

## THE FORECLOSURE CRISIS

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### FORECLOSURES ON THE RISE: “HARD TO TALK ABOUT ANY RECOVERY”

Since the housing bubble burst, about four million families have lost their homes to foreclosure<sup>1</sup> and another four and a half million<sup>2</sup> have slipped into the foreclosure process or are seriously behind on their mortgage payments. When the economic damage finally abates, foreclosures may total between 8 million and more than 13 million, according to various estimates.<sup>3</sup> The foreclosure epidemic has hurt families and undermined home values in entire zip codes, strained school systems as well as community support services, and depleted state coffers. Even if the economy began suddenly booming the country would need years to recover.

Prior to 2007, the foreclosure rate was historically less than 1%. But the trend since the housing market collapsed has been dramatic: In 2009, 2.2% of all houses, or 1 out of 45, received at least one foreclosure filing.<sup>4</sup> In the fall of 2010, 1 in every 11 outstanding residential mortgage loans in the United States was at least one payment past due but not yet in foreclosure—an ominous warning that this wave may not have crested.<sup>5</sup> Distressed sales account for the majority of home sales in cities around the country, including Las Vegas, Phoenix, Sacramento, and Riverside, California.<sup>6</sup>

Returning to the 4,499 borrowers whose loans were pooled into CMLTI 2006-NC2: by September 2010, many had moved or refinanced their mortgages; by that point, 1,917 had entered foreclosure (mostly in Florida and California), and 729 had started loan modifications. Of the 1,715 still active loans then, 579 were seriously past due in their payments or currently in foreclosure.<sup>7</sup>

The causes of foreclosures have been analyzed by many academics and government agencies. Two events are typically necessary for a mortgage default. First, monthly payments become unaffordable owing to unemployment or other financial

hardship, or because mortgage payments increase. And second (in the opinion of many, now the more important factor), the home's value becomes less than the debt owed—in other words, the borrower has negative equity.

"The evidence is irrefutable," Laurie Goodman, a senior managing director with Amherst Securities, told Congress in 2009: "Negative equity is the most important predictor of default. When the borrower has negative equity, unemployment acts as one of many possible catalysts, increasing the probability of default."<sup>8</sup>

After falling 32% from their peak in 2006 to the spring of 2009, home prices have rebounded somewhat, but improvements are uneven across regions.<sup>9</sup> Nationwide, 10.8 million households, or 22.5% of those with mortgages, owe more on their mortgages than the market value of their house (see figure 22.1). In Nevada, 67% of homes with mortgages are under water, the highest rate in the country; in California, the rate is 32%.<sup>10</sup>

Given the extraordinary prevalence and extent of negative equity, the phenomenon of "strategic defaults" has also been on the rise: homeowners purposefully walk away from mortgage obligations when they perceive that their homes are worth less than what they owe and they believe that the value will not be going up anytime soon.

By the fall of 2010, three states particularly hard hit by foreclosures—California, Florida, and Nevada—reported some recent improvement in the initiation of foreclosures, but in November Nevada's rate was still five times higher than the national average. Foreclosure starts climbed in 33 states from their levels a year earlier, with the largest increases in Washington State (which has 9.2% unemployment), Indiana (9.8% unemployment), and South Carolina (10.6% unemployment), according to the Mortgage Bankers Association.

In Ohio, the city of Cleveland and surrounding Cuyahoga County are bulldozing blocks of abandoned houses down to the dirt with the aim of creating a northeastern Ohio "bank" of land preserved for the future. To do this, authorities seize blighted properties for unpaid taxes, and they take donations of homes from the Department of Housing and Urban Development, Fannie Mae, and some private lenders.<sup>11</sup> Now, the county finds itself under increasing duress, having endured 14,000 foreclosures in 2009.<sup>12</sup> After years of high unemployment and a fragile economy, the financial crisis took vulnerable residents and "shoved them over the edge of the cliff," Jim Rokakis, Cuyahoga's treasurer, told the Commission.<sup>13</sup>

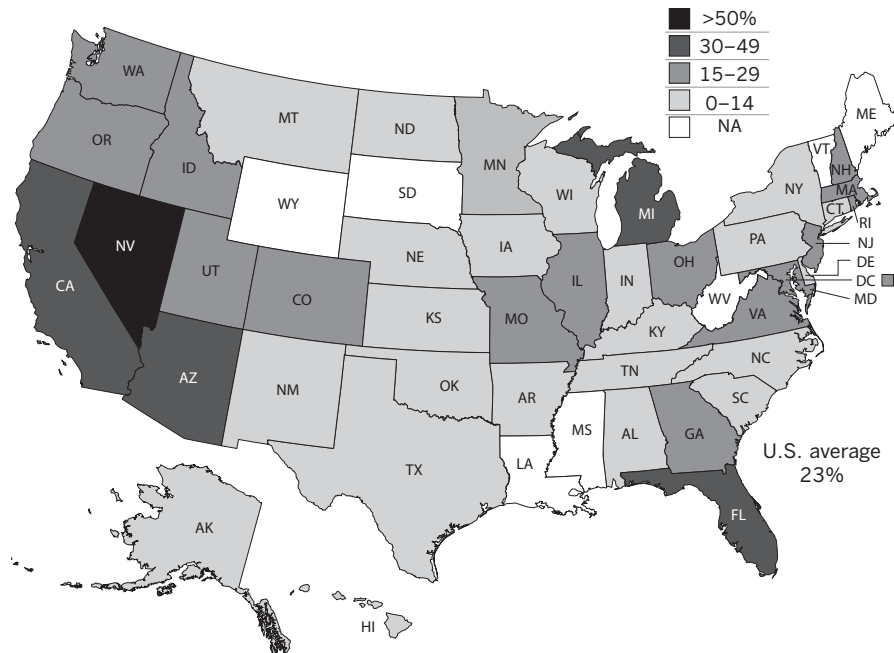
In a spring 2010 survey, 85% of the responding mayors ranked the prevalence of nonprime or subprime mortgages as either first or second on a list of factors causing foreclosures in their cities. Almost all the mayors, 92%, said they expected the foreclosure problems to stay the same or worsen in their cities over the next year.<sup>14</sup>

"There has been no meaningful decline in the inventory of distressed properties found in the housing market," Guy Cecala, the chief executive and publisher of Inside Mortgage Finance Publications, told a congressional panel overseeing the Troubled Asset Relief Program in October 2010. "It is hard to talk about any recovery of the housing market when the share of distressed property transactions remains close to 50 percent."<sup>15</sup>

## “Underwater” Mortgages

Many mortgage holders find themselves underwater; that is, owing more than their homes are worth. This is particularly true in Arizona, California, Florida, Michigan, and Nevada.

SHARE OF LOANS WITH NEGATIVE EQUITY, THIRD QUARTER 2010



SOURCE: CoreLogic

Figure 22.1

“There was a fundamental change in our financial services sector that really is the reason we’re in this crisis, this economic crisis, and is the reason we’re seeing and will see in total probably before we’re done, between 15 and 16 million foreclosure filings in this country,” John Taylor, the president and CEO of the National Community Reinvestment Coalition, explained to the FCIC. “And by the way, a few hundred thousand people, even a million people going into foreclosure, you can kind of blame and say, ‘Well they should have known better.’ But 15 [or] 16 million American families can’t all be wrong. They can’t all be greedy and they can’t all be stupid.”<sup>16</sup>

INITIATIVES TO STEM FORECLOSURES:  
“PERSISTENTLY DISREGARD”

The same system that was so efficient at creating millions of mortgage loans over the past decade has been ineffective at resolving problems in the housing market, including the efforts of homeowners to modify their mortgages. As mortgage problems mounted, the federal and state governments responded with financial incentives to encourage banks to adjust interest rates, spread loan payments over longer terms, or simply write down mortgage debts. But to date, federal auditors and independent consumer watchdogs have given the federal government's and the banks' mortgage modification programs poor grades.

The Home Affordable Modification Program (HAMP) is falling short of the 3 to 4 million families targeted for help by the end of 2012. (The program's resources come from the federal TARP funds.) As of December 2010, HAMP has resulted in the permanent modification of only 520,000 mortgages.<sup>17</sup> Meanwhile, the banks report that they have independently approved 3.4 million loan alterations of various kinds, although many of these modifications simply roll missed payments into a new mortgage and thus result in higher monthly payments.<sup>18</sup>

The effectiveness of state mortgage modification and foreclosure assistance programs is unclear. Some are just getting started. New Jersey, for instance, will begin a \$112 million “HomeKeeper Program” in 2011, to offer some residents who face foreclosure because of unemployment or “substantial underemployment” a deferred-payment, no-interest loan so that they can continue making payments on their mortgages.<sup>19</sup>

During a series of hearings in communities around the country affected by the housing crisis, the Commission heard from many witnesses about the extraordinary difficulties they had encountered in seeking to modify their mortgages and stay in their homes. Borrowers who have been paying down mortgages for years and have built up substantial equity are especially susceptible to being turned down for loan modifications, because the lender would prefer that they simply sell their homes. Kirsten Keefe, a senior staff attorney with the Empire Justice Center in Albany, New York, brought this issue to regulators' attention in March 2010. Speaking to the Federal Reserve Board's Consumer Advisory Council in Washington, Keefe identified trends among borrowers in New York who tried to qualify for the government's HAMP program. “We are also routinely hearing that folks who have a lot of equity are . . . being denied HAMP modifications,” she said.<sup>20</sup> Diane Thompson, from the National Consumer Law Center, testified to the United States Senate Committee on Banking, Housing, and Urban Affairs in November 2010 about the challenges of the program. She stated, “Only a very few of the potentially eligible borrowers have been able to obtain permanent modifications. Advocates continue to report that borrowers are denied improperly for HAMP . . . and that some servicers persistently disregard HAMP applications.”<sup>21</sup>

Competing incentives may encourage banks to view foreclosure as quicker, cleaner, and often cheaper than modifying the terms of existing mortgages.<sup>22</sup>

For them, foreclosure is a prudent response to default because, the data suggest, many borrowers who receive temporary or permanent forgiveness on their terms will slide into default again.<sup>23</sup> Also, servicers may receive substantial fees for guiding a mortgage through the foreclosure process, creating an incentive to deny a modification.<sup>24</sup>

Frequently, there's another complication to attempting a foreclosure or modification: the second mortgages that were layered onto first mortgages. The first mortgages were commonly sold by banks into the securitization machine. The second mortgages were often retained by the same lenders who typically service the mortgage: that is, they process the monthly payments and provide customer service to borrowers. If a first mortgage is modified or foreclosed on, the entire value of the second mortgage may be wiped out. Under these circumstances, the lender holding that second lien has an incentive to delay a modification into a new loan that would make the mortgage payments more affordable to the borrower.<sup>25</sup>

The country's leading banks now hold on their books more than \$400 billion in second mortgages.<sup>26</sup> To the extent the banks have reported these loans as performing, the loans have not been marked down on their books. The actual value of these second mortgages could be much less than their \$400 billion-plus reported value.<sup>27</sup> The danger of future losses is self-evident. Some frustrated first-lien investors have sued servicers, asserting they are not protecting investors' financial interests. Instead, they claim that because the servicer is holding the second lien, the servicers are looking after their own balance sheets by encouraging borrowers to keep up the payments on their second mortgage when they cannot afford to make payments on both obligations. According to Laurie Goodman, for mortgage modifications to work, the holders of the second mortgages will have to accept some losses—a potentially expensive proposition.<sup>28</sup>

A number of other obstacles have made modifications difficult. For example, there are competing interests among various investors in a mortgage-backed security. Proceeds from a foreclosure may be enough to pay off the investors holding the highest-rated tranches of securities, while the holders of the lower tranches would likely be wiped out. As a result, the holders of the lower-rated tranches might prefer a modification, if it produced more cash flow than a foreclosure.

Other efforts in the private and public sectors to address the foreclosure crisis have focused on encouraging short sales. In theory, short sales should help borrowers, neighborhoods, and lenders. Borrowers avoid foreclosure; neighborhoods avoid vacant, dilapidated homes that encourage crime; and lenders avoid some of the costs of foreclosure. Nonetheless, such deals frequently stall because the process is cumbersome, demands coordination, and eats up resources. For example, lenders can be reluctant to sign off on the buyer's bid because they are not sure that the home is being sold at the highest possible price. In addition, when there are two mortgages, the holders of the first and second mortgages must both agree to the resolution.

FLAWS IN THE PROCESS:  
“SPECULATION AND WORST-CASE SCENARIOS”

In 2010, additional issues have come to the fore, as problems with individual foreclosures have revealed systemic flaws in how lenders documented and processed mortgages for securitization. Legal experts and consumer advocates told the Commission that procedural and documentation problems with foreclosure have been laid out in court cases and academic studies for years, but were ignored until the number of foreclosures rose so dramatically.

All 50 of the nation’s state attorneys general banded together in the fall of 2010 to investigate foreclosure irregularities, identify possible solutions, and explore potential redress for borrowers who were harmed by improper foreclosures. For example, lenders have relied on “robo-signers” who substituted speed for accuracy by signing, and sometimes backdating, hundreds of affidavits claiming personal knowledge of facts about mortgages that they did not actually know to be true. One such “robo-signer,” Jeffrey Stephan of GMAC, said that he signed 10,000 affidavits in a month—roughly 1 per minute, in a 40-hour workweek—making it highly unlikely that he verified payment histories in each individual case of foreclosure.<sup>29</sup> In addition, a number of court cases have been filed alleging invalid notarizations, forged signatures, backdated mortgage paperwork, and failure to demonstrate having legal standing to foreclose—that is, being the entity with the right to repossess a home.<sup>30</sup>

The problem of legal standing arose because the rapid growth of mortgage securitization outpaced the ability of the legal and financial system to accurately record who owns the mortgage. During the securitization process, loans were sold multiple times. To speed up processing, the financial industry created Mortgage Electronic Registration Systems, Inc. (MERS), an organization made up of 3,000 mortgage lenders. It tracks changes in servicing rights and ownership interests in mortgage loans. MERS is designated as the “mortgagee of record” on behalf of its members, a status that is meant to give it the legal right to foreclose if the borrower fails to pay the loan. MERS has registered 66 million mortgages since launching in 1995 and had 33 million loans outstanding as of November 2010.<sup>31</sup>

The standing of MERS or its designees to foreclose has been called into question by courts and academics, however.<sup>32</sup> In a hearing before the House Judiciary Committee on the foreclosure crisis, New York State Supreme Court Justice F. Dana Winslow testified that “standing has become such a pervasive issue that I frequently use the term ‘presumptive mortgagee in foreclosure’” to describe MERS. Because of “multiple unrecorded transfers of the legal ownership of the [m]ortgage,” it is unclear whether MERS continued to be the mortgagee after subsequent sales of the loan, according to Winslow.<sup>33</sup> Moreover, courts have held that MERS does not own the underlying note and therefore cannot transfer the note or the deed of trust, or foreclose upon the property.<sup>34</sup>

Winslow also highlighted other deficiencies in MERS’ standing, many involving sloppy paperwork: the failure to produce the correct promissory notes in court during

foreclosure proceedings; gaps in the chain of title, including printouts of the title that have differed substantially from information provided previously; retroactive assignments of notes and mortgages in an effort to clean up the paperwork problems from earlier years; questionable signatures on assignments and affidavits attesting to the ownership of the note and mortgage; and questionable notary stamps on assignments.<sup>35</sup>

On November 16, 2010, a bankruptcy court ruled that the Bank of New York could not foreclose on a loan it had purchased from Countrywide, because MERS had failed to endorse or deliver the note to the Bank of New York as required by the pooling and servicing agreement. This ruling could have further implications, because it was customary for Countrywide to maintain possession of the note and related loan documents when loans were securitized.<sup>36</sup>

Across the market, some mortgage securities holders have sued the issuers of those securities, demanding that the issuers rescind their purchases.<sup>37</sup> If the legal challenges succeed, investors that own mortgage-backed securities could force the issuers to buy them back at the original price—possibly with interest. The issuers would then be the owners of the securities and would bear the risk of loss.<sup>38</sup>

The Congressional Oversight Panel, in a report issued in November 2010, said it is on the lookout for such risks: “If documentation problems prove to be pervasive and, more importantly, throw into doubt the ownership of not only foreclosed properties but also pooled mortgages, the consequences could be severe.”<sup>39</sup> This sentiment was echoed by University of Iowa law professor Katherine Porter who has studied foreclosures and the law: “It is lack of knowledge of how widespread the problems may be that is turning the allegations into a crisis. Lack of knowledge feeds speculation and worst-case scenarios.”<sup>40</sup> Adam Levitin, a Georgetown University associate professor of law, has estimated that the claims could be in the trillions of dollars, rendering major U.S. banks insolvent.<sup>41</sup>

#### NEIGHBORHOOD EFFECTS: “I’M NOT LEAVING”

For the millions of Americans who paid their bills, never flipped a house, and had never heard of a CDO, the financial crisis has been long, bewildering, and painful. A crisis that started with a housing boom that became a bubble has come back full circle to forests of “for sale” signs—but this time attracting few buyers. Stores have shuttered; employers have cut jobs; hopes have fled. Too many Americans today find themselves in suburban ghost towns or urban wastelands, where properties are vacant and construction cranes do not lift a thing for months.

Renters, who never bought into the madness, are also among the victims as lenders seize property after landlords default on loans. Renters can lose the roof over their heads as well as their security deposits. In Minneapolis, as many as 60% of buildings with foreclosures in 2006 and 2007 were renter-occupied, according to statistics cited in testimony by Deputy Assistant Secretary Erika Poethig from the U.S. Department of Housing and Urban Development to the House of Representatives Subcommittee on Housing and Community Opportunity.<sup>42</sup>



For children, a repossessed house—whether rented or bought—is destabilizing. The impact of foreclosures on children around the country has been enormous. One-third of the children who experienced homelessness after the financial crisis did so because of foreclosures of the housing that their parents owned or were renting, according to a recent study.<sup>43</sup> One school official in Nevada told the Commission about the significant challenges to the educational system created by the economic crisis.<sup>44</sup>

All around, the demand from people who need help is outstripping community resources. Coast to coast, communities are trying to stretch housing aid budgets to help people displaced by foreclosures. In Nevada, for example, Clark County, which contains 1.9 million people living in and around Las Vegas, was forced to cut its Financial Housing Assistance program, despite the clear needs in the community. Gail Burks, the president and chief executive of the Nevada Fair Housing Center, told the Commission that her group finds that many they counsel through the foreclosure process are in despair. “It’s very stressful. There are times that the couples we are helping end up divorcing, sometimes before the process is over. . . . We’ve also seen threats of suicide.”<sup>45</sup>

And the stories continue. Karen Mann, the appraiser from Discovery Bay, California, testified to the Commission about her family’s circumstances. Her daughter and son-in-law refinanced their mortgage into an adjustable-rate mortgage. When the time came for the rate to adjust upward, new financial troubles made the payments more than the family could afford. Because the market value of the home was nearly equal to their mortgage debt, the family’s attempts to get the mortgage modified were fruitless. They lined up a buyer for a short sale, but the deal was nixed. Then, when medical problems created yet another challenge, the couple and their four children moved in with Mann. “The children were relocated to new schools, and the adults dealt with the pain and emotional suffering while they were trying to rebuild their lives,” Mann said. The couple filed for bankruptcy. Two months after the bankruptcy was completed, the lender asked them if they wanted to modify their mortgage.<sup>46</sup>

In Cape Coral, Florida, Dawn Hunt and her husband, a mailman, and their two children live in an attractive ranch-style home they bought for about \$100,000 more than a decade ago. It was a quiet, 20-year-old subdivision where most of the residents were homeowners. In 2005 and 2006, builders rushed to the area and threw up dozens of new homes on empty lots. Homebuilder Comfort Homes of Florida LLC broke ground for a house across the street from the Hunts, but did not complete it. This fall, the house sat vacant, an empty shell. No stucco was ever applied to the concrete block exterior, and the house had no interior walls. A wasp nest decorated the electrical box near the front door. The untended grass had grown four feet high. Sharp sand spurs in the brush made it difficult to approach the property. Two doors down from the Hunts, another house was also vacant, left empty when a family split up and moved a year earlier. They abandoned a car in the garage. The roof leaked, and a blue plastic tarp put in place to keep the rain out now flaps in the breeze. The Hunts called the police after vandals broke into the house one night; intruders have been back twice more in the daylight.<sup>47</sup>



Now 44% of the homes in the Hunts' neighborhood are in default, are in the foreclosure process, or have been taken back by the bank.<sup>48</sup> Most of the other houses in the community are occupied by renters whose absentee landlords bought the houses when the homeowners lost their homes to their banks. The Hunts' house has lost two-thirds of its value from the peak of the market. Nonetheless, even though the neighborhood is not as lovely as it used to be, Dawn Hunt told the FCIC, "I'm not leaving."<sup>49</sup>

#### COMMISSION CONCLUSIONS ON CHAPTER 22

The Commission concludes the unchecked increase in the complexity of mortgages and securitization has made it more difficult to solve problems in the mortgage market. This complexity has created powerful competing interests, including those of the holders of first and second mortgages and of mortgage servicers; has reduced transparency for policy makers, regulators, financial institutions, and homeowners; and has impeded mortgage modifications. The resulting disputes and inaction have caused pain largely borne by individual homeowners and created further uncertainty about the health of the housing market and financial institutions.