Newark and East Orange. Based on the projected MFF data, approximately 4.8 percent of 2001 originations in Newark entered foreclosure in 2004 alone. Still, East Orange felt the largest impact with a projected 7.82 percent and 8.41 percent of mortgages from 2001 and 2002 defaulting respectively.

Figure 16. Foreclosure Rates: Newark, Irvington, East Orange, Essex County

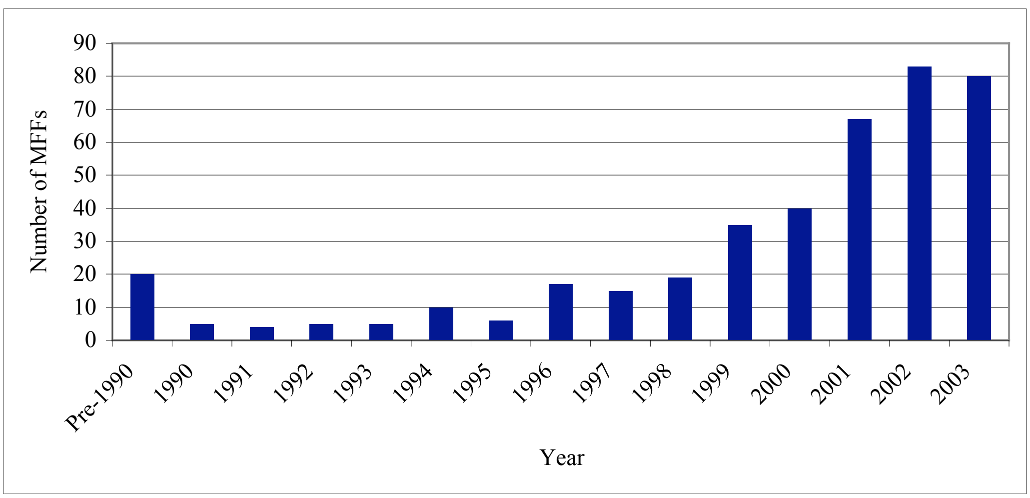


Source: Mortgage Foreclosure Filings January and February 2004; HMDA 1993-2004

Short Time to Foreclosure

If borrowers default for the reasons cited by many experts—divorce, health problems, and job loss—the origination year of foreclosed mortgages should be reasonably distributed over a fifteen- to thirty-year period. However, the MFF data reveal something different. A majority (56 percent) of mortgages that began the foreclosure process in January and February of 2004 originated between 2001 and 2003. The number of loans in foreclosure that originated between 1990 and 1993 was miniscule and not much higher between 1994 and 1998 (See figure 17). This discrepancy suggests that mortgages originated after 2000 foreclosed for reasons other than personal crises. A rise in subprime lending may be one explanation.

Figure 17. Loan Origination Dates for Loans in the Mortgage Foreclosure Filing Stage 2004

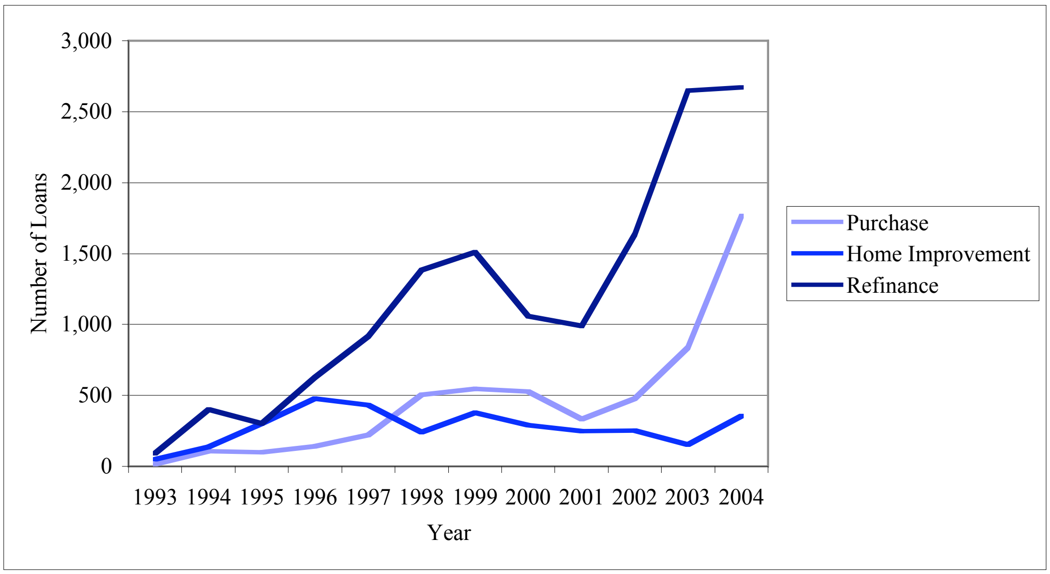


Source: Mortgage Foreclosure Filings January and February 2004

As previously discussed, subprime market share decreased between 2001 and 2003 in Essex County; however, during this period, the total number of originations grew in all three categories of residential mortgages: for purchases, home improvements, and refinance (See figure 18). The number of subprime refinance loans far surpassed the other two categories. Subprime refinance loan market share is high in the same cities that have high numbers of MFFs.

In East Orange, refinance originations made up 30 to 45 percent of all originations during 2001 and 2004. While the share was slightly less in Newark, the total number of subprime refinance loans shot up 57 percent between 2002 and 2004. In total, these communities experienced much higher rates of subprime refinance loans than Essex County.

Figure 18. Number of Subprime Mortgage Originations in Essex County by Loan Type



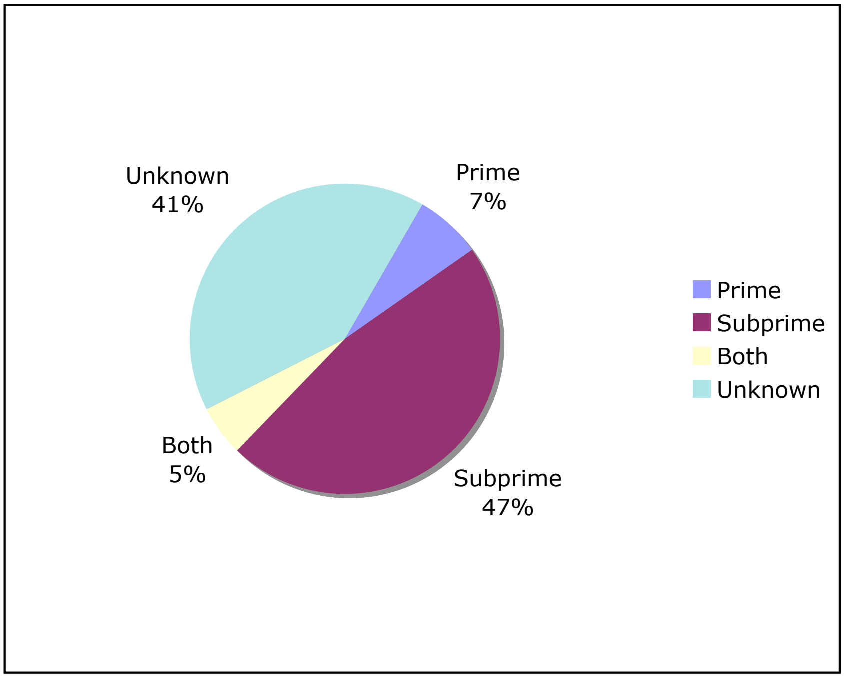
Source: HMDA 1993-2004

Understanding the relationship between subprime originations and foreclosures is often difficult because it is hard to gather information on the loan originator from foreclosure data. Because MFF data identify the loan originator, we were able to label the lenders in our sample as prime, subprime, or both.[14] Subprime lenders originated nearly half (47 percent) of the loans, while prime lenders were responsible for only 7 percent. We classified the remaining 41 percent as "unknown" since we were unable to identify them using HUD's subprime list or the New Jersey state licensed lender list. Most of these lenders appear to be small companies regulated by other states (See figure 19). While the "unknown" lenders limits our ability to talk about the type

[14] We match lenders to HUD's subprime list and The Reinvestment Fund (TRF) reviewed the list and classified other lenders based on their experiences in Pennsylvania.

of lenders that offered financing to these borrowers who eventually defaulted, we anticipate that a majority of loans were made by subprime lenders.

Figure 19. Mortgage Originator by Lender Classification

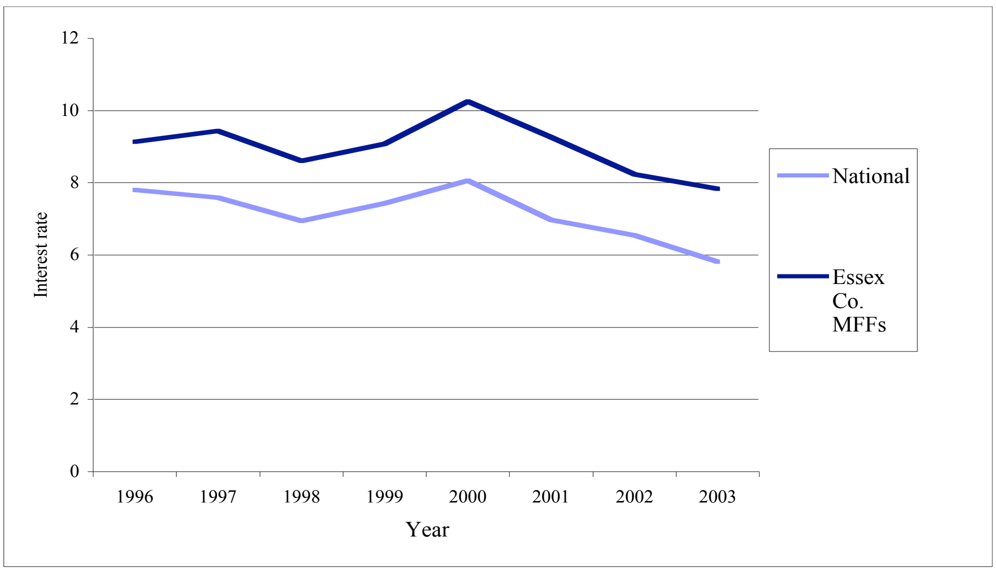


Source: HUD "Subprime Lender List", The Reinvestment Fund "Lender Database" and MFF

Interest Rate

The majority of MFFs included the interest rate, which enabled us to examine changes in the interest rate over time and in different municipalities. The interest rate for mortgages depends on the length of the mortgage and the credit risk of the borrower. Interest rates fluctuated during the 1990s and early 2000s, but, on average, rates fell to their lowest levels in 40 years. We used this historical context to examine the interest rates of the MFFs. Most of the MFFs were for 30 year fixed rate mortgages although some were 15 year mortgages; a handful were ARMs. Interest rates ranged from lows in the 5 percent range to highs above 15 percent. In one case, a $30,000 loan originated by Household Finance carried a 21 percent interest rate. The average MFF interest rate was substantially higher than the average national 30-year fixed rate mortgage between 1996 and 2003.[15] Based on the sample, the average interest rate was 1.33 (1996) to 2.29 (2001) points higher than the national average (See figure 20). The curve created by MFFs follows changes in the average national interest rate for fixed 30-year mortgages almost exactly, just 1.8 points higher, on average. Some loans far exceed the average interest rate (See table 4).

Figure 20. Yearly Average Interest Rates: National and Essex County



Source: Freddie Mac; Mortgage Foreclosure Filings January and February 2004

[15] The calculation of mean interest rates for MFF data used all filings (except ARMs), not just 30 year mortgages. All MFFs were included because of the small data set. The mean length of mortgages in the MFF data was 27.39 and the median was 30, suggesting that the average interest rate should have been equal to or slightly less than the national average, assuming all else equal.

Table 4. Mortgage Foreclosure Filing Interest Rates by Year

Interest rate averages & ranges by mortgage origination year				
Year	*Low*	*High*	*Mean*	*Median*
1996	6.38	13.35	9.13	8
1997	7.25	15.99	9.43	8.5
1998	5.38	15.5	8.61	7.88
1999	5.5	15.75	9.08	8.5
2000	7	16.59	10.25	9.5
2001	4.51	21.9	9.26	8.75
2002	5.5	13.99	8.23	7.88
2003	5	11.94	7.84	7.88

Source: Mortgage Foreclosure Filings January and February 2004

We also explored MFF interest rates by municipality. For January and February 2004 MFFs, the municipalities grouped within the "other suburbs" category had the highest average interest rate (9.28 percent). The average interest was above 9 percent in Newark (9.10) and East Orange (9.04). Orange, West Orange, Irvington, Bloomfield, and Belleville—the five other communities with high numbers of foreclosures—had average interest rates over 8 percent. The yearly average for national fixed rate 30-year mortgages only rose above 8 percent once since 1996, which supports other evidence that the majority of foreclosed properties in Essex County had subprime mortgages (See table 5).

Table 5. Mortgage Foreclosure Filing Interest Rate Averages By Municipality

Interest rate averages & ranges by municipality				
Municipality	*Low*	*High*	*Mean*	*Median*
Newark	5	21.9	9.1	8.5
East Orange	5.88	13.99	9.04	9
Irvington	5.5	12.39	8.3	8
West Orange	4.51	14.12	8.34	8.38
Bloomfield	6.38	11.5	8.26	8.38
Belleville	5.5	14.33	8.8	8.4
Other suburbs	4.88	16.59	9.28	8.5

Source: Mortgage Foreclosure Filings January and February 2004

Conclusion

Lenders and their representatives argue that they do not have anything to gain from making loans destined for foreclosure. However, not all agree that lenders are likely to loose money in foreclosure. Some loans contain recovery clauses, protecting the lender from fees acquired through lender-initiated foreclosure. Lenders are also protected through the secondary market. Many lenders sell their loans on the secondary market and the risk associated with the loans is packaged with the cost of selling a particular bundle of loans. They are passing the risk on but pricing it accordingly. The high number of risky loans suggests that many lenders are willing to assume the risk of foreclosure (Interviews 2006).

REASONS FOR FORECLOSURES

As we mentioned, life events are the major cause of foreclosure, including job loss, divorce, and illness. We reviewed the literature and conducted interviews with loan counselors and staff who work with non-profit developers to find a variety of other reasons that present a fuller picture of the reasons for foreclosures.

Subprime Lending

Foreclosures appear to be related to subprime lending: we found that Newark and surrounding cities had relatively high numbers of foreclosures, especially in neighborhoods with substantial amounts of subprime lending. In our sample of mortgage foreclosure filings, we found that subprime lenders originated nearly half and we could not identify more than forty percent of the other originations, which we suggest are also likely subprime lenders.

Loan Quality

Some loans fail because they are poor quality loans or are a bad match for borrowers. This is likely due to subprime loans, but there may also be loan quality problems in the prime market. We found that of the loans that went into foreclosure in January and February of 2004, a considerable number were originated one or two years earlier; this suggest potential loan quality problems. Furthermore, interviewees described situations in which lenders and brokers originated loans and maximized fees, interest rates, and loan amounts, often encouraging borrowers to take additional cash from the loan and to consolidate consumer debt into the loan. Lenders who make these loans are seeking to maximize fees and or strip equity from borrowers' homes. One interviewee explained the cases she saw:

> What they'll do also, you'll have people who have a mortgage on their home that might be from a long time ago. There's not much left and it's at a decent rate. They'll say, sure we can give you that $2 to 3,000 and take that mortgage that was manageable and refinance it. They will take an 8 percent loan and turn it into a 12 percent loan and there will be fees involved. Do you need a little bit of money and instead of getting a little bit, every debt is rolled into one thing. When they miss a payment, their house is at stake. They won't make these loans unless they feel there is equity in the case (Interview 2006).

In another case, an interviewee described a widow in her 60s:

> She needed some money after her husband passed away. She wasn't used to dealing with the bills. She had a lot of equity in her house. She was asked if she needed some money and they took her mortgage which was a low rate mortgage –6 percent or so—and refinanced it for several points higher. She was charged various fees and points and she couldn't afford to pay it (Interview 2006).

Some borrowers may get loans that are more than they can afford making it unlikely that they will be able to maintain the loan. One interviewee explained:

> Many of the folks who entertain these types of loans have serious credit issues. A good salesman can sell you anything and I look at you as a salesman and I say how bad do you want it, like that house across the street. I can get that for you and if you want that bad enough, you'll sign on the bottom line and you might ask what about my credit—don't worry about it (Interview 2006).

Another interviewee explained: “In the city of Newark many individuals are buying homes in my opinion at well above what they can afford.” For example, borrowers may purchase two and three family homes thinking that the rental income will enable them to afford the house. However, they lack the skills to manage a multi-family house and may not know how to create a lease or collect rent. If their finances are tight and their tenants miss one or more payments, they may find themselves unable to pay their mortgage. Landlord counseling/training and other resources can help but few people know about such programs or take advantage of them.

Some borrowers may be unaware of their specific loan terms such as balloons. For example, a balloon mortgage will begin with several years of steady, affordable payments. However, when the balloon payment comes due, the sudden increase in the payment amount can catch a borrower unaware and may force often-expensive refinancing or default. A community organizer we interviewed shared a story of an individual with a balloon mortgage. The borrower paid $800 monthly for two years without problem. However, when the balloon payment came due, he suddenly faced a bill of $80,000. Even with planning, a substantial jump in amount due was impossible to meet and he had to refinance (Interview 2006).

Still others find that their loan documents are fraudulent. Predatory lenders may lure in unsuspecting borrowers with what appear to be reasonable loan terms, but write different, onerous terms in the loan documents. A broker promised a Newark woman a single loan at 5.5 percent interest rate; when she came to the closing meeting, she discovered that she had actually signed loan documents for two loans with interest rates of 9.9 percent and 13 percent, respectively, with a balloon payment attached. The woman could have repaid the loan on the terms to which she had originally agreed. However, the terms on the document that she signed were unmanageable (Interview 2006).

Aggressive Marketing

Foreclosures sometimes result from aggressive loan marketing. Lenders target people based on individual and neighborhood characteristics. They heavily market their loans in neighborhoods that allow them to capitalize on high levels of home equity, lack of access to prime credit, and low financial literacy.[16] Our interviews with loan counselors and non-profit community development organization staff suggest that many people in foreclosure did not shop for their home loans; the loans were marketed to them. One interviewee (2006) described what she called asset based lending or equity stripping: “seniors, widows, women, own their house free and clear and somebody comes knocking at the door a home repair contractor and this house they own free and clear wind up with $50,000 mortgage on it with payments they can’t possibly make.” A community organizer explained, “In some neighborhoods, push marketing is so aggressive that lenders send checks to homeowners with fine print describing the terms of cashing or depositing the check. Some people use these checks without fully understanding that the check is a high-cost loan” (Interview 2006).

Consumer Debt

High interest rate credit cards, home equity lines of credit, and home equity credit cards are appealing to people in need of money, but we know little about how credit card debt is related to foreclosure. Borrowers may pay high interest credit card bills instead of home mortgages, leaving them even further in debt. One interviewee who works for an affordable housing organization stated that many borrowers accrue severe debt with multiple credit cards. As their credit card bills increase, they let their mortgage or property tax payments slip instead of missing credit card payments (Interview 2006). Still others may refinance their home loans consolidating credit card and other debt into their home loan. Rather than face the increased interest charge on a home loan, borrowers now risk their homes if they miss mortgage payments.

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[16] Database technology has facilitated push marketing. One company that prepares databases for target marketing offers brokers lists containing detailed information on potential customers. Computerized records of new homeowners contain information on age, income, ethnicity, and mortgage details. Another company markets databases of “mortgage leads.” This database allows brokers to reach their “best prospects” by providing many characteristics on individuals including: street address, city, income, mortgage origination date, length of residence, ethnicity, mortgage amount, home value, loan-to-value ratio, loan type, interest rate, credit scores, debt consolidation needs, and income/debt ratio (Lists Are Us 2001).

A few interviewees suggested that credit cards and credit cards that look and work like home equity loans are heavily marketed in low-income neighborhoods. As borrowers use credit cards, they can easily find themselves in a debt spiral.

> If you default on an unrelated bill, like pay your utility rate late, the credit card company will raise your rate. If you go over your credit limit, your interest rate will skyrocket. These things multiply phenomenally. We've had clients put their house in danger. Some of these lines of credit are secured by your house. For example Household [Finance]. Some of them looked like typical credit card loans and they graduate them into home equity loans (Interview 2006).

Financial Literacy

Borrowers must navigate a lending system that even mortgage market experts have difficulty understanding. The myriad of details (such as interest rates, fees, and loan terms) can overwhelm some consumers. Given the growing number of mortgage products available, it is increasingly difficult for borrowers to understand the loan products offered to them. Brokers and lenders have access to more information than borrowers do, making it difficult for borrowers to shop competitively (Engel 2001). Information asymmetries are exaggerated when we consider that certain groups have been denied access to credit for generations. Some people lack networks of family and friends who can share information about borrowing. Interviewees suggested that many borrowers do not understand credit. Some have better credit than they realize but because they fear their credit is poor, they accept overpriced loans or do not shop around. Borrowers with limited financial skills or financial alternatives may more readily accept loans that brokers aggressively market to them—what the industry calls "push marketing." Borrowers may depend on lenders and brokers to lead them through the lending process.

Attorneys and Loan Counseling

A few interviewees suggested that even when borrowers run into trouble with their loans, foreclosure could be prevented with the intervention of attorneys and or loan counselors. Borrowers suffering through a financial crisis may not know to call their lender to ask for a grace period on the mortgage (Interview 2006). Delinquent borrowers may be able to create a flexible payment plan with lenders if they contact them as soon as they go into default. However, few borrowers set up these plans; if they do get legal or counseling assistance, they often do so after months of delinquency, making it far more difficult to remedy the situation. Owing one or two mortgage payments can be fixed, but the problem gets much worse if several months go by (Interview 2006). Borrowers with abusive or predatory loans may not know where to access help or may not seek it because of they are embarrassed. They accept foreclosure silently rather than with the help that could expose a predatory loan.

Nontraditional Mortgages

We turn now to a full discussion of nontraditional mortgages. We anticipate that one of the leading reasons for foreclosures in the coming years will be linked to the expansion of nontraditional mortgages and their increased use by low- and moderate-income households.

NONTRADITIONAL MORTGAGES

In this section, we discuss the mortgage industry's replacement of the 30-year, fixed-rate loan with an array of NTMs or "exotic" mortgages. The exact definition of an NTM is a vital component to any discussion of their risks, benefits, and role in the mortgage market. NTMs have, however, been defined in various ways depending on the perspective of the party discussing them. The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the "Agencies") define NTMs as mortgages that allow borrowers to defer payment of principal and, sometimes, interest for a fixed period (Federal Register 2005, 77250). Many NTMs include: (1) negative amortization; (2) time-limited "teaser" interest rates; (3) balloon payments; (4) adjustable interest rates; and (5) flexible payment structures. To add to the confusion, new products constantly emerge in the market. NTM terms make loans attractive to borrowers so they can manage lower monthly payments during an introductory period. This allows some borrowers to qualify for a home purchase and others to buy a more expensive home than otherwise. Particularly, in a state like New Jersey with high and increasing housing costs, NTMs provide payment flexibility surpassing that of 30-year fixed mortgages.

The development of nontraditional mortgages began in the hot housing markets of Southern California and spread across the country. As housing prices skyrocketed and families found themselves priced out of the housing market, many demanded instruments that allowed them to buy houses with lower interest rate and upfront costs. In part, they demanded alternatives to the 30-year, fixed-rate mortgage. The mortgage banking industry responded with a variety of loans that reduced initial costs that eased entry into the market: adjustable rate mortgages, interest-only loans, and other vehicles appealed to mostly high-income, sophisticated borrowers. Some planned to own a home for only a few years. Others preferred to leave their money liquid or invest in the stock market.

Problems occurred when housing costs rose throughout the country and the low monthly payments available through NTMs broadened the appeal to a wider spectrum of homebuyers.

When managed by experienced investors, NTMs are appropriate financial tools. However, their proliferation among unsophisticated consumers interested in buying "more" home suggests the possibility of looming financial instability. Additionally, NTMs have become commonplace: the lending industry has marketed these loans aggressively, labeling them as "exotic" to increase their appeal. Lenders advertise on posting boards, place on-line ads, and air ubiquitous television spots. These ads suggest that a homebuyer would be foolhardy to take a standard loan when they could "pay less" with an NTM.

It is critical to acknowledge that for many users, NTMs are useful financial management tools that have been available to upper-income clients for many years. Recently, however, these tools are being offered to a wide spectrum of low- and moderate-income borrowers, many in the subprime market (Federal Register 2005, 77250). An altered payment structure and varying payment schedule makes NTMs appropriate for high-income consumers that prefer to leave most of their income liquid or in non-housing investments. These consumers can either access the "quick cash" needed to weather an increasing payment or simply sell the home before exiting the introductory period. For low- and moderate-income borrowers, however, dramatic increases in monthly mortgage payments as the introductory period expires and payment amounts increase can be devastating—a phenomenon known as "payment shock."

Table 6 provides details on the benefits and risks of the 30-year, fixed-rate mortgages in comparison to some common NTMs. Table 6 also details the risks associated with three basic loan structures. These are a small sampling of the literally dozens of loan products being introduced to the market (both prime and subprime) on a daily basis. The option ARMs and interest-only loans are NTMs. Other NTM loans include:

- 103s/107s mortgages, where 103 percent to 107 percent of the home cost is financed to cover initial fees of buying the home;
- Portable mortgages, which allow borrowers to lock in a low interest rate and take the mortgage with them if they move within 1—2 years;
- Home equity lines of credit, which allow borrowers to finance home purchases using a credit line rather than a traditional mortgage; and

- Piggy-back or combo mortgages, which are essentially two loans—one that covers 80 percent of the home's value and a second to cover the remaining balance at a higher rate.

Table 6. Mortgage Types and Risks

Loan Type	Benefits	Risks	Who Should Consider It?
30-Year, Fixed-Rate Traditional mortgage product	Rates and payments remain constant. Rate stability makes budgeting easier Simple to understand	No real risks exist for those who maintain employment and sufficient income.	People with stable incomes and do not expect it to fluctuate Plan to be in their homes for a long time Want to build equity in their home
Option ARM Adjustable rate mortgage with optional monthly payment amounts	Flexible loan Lenders generally charge lower initial interest rates ARM could be less expensive, if rates drop	Risk of the rate increase that could lead to drastic change in payment. Negative amortization if mortgage rates rise, which means you may owe more than the property is worth	People who do not anticipate holding on to the property for the full term Expect their income to increase in the next couple of years Want the benefit of a lower initial rate and monthly payment
Interest-only loan Mortgage where the monthly payment amount only pays back the interest, not the principal	Lower monthly payments than a traditional mortgage during the interest-only period More purchasing power Borrowers can pay down principal when they choose	Negative Amortization Possibility of a balloon payment The payments at that time will be higher than payments would have been with a traditional mortgage.	People who can realistically expect to earn a lot more money in a few years. Part of incomes comes in bonuses or commissions and can pay down principal when those arrive.

Of the riskier loans cited in Table 6, the most popular is the option ARM loan. This loan, also known as a flexible adjustable rate mortgage, is a hybrid ARM with potential negative amortization (negative amortization occurs when payments are so low, the principal grows over time due to added interest). These loans may offer a low introductory rate for the first months or the first few years, but adjust upwards annually at a predetermined point in time. Once the readjustment (or "reset") takes place, the loan's interest rate can increase to a level that shocks the consumer, especially when rates are rising. A further problem with these loans is their "payment option" feature. This occurs when the lending institution allows the borrower to choose what their monthly payment will be; some lenders will provide a variety of payment options each month, consistent with the borrower's financial situation. This can be risky if the borrower habitually chooses a repayment amount that does not pay down the principal or pays down a small portion of the principal over a long period.

Table 6 also includes the interest-only loan, where no principal is paid. Typical variations of this loan may include a mortgage where borrowers pay only the interest or a portion of the interest for the first five to ten years depending on the individual loan. After that time, the loan essentially becomes a new mortgage with a variable interest rate and principal payments stretched out over the remaining twenty years. This loan presents a risk to homeowners since if the price of their home stagnates during the initial payment period, the homeowners may be unable to build significant equity in the home. In some cases, the home may also be worth less than the loan. While the principal has been growing, the borrower has not been paying it down with their interest only payments. Young professionals who expect their incomes to increase or employees who receive bonus payments as a part of their professional compensation may be able to utilize this loan and undermine its inherent risks. The interest-only loan is inappropriate, however, for anyone with an income that does not increase substantially over time or who suffers from sporadic employment at low wages, as many poor families do.

Central to the particular difficulty faced by low- and moderate-income borrowers is the phenomenon of payment shock, illustrated in Table 7.

Table 7. “Payment Shock” for a $200,000 loan with Adjustable Rate Mortgages

	30-year fixed-rate (at 6% interest rate)	5/1 ARM (at 5.625% for 5 years, adjusted annually thereafter)	Option ARM (minimum payment of 1% with 115% negative amortization ceiling)
Initial Monthly Payment	$1,199	$1,151	$643
Loan Balance after yr.5	$186,106	$185,225	$230,000
Monthly Payment, Year 5:			
(2) Interest Rate decreases by 1%	$1,199	$1,043	$1,295
(3) Interest Rate remains the same	$1,199	$1,151	$1,430
(1) Interest Rate rises by 1%	$1,199	$1,265	$1,571

The payment shocks are most obvious with the 5/1 ARM and the Option ARM. The initial monthly payment for the 5/1 ARM is $1,151. After a one-point increase in the interest rate, the monthly payment jumps an additional $114 (10 percent) to $1,265. While this may not be such a severe increase for middle- and upper-income borrowers, a low-income family of four may need this additional money each month for food or other expenses. The Option ARM gives a much bleaker scenario for the low-income family. While their initial monthly payments appear cheap at $643, after a one-point increase in interest rates, monthly payments jump two and half times, to a whopping $1,571 per month. Of particular concern with the Option ARM is the loan balance after five years of payments. Whereas the 30-year, fixed-rate mortgage borrower owes a total of $186,106, the Option ARM borrower’s principal has actually grown to $230,000, more than the original amount of the loan.

Many low- and middle-income families attempt to build wealth through homeownership, an investment strategy that benefits them and their neighborhoods. When NTM-holders find that they are unable to meet their monthly mortgage payments, this wealth-building strategy can be turned upside down and force borrowers into foreclosure. This is a concern among federal regulators as noted in their recently released federal guidance (Federal Register 2005). As larger numbers of low- and moderate-income people use NTMs, the risk to neighborhoods increases. Housing markets are threatened when, using NTMs, home prices are inflated and borrowers begin buying more expensive and larger homes than they can afford. When areas realize many foreclosures in a short period, the very fabric of that community is hurt. Neighborhoods with concentrations of low- and moderate-income families face this risk at a large scale—all of which can contribute to neighborhood decay.

What does the future hold for nontraditional mortgages? As noted, the mortgage banking industry has created a bewildering array of these instruments in recent years, first to appeal to wealthy, sophisticated borrowers and later to those in the subprime market with less access to financial advice. Given the speed of introduction and variety of new instruments, it is very hard to forecast what new mortgages will be on the market in two or three years. The use of these ARM loans by less sophisticated borrowers presents a risky proposition down the road. When these loans reset in five to ten years, there could be a large number of people facing harsh situations. Looking at likely market changes in the future, the possibility of rampant foreclosures certainly appears to be a valid concern.

RECOMMENDATIONS

With our analyses of foreclosures and new mortgage instruments complete, we can now make recommendations to policymakers about these important areas. As our research on mortgage foreclosures showed, the process of data collection and analysis would have been more fruitful had there been more usable data available. Policymakers and advocates need good data, so we present some suggestions for improvement in data availability. In addition, we have indicated some of the problems that uninformed borrowers face in an increasingly complicated mortgage market. In this section, we recommend some innovations in training and education to help relieve some of those consumer burdens. Finally, we present suggestions for changes in regulation in the mortgage industry to help borrowers get a fairer shake in the marketplace.

Make Foreclosure Data More Accessible

Analysts and policymakers need access to foreclosure data to determine whether foreclosure is a problem. Access to foreclosure data allows researchers to ask and answer the following types of questions:

- Where are foreclosures most common?
- Are foreclosure rates increasing or decreasing?
- Do particular lenders have unusually high foreclosure rates?
- Are foreclosures concentrated in particular markets, such as the subprime market?

Foreclosure data is not readily available in New Jersey, even though public bodies hold that data. Analysts must rely on private sources, such as the Mortgage Bankers Association delinquency survey. Gathering foreclosure data in New Jersey is prohibitively time consuming because it is not recorded in easily usable formats. Foreclosure data is available in different forms from different entities. Counties keep track of *lis pendens* filings. The state keeps track of sheriff sales and mortgage foreclosure fillings (MFFs). Each data source is useful, but all are fraught with data-collection difficulties. To remedy these problems, the state and the county agencies should standardize the reporting of these data and make them accessible electronically.

At present, counties collect *lis pendens* information, each with its own data collection and dissemination system. Essex County has its data digitized, but it has not yet created a public access process. Instead, we were offered an expensive and tedious process that outstripped our resources. The availability of *lis pendens* data would allow researchers to answer all of the above questions with the exception of questions about particular lenders. Without that data, we do not know whether the lenders were prime or subprime and we cannot examine whether lenders have unusually high foreclosure rates.

Mortgage foreclosure filings data, which the New Jersey Foreclosure Division of the Administrative Office of the Courts collects, includes considerably more information than the *lis pendens* filing, including the name of the originating lender. MFF data in New Jersey is the gold standard for foreclosure analysis, but it is extremely time-consuming to access. The state foreclosure division digitizes only some of the information in foreclosure files—such as docket number, plaintiff, and county—which enables the court system to access the records. To gather MFF data for foreclosure analysis means accessing paper files at the state courthouse. State officials were extremely helpful and allowed us a more streamlined access process than is typically available to the public. Even so, after four full-day trips to the state office in Trenton with eight students on each trip, we recorded only two months of data. We recorded information from approximately 15 to 20 mortgage foreclosure files an hour. At that rate, it would take eight people 150 to 200 visits to record all of the 2004 mortgage foreclosure filings for Essex County alone.

The court's database is constructed to facilitate the work of the court. However, the foreclosure data could be used by many other entities such as the Division of Banking and Insurance. If the court added loan amount, duration, interest rate, originating lender and a few other key variables, researchers and state regulators could use this data to track foreclosure trends and explore the questions we suggest above. This digitizing process would require foreclosure attorneys to provide consistent categories of information that would streamline data collection and analysis. Over the long term, a digitized system would likely cost the state less in administrative fees and provide information to the state attorneys and the public.

Enhance Consumer Education

Borrowers could best safeguard themselves against mortgage foreclosure and lending fraud by better understanding credit and how borrowing affects them. Since the mortgage market is extremely complicated and difficult for consumers to understand, learning about how mortgages work will reduce consumer risk. We recommend two broad categories of educational programs to aid borrowers in navigating the confusing and potentially dangerous mortgage market.

Formal Education Programs

Some existing formal education programs focus on the pros and cons of different types of mortgages. These standardized programs are best offered in classroom settings over a short time periods. For example, a two-week homebuyer's workshop comprised of two to three sessions would be an ideal vehicle for a standard, organized education effort. The Resurrection Project, a community development corporation in Chicago, has a successful homebuyer's program that is an ideal example of this recommendation in action. Their primary program is a two-session course entitled, "The ABC's of Home Ownership," though they offer secondary courses each month called, "How to Finance Home Repairs," and "How to Prevent Foreclosure" (The Resurrection Project 2006).

The New Jersey Financial Literacy Awareness Network (NJFLAN) coordinates financial literacy education efforts among private and public organizations. They may be the best group to organize a standard financial literacy program for the state. In addition, the New Jersey Department of Banking and Insurance recently announced that its staff will hold Consumer Awareness and Educational Workshops dealing with financial literacy. Topics include homeowner's insurance and predatory lending. This is a good first step to build on a broader, statewide financial education system.

Additionally, a standardized education series may lead some participants to their own research in which, given the prior recommendation, they would receive more sophisticated self-help education tools. Ideally, the successful flow of the first two recommendations would lead to a third recommendation: an increase in personalized financial counseling. Fannie Mae's "Growing Your Money: Personal Financial Tools" course is a good example of this kind of program; it devotes a full session to understanding credit. The course teaches basic financial literacy to individuals who need help navigating the home purchase process.

Self-Help Programs

Consumers with some knowledge of the mortgage market can take advantage of self-help efforts; these include online mortgage calculators that include NTMs as loan options and guides that provide a detailed description of complex loan terms. Borrowers using this sort of service are generally well informed and have some understanding of highly detailed mortgage products; they are less likely to be taken advantage of in the market.

Self-help efforts must be clearly defined, though. To this end, we propose that any consumer education tool that is accessible via the Internet, available to take home at a walk-in center, or distributed widely be defined as a self-help tool. Such tools should follow a similar design as the "Looking for the Best Mortgage" guide available on the Federal Reserve Board's website (Federal Reserve Board 2006). This document gives consumers questions to ask when talking to lenders as well as a checklist of important rates, fees, and terms that should be known before signing a loan document. The checklist allows the user to enter up to four different loan offers into an easy to use grid for side-by-side comparison of loan terms such as interest rates, points, the presence of prepayment penalties, and credit life insurance terms. We suggest creating a standardized mass-use tool that covers the points above for NTM products.

Provide Loan Counseling for Existing Homeowners

Many of our interviewees stressed the importance of loan counseling before and during homeownership. Many loan-counseling courses are offered for new homeowners, but many of the abuses are occurring with borrowers who already own homes. According to many experts, borrowers often do not have someone to turn to for guidance when taking out or refinancing a loan. By expanding awareness of and access to loan counseling services, individuals can ask questions about the loan process, find reputable lenders, learn about the importance budgeting and making regular, timely payments, and learn how to communicate with their lender.

One attorney suggested that counseling is especially necessary for homeowners considering home repair contracts and debt consolidation. In her experience, these are the areas where most borrowers encounter predatory loans (Interview 2006). Recent research conducted by NJISJ supports this. The home repair industry has become fraught with unscrupulous lenders and contractors seeking to profit off the home improvement needs of low-income homeowners. While there are programs available to assist homeowners, they are limited and may not be well known to those who would benefit from their services (Cleary 2005). Thus, ongoing counseling programs should be encouraged, especially those targeted to individuals seeking home repair loans.

Mandate Loan Counseling in the Foreclosure Notice

A loan counselor with a non-profit organization told us that counseling is the most effective way to avoid foreclosure once foreclosure proceedings have started. In New Jersey, the 30-day foreclosure notice includes information that loan counseling is available; however, it is not required. In the counselor's experience, fewer than 10 percent of people receiving this notice seek counseling (Interview 2006). By meeting with a counselor either in person or over the phone, individuals are often able to take action and avoid foreclosure. Those who wait longer find that it is nearly impossible to restructure the debt or work with a lender to resolve the problem. We recommend that individuals receiving 30-day notices be required to seek counseling immediately. The counselor noted that the longer people wait to seek help, the more difficult it is to avoid foreclosure.

Facilitate a Foreclosure Roundtable to Address the Foreclosure Problem

A foreclosure roundtable of policy makers, lenders, and advocates that would share information about foreclosures and consider policies to reduce the incidence of foreclosures should be convened that includes representatives from the Governor's Office, the New Jersey Housing Mortgage Finance Agency, New Jersey Division of Banking and Insurance, the Philadelphia Federal Reserve, Citizen Action, foreclosure attorneys from the Administrative Office of the Courts, advocates, and lending industry groups such as the New Jersey Mortgage Bankers Association. Each of these parties holds a considerable amount of information. Bringing them together to discuss the issue is likely to facilitate discussion to share data and consider policy strategies to reduce foreclosures.

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GLOSSARY

ABA—American Bankers Association

ARMs—Adjustable rate mortgages

CRA—Community Reinvestment Act

FHA—Federal Housing Administration

GSEs—Government sponsored entities

HMDA—Home Mortgage Disclosure Act

HUD—United States Department of Housing and Urban Development

IO—Interest-only loan

LIHTC—Low Income Housing Tax Credit

MBA—Mortgage Bankers Association

MFF—Mortgage foreclosure filings

NTMs—Nontraditional mortgages

NCRC—National Community Reinvestment Coalition

NJISJ—New Jersey Institute for Social Justice