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Understanding Foreclosures in Massachusetts

by RICARDO BORGOS, PRABAL CHAKRABARTI, and JULIA READE

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Introduction

Recent increases in foreclosure rates in New England and other parts of the United States are raising concerns. Distressful for individual borrowers and potentially destabilizing for their communities, the negative effects of foreclosures flow beyond the impact on housing markets and the financial consequences for creditors. Public officials, lenders, current and potential homeowners, community organizations, and other stakeholders are paying careful attention.

In low- and moderate-income communities in New England, community leaders view current trends as especially worrisome. Among possible explanations, they stress the expansion of high-cost and subprime lending in these communities; and they cite aggressive or unscrupulous mortgage practices, and even mortgage fraud. Historically, however, other factors have been responsible for foreclosure activity. Regional job losses, rising interest rates, weak housing markets, and stretched borrowers facing negative life events are among the factors that usually push up foreclosure rates. And even critics of current mortgage lending practices acknowledge that homeownership is an effective asset-building strategy and that expanding the availability of credit to previously underserved population groups is a worthy goal.

This paper describes recent trends in New England foreclosure rates, discusses possible causes, and looks at the prevalence of foreclosures in Massachusetts cities and towns with significant populations of low- and moderate-income households. It finds that the prevalence of higher cost lending is associated with higher foreclosure rates.

Current Patterns

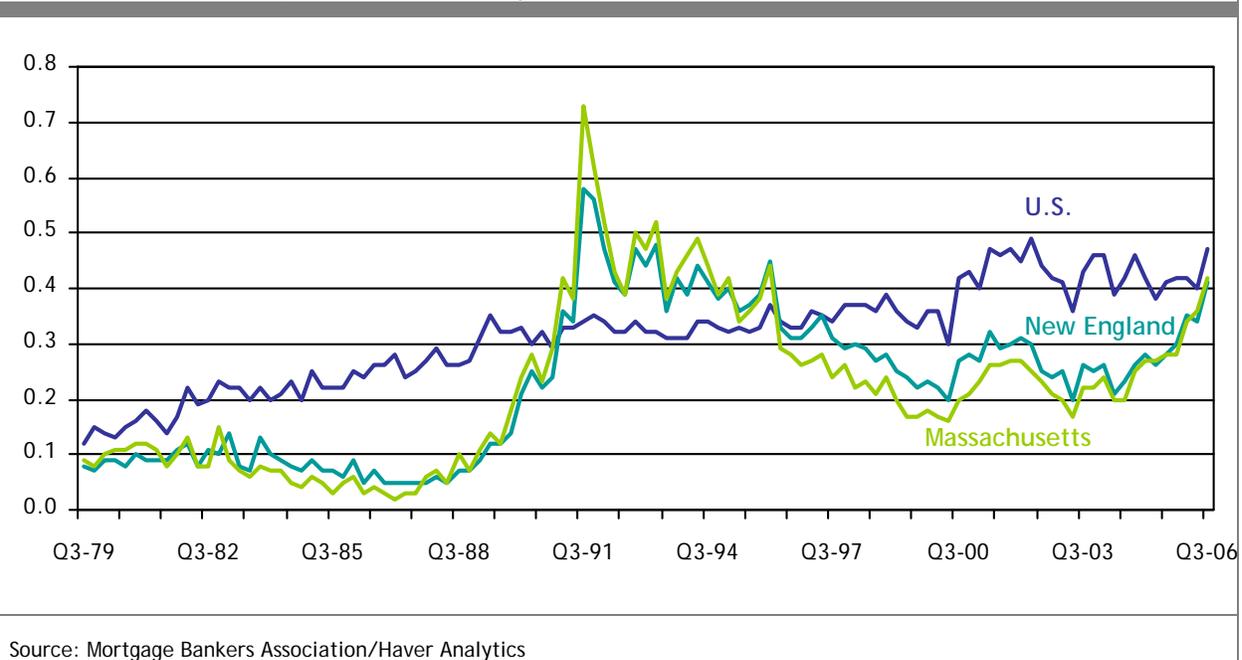
Foreclosure rates in both New England and Massachusetts are rising, as shown in Figure 1. In the third quarter of 2006, the foreclosure rate for Massachusetts was 0.42 percent. The rate for New England was essentially the same (0.41 percent). In both cases, rates have risen over the past three years. Foreclosure rates remain lower than in the early 1990s, when the region experienced a severe recession, accompanied by a sharp real estate downturn and a banking crisis. Foreclosure rates in Massachusetts and New England were also below the foreclosure rate of 0.47 percent for the country as a whole, but the difference has narrowed.

Throughout the paper, the term “foreclosure rate” refers to loans entering foreclosure process—that is, mortgages where foreclosure proceedings were initiated, but not necessarily completed.

Unfortunately, data are not readily available that are comparable across year and geography for completed foreclosures. Also, the initiation of foreclosure may be a better measure of financial distress, because many homeowners facing foreclosure will sell their property at a loss before the foreclosure is completed. For U.S. and state-level estimates, data are from the Mortgage Bankers Association’s National Delinquency Survey. The “foreclosure rate” is calculated as mortgages with foreclosures initiated as a percent of total mortgages serviced.

Ricardo Borgos is a Community Affairs Analyst, Prabal Chakrabarti is the Deputy Director of Community Affairs, and Julia Reade is a Senior Research Associate at the Federal Reserve Bank of Boston. The views expressed in this discussion paper are those of the authors and do not necessarily represent positions of the Federal Reserve Bank of Boston or the Federal Reserve System. **Please note a correction on pg. 10 from the previously posted version: the estimated cost of foreclosure is for the lender, not borrower.**

Figure 1: Foreclosure Rates, United States, New England, and Massachusetts, 1979-2006 (Q3)
Foreclosures initiated in quarter as a percentage of loans



Why Are Foreclosure Rates Rising?

When examining foreclosure trends, analysts generally look at three issues: employment, interest rates, and the housing market. A homeowner's ability to keep up on mortgage payments depends upon the household's income stream and the size of the mortgage payments. When a homeowner is unable to cover payments, sale of the home may be the best option for avoiding foreclosure and this, in turn, depends upon conditions in the housing market.

Job losses

Job losses are perhaps the most common cause of increased foreclosures, but their contribution to the recent rise in foreclosures is not clear. Nationally, employment has been growing steadily since 2003, although the regional pattern of foreclosures, with higher rates in the East North Central states, may reflect widespread cutbacks in the auto and related industries. But in New England, including Massachusetts, jobs have been increasing since 2003—a year with low foreclosure activity.

Rising mortgage payments

Making mortgage payments also becomes difficult if the required payment increases. Until recently, this was rarely an issue in most of the United States, because the preponderance of homes was mortgaged with fixed-rate products where the monthly payment was the same for the entire duration of the loan. However, since the 1990s, products featuring changing monthly payments have grown increasingly popular. These can include adjustable-rate mortgages (ARMs), where monthly interest rates and payments size are linked to some index, such as the prime rate; or products with features like “teaser rates” where initial interest rates are low, but are set to increase after fixed time periods. While some ARMs are structured to have only moderate shifts in monthly payments, some have dramatic increases, often occurring a fairly short time after origination.

Housing market

The weakening housing market has likely played a strong role in the recent foreclosure increase. Since 2004, rates of housing price appreciation in Massachusetts and New England have slowed dramatically, and by some estimates, property values have declined. In strong housing markets, homeowners who become economically strained and unable to make their mortgage payments can avoid foreclosure by selling their homes and paying off their mortgages. Alternatively, they may be able to refinance and apply some of the increase in equity to their mortgage payments. In weak housing markets, homeowners often lack these options, because debt on a home may exceed the market price. Even if a homeowner can expect enough from a sale to cover outstanding debt, homes generally take longer to sell in weak markets.

The increased popularity in recent years of mortgages that allow homeowners to make minimal downpayments and then make only minimal interest payments, with the interest differential folded into the loan outstanding, raises concerns that more homeowners are either unable or unwilling to withstand the soft housing market.

Changing product mix

The recent rise in foreclosures in New England and Massachusetts can be traced to changes in the composition of mortgages originated, and specifically, the rising popularity of higher-risk loans. In addition, foreclosure rates for subprime ARMs have risen dramatically in the past year.

As can be seen in Figure 2, which compares foreclosure rates for major categories of conventional mortgages, subprime mortgages have always had much higher foreclosure rates than prime mortgages, both nationally and in Massachusetts. (In this paper, “conventional” refers to mortgages that are not insured by a government agency, such as the Federal Housing Administration [FHA], Veterans Administration [VA] or the Rural Development Services.) In the past few years, the share of loans outstanding that are subprime, particularly subprime ARMs, has risen dramatically.

Prime fixed-rate loans, the lowest risk category, declined from over 80 percent of outstanding loans to under 70 percent, as shown in Figure 3. Meanwhile, subprime ARMs, the highest risk category, grew from one percent of U.S. loans outstanding in 2000 to nine percent at the end of 2006. The share of conventional mortgages entering foreclosure that was subprime ARMs grew from nine to 49 percent. Figure 4 highlights these dramatic differences.

Figure 2: Foreclosure Rates by Product Group, United States and Massachusetts, 1998-2006 (Q3)
Foreclosures initiated in quarter as a percentage of loans

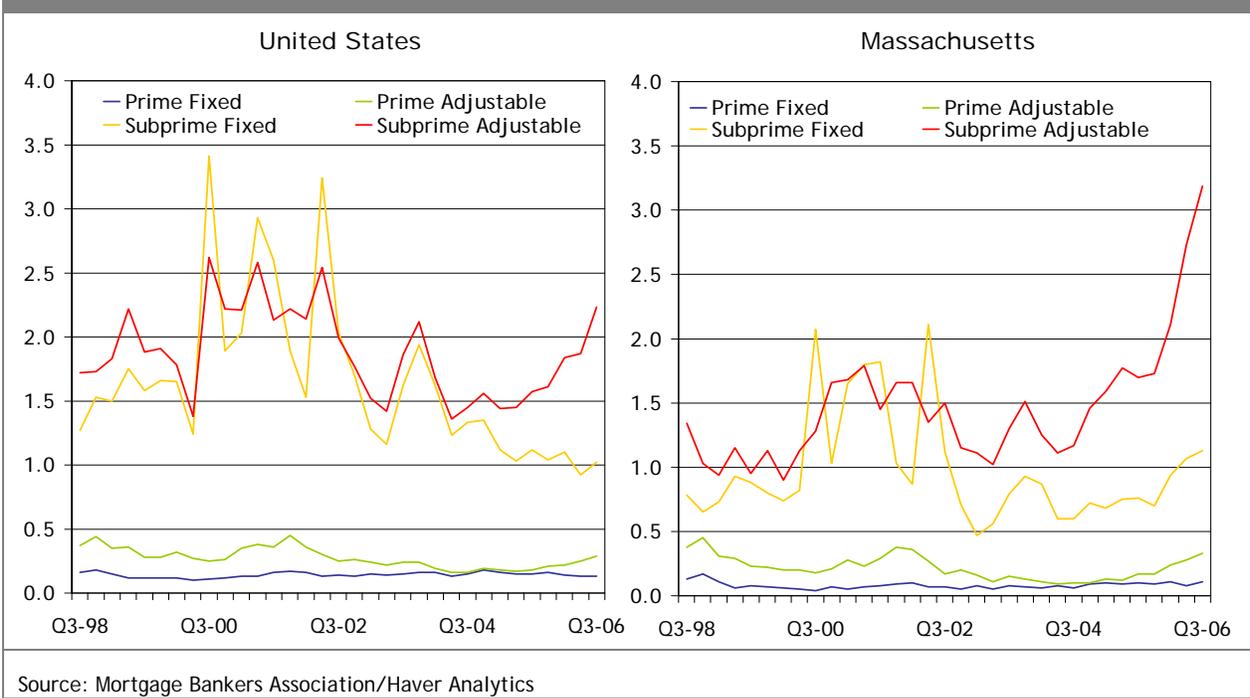
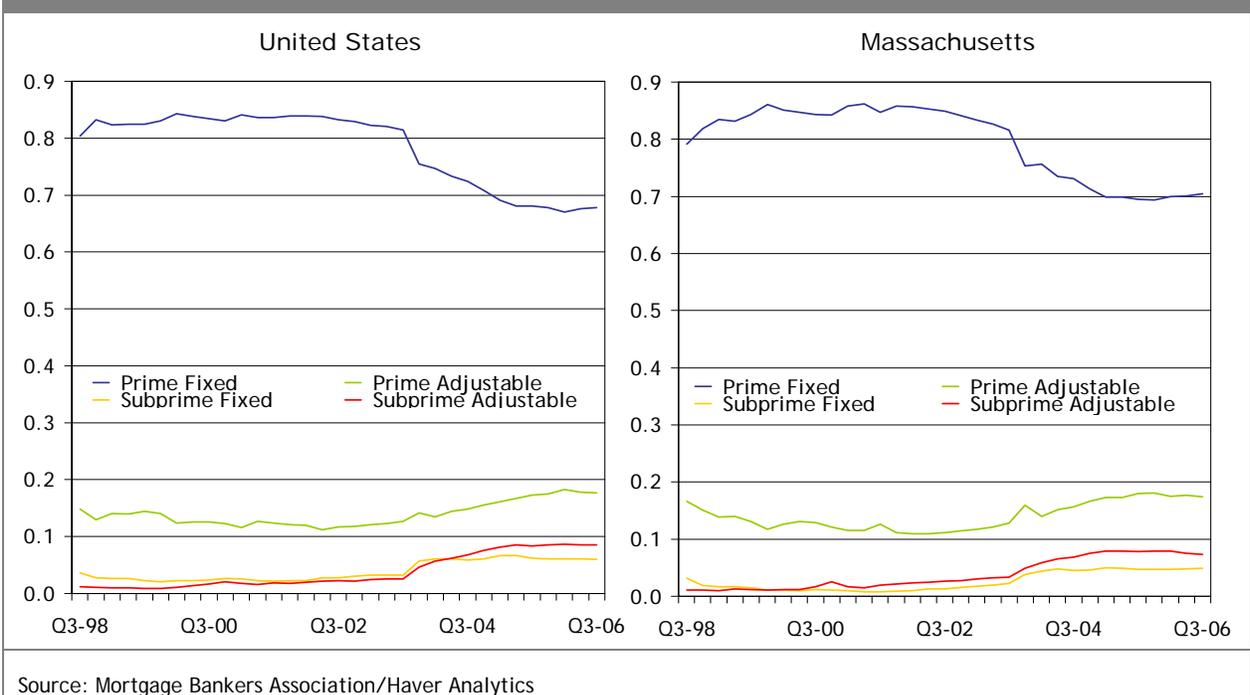
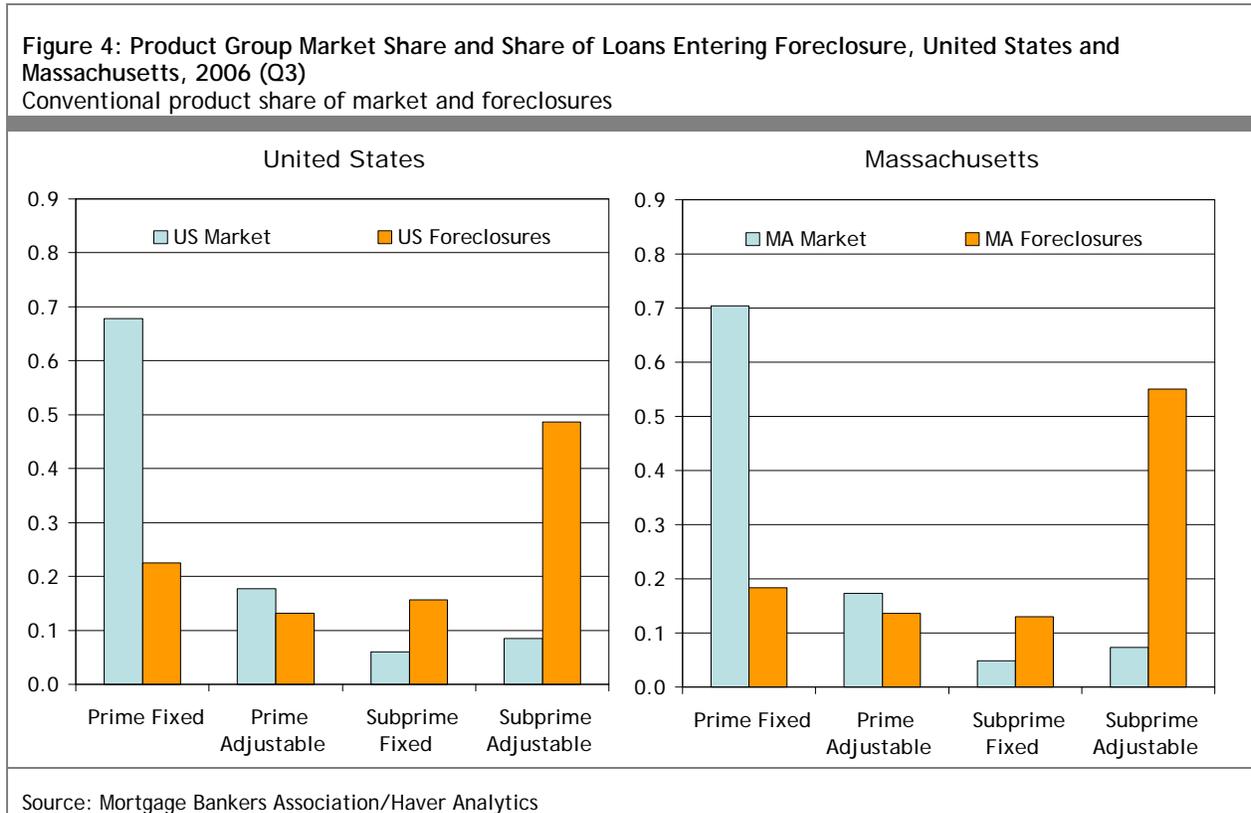


Figure 3: Product Group Market Share, United States and Massachusetts, 1998-2006 (Q3)
Conventional product market share



In Massachusetts, not only has the fraction of mortgages in the subprime adjustable category increased, but in addition, the foreclosure rate for subprime ARMs has also risen very rapidly. Over 3 percent of subprime ARMs for properties in Massachusetts entered foreclosure proceedings in the third quarter of 2006 (Figure 2). While subprime ARMs accounted for only 7 percent of conventional loans in Massachusetts (Figure 3), they accounted for 56 percent of conventional loans entering foreclosure (Figure 4).

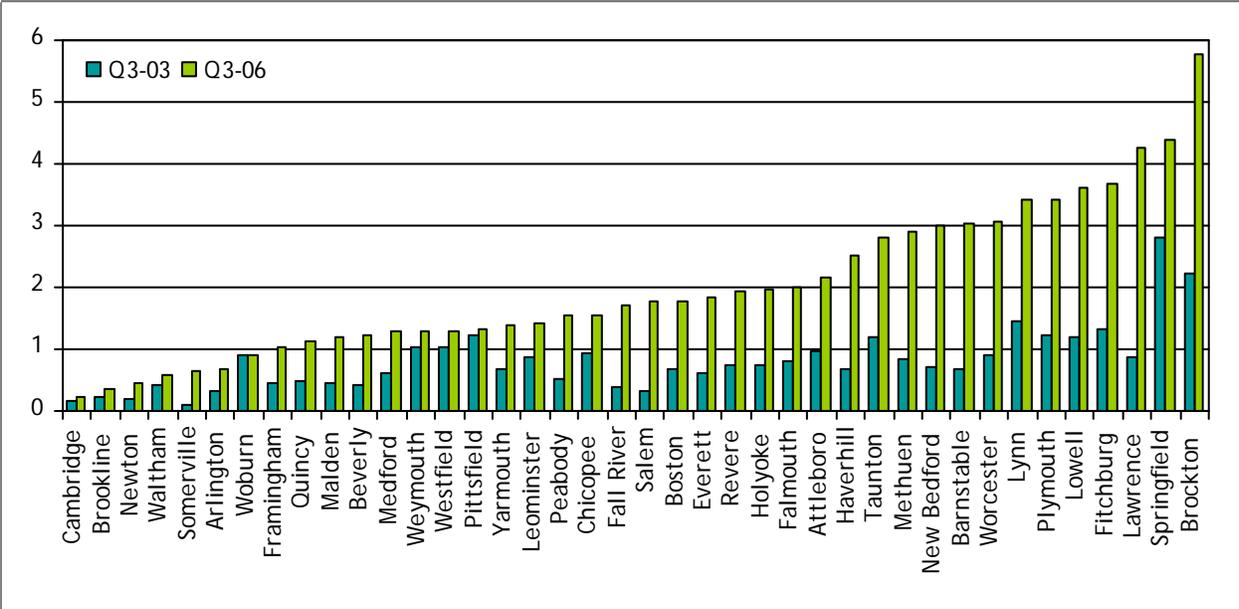


Subprime Lending and Foreclosures in Massachusetts Communities

In Massachusetts, local foreclosure rates vary widely. Figure 5 shows foreclosure rates across the 40 largest cities and towns. The highest foreclosure rates were observed in Brockton, Springfield, and Lawrence. Those familiar with Massachusetts will recognize that many of the communities with high foreclosure rates are among the poorest towns and cities in the state. While the poorest areas have had higher than average foreclosure rates for the past three years, the differences were at first modest. In the past year, however, the gaps have widened markedly. Thus, not only have foreclosure rates gone up, but they have gone up most in the poorest communities (Figure 6).

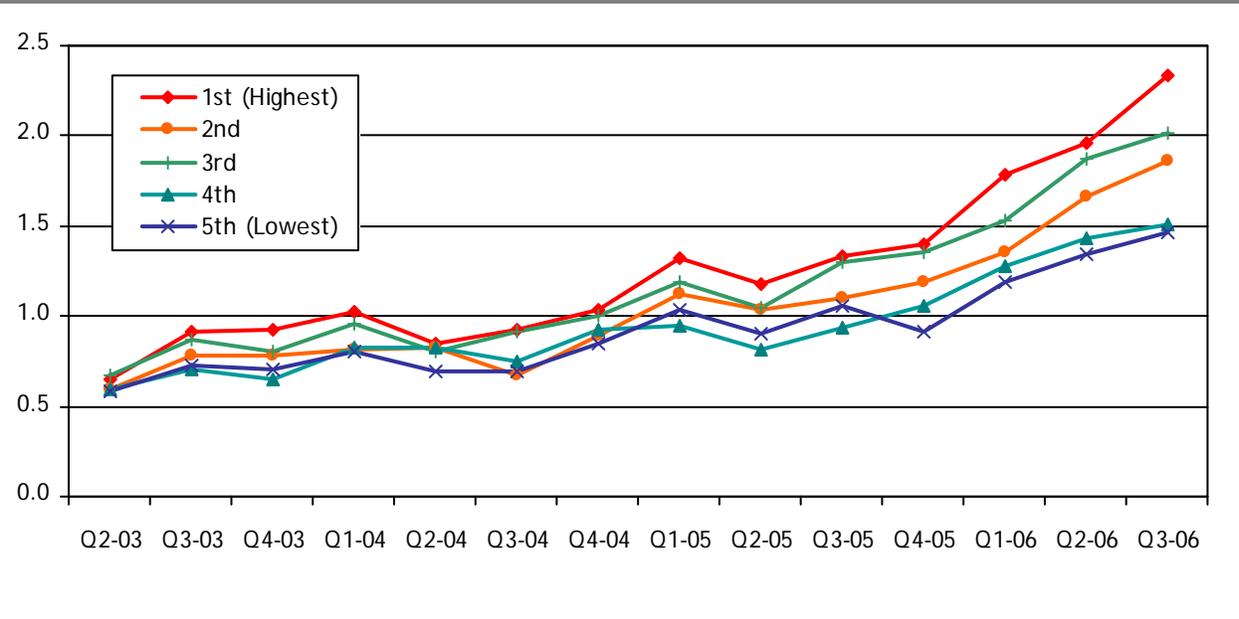
Foreclosure rates for cities and towns are constructed as the number of foreclosure initiations filed at Massachusetts registries of deeds per 1,000 housing units estimated in the 2000 Census. Sensitivity tests comparing alternative denominators, including owner-occupied units and population, showed similar patterns.

Figure 5: Variation In Local Foreclosure Rates, 2003 and 2006
 Quarterly foreclosures initiated per thousand housing units, largest 40 Massachusetts cities



Source: ForeclosuresMass Corp., Census 2000

Figure 6: Foreclosures by Poverty Quintile, Massachusetts Cities and Towns, 2003-2006(Q2)
 Foreclosures initiated in quarter per 1,000 Housing Units, Massachusetts Towns by Poverty Quintile

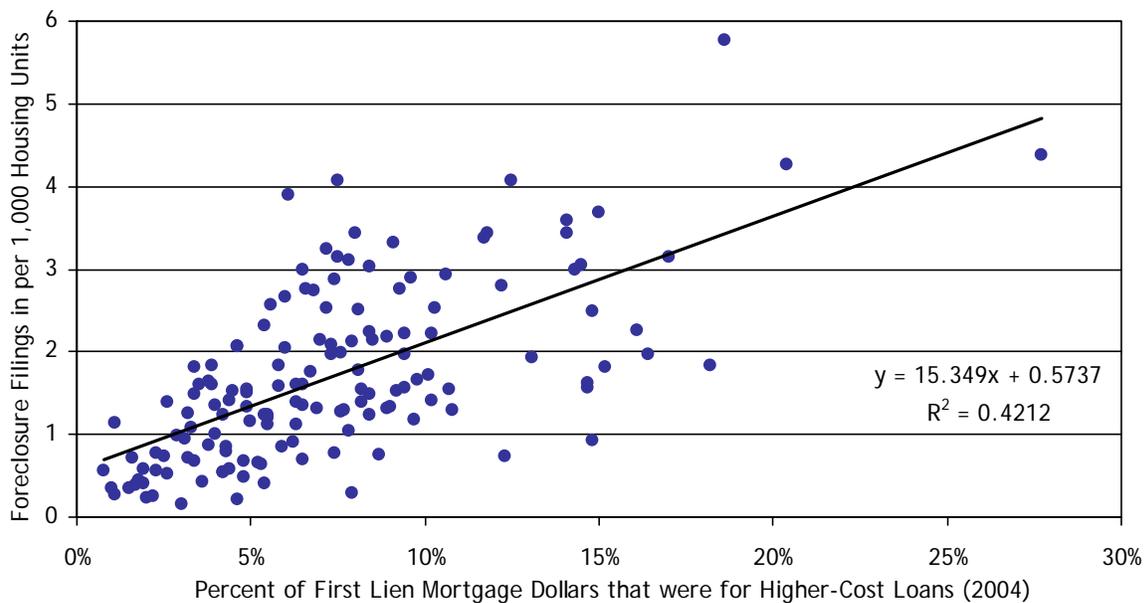


Note: Within quintiles, averages are weighted by each city or town's total number of housing units.
 Source: ForeclosuresMass, Corp., Census 2000

Higher rates of foreclosures in Massachusetts communities are also correlated with the prevalence of higher cost lending. Data collected under the Home Mortgage Disclosure Act (HMDA) in 2004 include information on higher-cost loans, which can be used as a proxy for subprime lending. In these analyses, the measure of a community's higher-cost lending is the dollar volume of higher-cost loans as a percentage of the total dollar volume of loans. With the median foreclosure occurring two to three years after the loan is made, the 2004 vintage of loans would approach peak foreclosure risk in 2006-2007. As shown in Figure 7, below, the correlation between higher-cost lending and foreclosure rates is strong.

Figure 7: Foreclosure Rate, by Level of Higher-Cost Mortgage Lending for Massachusetts Cities and Towns, 2006 (Q3)

Foreclosure Filings in quarter per 1,000 Housing Units



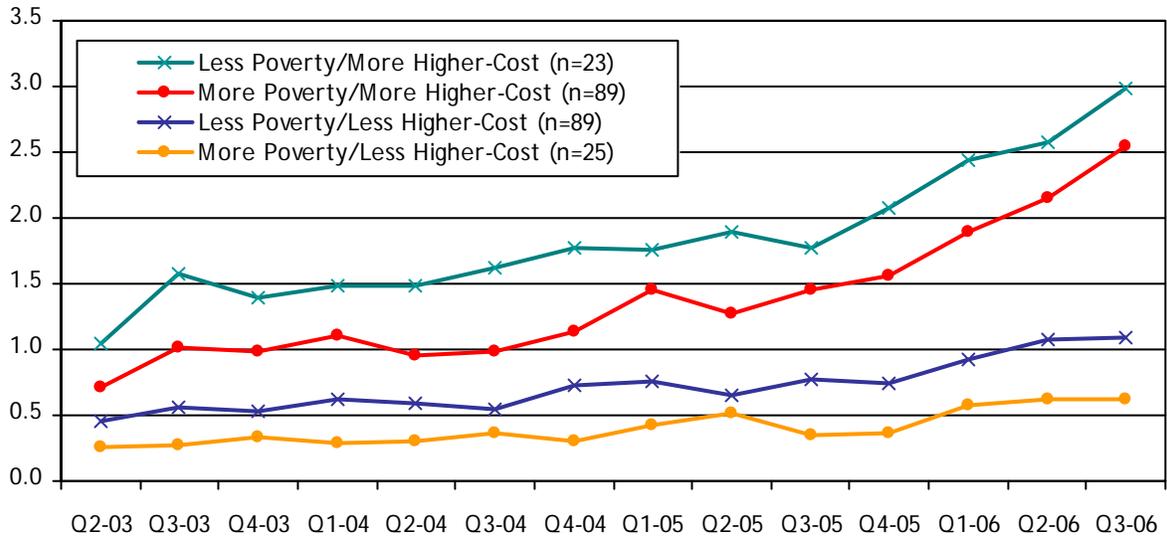
Note: Restricted to first-lien, nonbusiness mortgages on owner-occupied, site-built, single-family housing units. For loans secured by first liens, higher-cost loans had annual percentage rates (APRs) exceeding comparable Treasury securities by three or more points.

Source: ForeclosuresMass, Corp., Census 2000, HMDA 2004

Since higher cost lending appears to be more prevalent in lower income communities, the question arises whether the link between higher cost lending and foreclosures is really a link between income and foreclosure. To shed some light on this, cities and towns were categorized according to their levels of both higher-cost lending and poverty. Figure 8 shows that higher foreclosure rates were more closely associated with higher-cost lending than with high levels of poverty—in fact, within each level of higher-cost lending, areas with more poverty have *lower* foreclosure rates.

Figure 8: Foreclosures by Poverty and Higher-Cost Lending, Massachusetts Cities and Towns, 2003-2006 (Q3)

Foreclosures initiated in quarter per 1,000 Housing Units, by Higher-Cost Lending and Poverty



Note: 'More' and 'Less' are measured as top two or bottom two quintiles. Within quintiles, averages are weighted by each city or town's total number of housing units.

Source: ForeclosuresMass, Corp., Census 2000

Looking Ahead: Will Foreclosure Rates Continue to Rise in Massachusetts?

Given the popularity of higher-risk mortgage products and the softening of the housing market, further increases in foreclosures are likely. As noted, foreclosure rates are much higher for subprime mortgages, especially subprime ARMs, than for other conventional mortgage types. Given the normal lags between mortgage origination and the period of highest risk of foreclosure, the peak has yet to arrive. (Phillips and VanderHoff, 2004). Moreover, with the housing market softening and prices flattening and even declining in some communities, borrowers will have more difficulty extricating themselves from too-expensive loans than they would have a year or two ago. Refinancing may not be an option, unless there is significant equity in the home; and selling may take time and may not yield enough to cover the mortgage. Potential job losses from construction cutbacks are a further concern in communities where construction is a significant employer.

Foreclosure Prevention

Early intervention is the key to preventing foreclosures. This can involve counseling and education, legal advice and support, specialized or subsidized loan products, regulatory responses, or other creative efforts, such as programs to help support declining neighborhood home values. This section looks at what might help homebuyers during three stages of intervention: pre-purchase, post-purchase, and after initiation of foreclosure. Though this paper does not specifically address it, regulation also plays an important role. Many states have passed forms of predatory lending legislation, including all New England states except Vermont.

There are many informational and counseling resources available to help potential homebuyers before purchase. Such programs typically start by helping individuals determine whether buying a home makes sense for them. These programs address important considerations such as credit history, ability to maintain a stable income, and assumptions about costs, taxes and fees. When talking specifically about loans, these programs outline the process, the various costs and fees and emphasize the need for potential homebuyers to shop around, to read and understand the loan terms, and to understand basic rights and responsibilities. They also talk about ways to avoid mortgage fraud.

Some counseling programs are combined with state or federal loan programs, often supported by government agencies, approved community development organizations, and faith-based groups. The Department of Housing and Urban Development (HUD) sponsors counseling agencies that can guide homebuyers. Their approved list combines government, nonprofit, and for-profit counselors, and is available on the HUD website www.hud.gov. Fannie Mae and Freddie Mac both have online calculators and tools designed to guide a potential homebuyer through a purchase decision, and provide information about counselors. In Massachusetts, homebuyers utilizing certain loan programs are required to take homeownership counseling courses. Low- to moderate-income homebuyers using the state's 'Soft Second' loan program can use a list of Mass Housing Partnership-approved homeownership counselors. For ten years, the Citizen's Housing and Planning Authority (CHAPA) has been supporting an educated homebuyer before their purchase, granting a 'seal of approval' to a list of approved homebuyer counseling agencies. Many financial institutions also have homebuyer education programs. The Federal Reserve Bank of Boston recently produced a brochure, *Know Before You Go ... To Get a Mortgage*, that provides a simple guide to new mortgage products. Based upon the HUD list, the Bank also provides a list of HUD-approved counselors on the website www.bos.frb.org under 'Consumer'. The Federal Reserve Board's website also contains links to valuable resources about taking out a home purchase loan.

Some mortgage products for homebuyers carry lower risk. For instance, the MyCommunity mortgage is a fixed-rate product developed and financed by Fannie Mae, serviced by Mass Housing, and originated through approved lenders. The MassAdvantage mortgage offers fixed interest rates, below standard market-rates, and is financed by MassHousing through approved lenders. Both products work to pre-empt foreclosures by combining flexible underwriting guidelines and low down payments with low fixed rates and state-sponsored low-cost mortgage insurance. MassHousing also offers an affordable loan product for purchasing a home in need of rehabilitation and repair. These particular products are not for everyone, as they are subject to certain income limits, and borrowers must have a satisfactory credit history. Visit www.masshousing.com for more details and to access their homebuyer resources.

Many resources apply post-purchase as well. Borrowers who are finding it difficult to make their mortgage payments, and who are contemplating re-financing, may be tempted to commit to even higher costs loans, hoping their situation improves in the future. Many states have public information campaigns like Boston's "Don't Borrow Trouble," which seeks to educate families and individuals about how to avoid predatory lending frauds and about available community resources. The "Don't Borrow Trouble" campaign has a hotline at 617-635-HOME (4663), which is a trustworthy place for Boston residents to call before signing documents that put homes at risk. Massachusetts residents can call a state mortgage hotline at 1-800-495-2265, extension 1501. Local community organizations can also provide help. For example, ESAC Boston maintains a

Sustainable Homeownership Center, where residents of Boston's Egleston Square can turn for assistance. Several members of the Massachusetts Association of Community Development Corporations (MACDC) also provide such services (www.macdc.org).

Why Foreclosures Matter

It is painful and demoralizing for borrowers to lose their property to foreclosure. In addition to losing their asset, defaulting homeowners' credit is damaged, negatively affecting their credit rating for years to come. As a result of foreclosure, the homeowner might have a hard time relocating, and the adverse credit effects may cost him or her money down the line. It is estimated that a foreclosure costs the lender about \$59,000 and takes 18 months to resolve¹ (Cutts and Green [2004] citing Focardi [2002]). Foreclosures also can destabilize entire neighborhoods by negatively affecting property values and reducing tax revenues.

One important study estimates that a single-family property within one-eighth of a mile of a foreclosure suffers a decline in property value of roughly 1 percent (Immergluck, Smith. 2005). According to the same study, even foreclosures between one-eighth and one-quarter of a mile can cause a decline of about one-third of 1 percent. Because of the revenue effect from lower assessed values, many foreclosures cost the city or town as well. In Chicago, the roughly 3,800 foreclosures that occurred in 1997 and 1998 cost the city between \$600 million and \$1.4 billion in cumulative citywide loss in poverty value (ibid., 2005). These estimates were conservative, as they included only the effects of foreclosures on single-family property values and did not include the effects on the values of condominiums, larger multifamily rental properties, and commercial buildings (ibid., 2005).

The pernicious effect of foreclosures matters even more in low-income neighborhoods. When they looked closely at the city of Boston, the authors of the study found that many of the foreclosures were located in these neighborhoods, and had a significant negative effect (ibid., 2005). In fact, foreclosures in low- and moderate-income neighborhoods had an even greater negative effect on single-family property values than in a typical neighborhood. A single-family property in a low- or moderate-income community within one-eighth of a mile of a foreclosure saw an estimated decline in property value between 1.4 percent and 1.8 percent (ibid., 2005). For example, owners of a hypothetical single-family property worth \$200,000 and located in a low- and moderate-income neighborhood, would experience an average loss of between \$2,800 and \$3,600.

Foreclosures may even contribute to rising crime rates. High foreclosure rates have a statistically significant effect on overall neighborhood crime (Immergluck and Smith. 2006), and contribute to higher levels of violent crime. Every three foreclosures of 100 owner-occupied properties in one year correspond to an increase in neighborhood violent crime of approximately 6.7 percent (ibid., 2006). Certainly, the presence of run-down or boarded-up properties that occur as a result of foreclosure can have negative effects.

Finally, in terms of investor or public perception, the higher foreclosure rates may stigmatize an area as a poor place for non-housing-related investment. Business owners look for positive signs of business-related activity when undertaking site selection. Other investors also seek positive signs of economic activity when developing retail or mixed-use projects. Foreclosures may have a dampening effect on investment potential, even in the presence of positive characteristics like an underserved market.

After foreclosure is initiated, options narrow but borrowers need to know that the first step is to get help. According to NeighborWorks America, about half of homeowners enter into foreclosure proceedings without having made contact with their mortgage lender. Most lenders do not want to foreclose. Many foreclosure prevention programs assist individuals facing foreclosure caused by a temporary financial crisis. The programs may provide case management services and, if applicable, mortgage payment, or other financial assistance on a one-time basis. Some lenders are taking steps to shift existing customers from the highest-risk products to more stable mortgages. MassHousing and others are offering refinance products with financing exceeding 100 percent loan-to-value ratios

¹ Corrected from previous version posted March 2007.

for some borrowers. Other lenders may allow ‘short sales’ of homes--a sale for less than the value of the loan that allows the borrower to avoid foreclosure and its harmful effects upon credit history; such sales may also allow the lender to cut their losses (WSJ 2007). Here again, community organizations may be able to provide one-on-one counseling that can help. In some cases, legal advice is helpful. In Massachusetts, nonprofit legal services may be able to help homeowners understand their rights and chart a way forward.

Conclusion

Foreclosure rates have risen sharply in Massachusetts and New England. This rise is attributable to both increased take-up of higher-risk loan products and rising foreclosure rates for these products. Public officials and community groups are moving to address the issue through greater consumer awareness and education campaigns, evaluating proposed legislation, and discussions of possible rescue loan products. Getting help quickly remains the key for homeowners in trouble.

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