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Ohio's Home Mortgage Foreclosure Crisis

Anyone who has paid even casual attention to newspaper, television, or online media sources over the past 6 months is probably aware of the rapid increase in the rate of home mortgage foreclosures over the past year and a half. A recent report by the Coalition of Homelessness and Housing in Ohio (COHHIO) explores the extent of this problem in Ohio ("Dimensions of Ohio's Foreclosure Crisis", Bill Faith and Paul Bellamy). This report can be found online at: ***www.cohhio.org/pdf/dimensionsforeclosure.pdf***

Consider the following mortgage foreclosure trends found in the COHHIO report and related sources:

- Analysis of Ohio Supreme Court records shows that the number of home foreclosures in Ohio in 2006 (79,072) was higher than in any of the past 13 years. This figure represents a 24% increase over the number of foreclosures in Ohio in 2005.

- According to data from the Mortgage Bankers Association (MBA), in 2006 Ohio had the highest overall foreclosure rate in the nation at 3.38%, nearly triple the national average of 1.19%. Michigan and Indiana have the second and third highest foreclosure rates.

- MBA data also showed that in the fourth quarter of 2006 Ohio had the second highest percentage of loans in "serious delinquency" at 5.12%. This category includes loans that are in foreclosure or where payments are late by 90 days or more. Ohio's rate of 5.12% is more than double the national average of 2.21% and is the highest rate since MBA began tracking this statistic in 1979. Only Mississippi (5.3%) had a rate higher than Ohio's.

- MBA data also shows that in 2006 Ohio had the highest rate of subprime loans in foreclosure, at 11.32% (Testimony by Douglas A. Garver, Executive Director of the Ohio Housing Finance Agency, before the United States House of Representatives Committee on Financial Services, April 17, 2007).

- This trend has continued in 2007. The MBA's First Quarter 2007 National Delinquency Survey (released June 14, 2007) shows that Ohio's rate of subprime loans in serious delinquency is 19.9%, nearly twice the national average of 10.1%.

- The foreclosure data in Ohio, Michigan and Indiana in 2007 has prompted Douglas Duncan, primary author of the MBA First Quarter 2007 National Delinquency Survey, to make the following statement:

  "While Ohio, Michigan and Indiana account for 8.7% of the mortgage loans in the country , those three states account for 19.9% of the nation's loans in foreclosure and15.0% of the all of the foreclosures in the country started during the first quarter [of 2007]. Without these 3 states, the percent of loans in foreclosure in the US would be below the average over the past 10 years….

  *He continues to say**, "[the level of foreclosures and foreclosure starts in] Ohio is the highest ever seen in the MBA survey for a large state."***

This issue of On the Money will explore the causes and possible ramifications of the home mortgage foreclosure crisis which is currently gripping the state of Ohio.

Factors in the Increase in Foreclosures

Housing finance experts point to a variety of factors influencing the recent spike in home mortgage foreclosures. Under typical circumstances, these factors include job loss, increases in interest rates, and lower rates of home value appreciation. Job loss clearly makes it harder to make monthly payments, increases in interest rates on adjustable rate loans increase the amount of monthly payments, and lower rates of home value appreciation make it more difficult for borrowers to tap into the equity of their homes.

Currently, these factors are exacerbated by rapid growth in the reliance on "subprime" loans. Subprime loans are loans made to borrowers with relatively poor credit histories. Because these borrowers have poor credit they do not qualify for the most favorable (or "prime") rates from standard lenders. Consequently, they are forced to take out riskier adjustable rate loans which are typically structured in a "2/28" or "3/27" fashion. A 2/28 subprime loan will usually offer the borrower an artificially low "teaser" rate of 3% or 4% for the first two years. After two years the teaser rate expires and the loan converts to a much higher adjustable rate (a process called "resetting") which can raise the monthly payment amount by 30-40%.

Once the loan resets many subprime borrowers find it very difficult to continue making their payments. If the value of the home has appreciated sufficiently it might be possible for the borrower to use the increased equity of the home for a "cash out" refinancing of the loan or to take out an equity line of credit to provide an income flow to help meet the higher monthly payments. In a worst case scenario, the borrower could sell the house and still come out with a small profit. However, home values have been relatively stagnant the past couple of years leaving subprime borrowers unable to avail themselves of these options.

An additional factor also working to the disadvantage of subprime borrowers is a marked increase in the practice of "securitizing" subprime loans. Securitization refers to the practice of pooling home loans and selling them to investor groups such as insurance companies, mutual funds, and pension funds. While this practice dates back over 30 years, it has "exploded" in recent years, according to a recent front page article in the New York Times ("More Home Foreclosures Loom as Owners Face Mortgage Maze", Gretchen Morgenson, New York Times, August 6, 2007).

The primary problem for subprime borrowers whose loans have been securitized is that the investor group which owns the loan has little incentive to negotiate more favorable terms with a borrower who is finding it difficult to meet the monthly payments. When local banks hold loans they tend to know both the homeowner and the value of the property. These lenders were much more willing to renegotiate loan terms to avoid foreclosure costs and allow the borrowers to stay in their homes than are investor groups.

An additional problem with the securitized loan process is that it is far more fragmented and confusing to borrowers than the typical mortgage process. As the New York Times detailed, it is not uncommon for a subprime borrower to get their loan initially from a mortgage broker, have the loan pooled with others and sold to an investor group, have yet another entity process the loan payments, and finally have a fourth party represent the interests of the investor group as a trustee. It is the trustee that determines what can be done (or not done) to help distressed borrowers at risk of foreclosure. The New York Times also explained how this fragmented loan process lends itself more easily to fraud, either in terms of changing the initial terms of loans from fixed rates to variable rates or by allowing parties without proper legal standing to foreclose on homes.

The final impediment for subprime borrowers to overcome involves the federal tax code. The Internal Revenue Service currently considers mortgage loan "forgiveness" to be taxable income. Therefore, even when borrowers are successful in negotiating more favorable terms of their loans, they will often face a prohibitive federal income tax "penalty" as result. U.S. Senators George Voinovich (R-OH) and Debbie Stabenow (D-MI) introduced legislation know as the "Mortgage Relief Act" in July 2007 to insulate borrowers from this income tax penalty.

Home Foreclosures Likely to Get Worse Before They Get Better

Mortgage experts estimate that more than 2 million adjustable rate mortgages are expected to reset at higher rates in the second half of 2007. Economist Mark Zandi of Moody's Economy.com estimates that in October 2007 alone $50 billion in adjustable rate mortgages will reset.

The COHHIO study reports that 14% of Ohio subprime adjustable rate mortgages were in foreclosure at the end of 2006 and another 19% were more than 30 days late in payment. As a result, 33% of Ohio's subprime adjustable rate loans at the end of 2006 were in foreclosure or at risk of going into foreclosure. The report continues to state that while subprime loans account for 18% of outstanding mortgages in Ohio, they account for 63% of foreclosure starts.

The report also estimates that the above figures will only escalate in 2007 and 2008. According to data from the Center for Responsible Lending, roughly $14 billion worth of 2/28 and 3/27 subprime loans are expected to reset in Ohio in 2007 and 2008, encompassing an estimated 150,000 to 200,000 mortgages.

Impact of Foreclosures on Ohio's Economy

One of the most direct effects of a large increase in the number of home foreclosures is downward pressure on property values. If you type "home foreclosures" into Google you will immediately find countless opportunities to purchase foreclosed property at "bargain" prices. With the housing market already in a prolonged slump, a widespread infusion of foreclosed properties at cut-rate prices into an already saturated housing market will only force property values lower.

A second effect of turmoil in the home mortgage market is on stock prices. A front page headline in the August 10, 2007 New York Times reads, "Mortgage Losses Echo in Europe and on Wall St.". According to the article, the 387 point drop in the Dow Jones Industrial average on August 9, 2007 (the largest one day decline since February 2007), was fueled in part by unexpectedly large losses in French and Dutch banks deriving from investor-owned home loan securities of the type described above. It is reasonably expected that instabilities in these types of investor-owned mortgage securities will only worsen as the adjustable rate loans reset later this year and next, with the accompanying increase in foreclosures which is likely to accompany it.

Impact on Ohio's Tax Revenues

Generally, the performance of Ohio's General Revenue Fund (GRF) taxes tends to reflect changes in the state's economy. Without attempting to detail all of the possible ramifications of the mortgage crisis on GRF tax revenues, a few examples show why Ohioans should be concerned about the current situation.

1) Investors in the various instruments related to the housing market will earn less income, and lower income tax receipts will result.

2) If the mortgage crisis continues to affect the stock market generally, lower investor returns will tend to spread to all investments with additional downward effects on personal income and personal income taxes.

3) As foreclosures create housing "bargains," the weak market for new housing construction may continue. Housing construction creates employment opportunities, and construction workers make wages subject to income taxes. Fewer jobs and less wages mean lower income tax revenues.

4) Housing construction contractors pay sales tax on materials and equipment incorporated into new homes. Less construction activity means lower sales tax payments.

5) Construction workers use the relatively higher wages paid by construction jobs to make taxable purchases from which the State gains sales tax revenues. Again, fewer construction jobs will depress wages and lower purchasing activity and sales taxes.

6) As sub-prime homebuyers struggle to make payments computed at higher interest rates, they will have less disposable income to spend on other goods and services. Some of those foregone purchases would yield more sales tax revenues, but the diversion of that income to mortgage payments will not result in taxable transactions.

7) Lower home equity value or equity value against which homeowners already have borrowed means that such equity cannot support borrowing for other consumer purchases. For example, homeowners often use home equity to support a home improvement loan. Home improvements generate income and sales taxes in the same way that new construction does.

Conclusion

The use of a variety of home loan and mortgage investment practices in new ways or in new combinations has placed a large number of Ohio homeowners at risk. The consequences of these developments have become only partially apparent. The prospect for further increases in the number of Ohioans in jeopardy from these practices already looks serious.

A collapse of the home loan market in Ohio could undermine the health of both local and State governments. A flood of property foreclosures could depress housing prices with consequences for property tax revenues used by local governments. Effects on the amount of income received by Ohio workers and investors could threaten income tax growth. Effects on the construction sector of the economy and on homeowners as consumers of other products could depress sales tax collections as well.