

YOU THOUGHT THE MORTGAGE CRISIS WAS BAD?

A coming foreclosure flood

BY JERRY HARTZELL

RALEIGH

The subprime mortgage meltdown is going to be a bigger problem than people realize. The problem is not mostly behind us, it is mostly yet to come. This week Citigroup announced that it expects to take a loss of \$8 billion to \$11 billion on subprime loans. Citi's loss is just the tip of the economic iceberg America is hitting.

The numbers are so large as to be almost incomprehensible. In 2003, \$332 billion in subprime mortgages were outstanding. Today subprime mortgage loans total \$1.3 trillion. A recent congressional report says studies "show that cumulative default rates are very high. Estimates range from almost 18 percent to more than 20 percent."

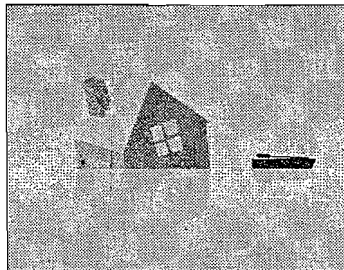
POINT OF VIEW

Foreclosure estimates based on past data are almost certainly too low, however, because three new, interrelated factors are at work.

■ The first is the kind of subprime mortgage that became prevalent in recent years. Roughly 90 percent of subprime mortgages originated in 2004 through 2006 were "2/28s" or "3/27s" — loans with low fixed rates of interest for two or three years ("teaser" rates), which then reset into adjustable rate mortgages at higher interest. When these loans adjust from the teaser rate, payments typically increase by one-third or more. The peak of the wave of 2/28 and 3/27 resets will occur during January through June of next year.

■ The second factor is that home values are no longer rising, they are declining. Between 1997 and 2006, average home prices across the nation increased by nearly 85 percent in inflation-adjusted dollars. Since the second quarter of 2006, home prices nationally have declined. Economists forecast further declines. Yale economics professor Robert Shiller, in recent congressional testimony, stated: "I am worried that the collapse of home prices might turn out to be the most severe since the Great Depression."

■ The third new factor is that subprime refinancing opportunities are disappearing. Lenders are getting out of the business. In September, Countrywide announced that it would no longer offer subprime loans. Other lenders have shut their doors. Wall Street has no appetite for providing money for new subprime loans.



● ● ●
THE DISAPPEARANCE OF THESE LOANS WILL HAVE A PROFOUND EFFECT on mortgage defaults and foreclosures. In the past, roughly three-fourths of subprime borrowers got out of their loans by refinancing, and the great majority of these borrowers refinanced into a new subprime loan. The subprime refinance option, for the most part, is no longer available.

These factors are obviously interrelated. Lack of subprime refinancing affects house prices; declining house prices affect the availability of refinancing; 2/28 resets affect both. But the fundamental point is that forecasts of defaults and foreclosures based on historical experience are inadequate. When the Center for Responsible Lending issued its estimate that 20 percent of the subprime mortgages originated in recent years would end in foreclosure, it wasn't exaggerating, it was being conservative.

America is facing the prospect of hundreds of billions of dollars of home foreclosures. The consequences of those foreclosures will include a depressing effect on house prices, particularly houses in the same neighborhood as homes in foreclosure. The economy as a whole will be profoundly affected. Most important, many families are going to lose their homes and many lives are going to be ruined.

● ● ●

THE SUBPRIME MORTGAGE CRISIS IS THE RESULT of the mortgage industry's getting out from under the regulatory limits to which it had formerly been subject, essentially eliminating state regulation, and marketing 2/28s as the mortgage product of the future.

If a few borrowers had taken out imprudent 2/28s, perhaps it might be appropriate to blame defaults on "irresponsible borrowers." But 90 percent of subprime loans in 2004-2006 were 2/28s or 3/27s — loans that were predestined to fail unless housing prices continued to go up significantly. This 90 percent figure compels the conclusion that the principal problem was the mortgage industry itself.

It may be easy to trace the sources of the problem, and it may be reasonably clear what needs to be done to avoid similar problems in the future. However prospective measures for how to avoid this problem again in the future are of limited immediate relevance. There is a crisis at hand now. The Titanic is hitting an iceberg. What we need urgently is lifeboats, more than new designs for how to build next year's ocean liner.

A bill currently before Congress — HR 3609, sponsored by Rep. Brad Miller, D-N.C. — could significantly reduce foreclosures. The bill would give bankruptcy judges the power to "modify" (reduce) home mortgages just like they can modify mortgages on vacation homes, farms, boats and automobiles. The bill would restore to bankruptcy law a provision that existed from 1976 to 1993. It would afford a means for mortgage borrowers to stay in their homes, making lower mortgage payments.

The mortgage industry, fighting efforts to deal with the problem it has created, has announced its opposition to the bill.

Jerry Hartzell is a Raleigh lawyer.