



Statement of

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Introduction

Chairman Angelides, Vice Chairman Thomas and members of the Commission, CoreLogic appreciates the opportunity to testify at today's hearing regarding the causes and effects of the financial crisis on the greater Sacramento region.

My name is Mark Fleming and I am Chief Economist of CoreLogic. CoreLogic (NYSE: CLGX) is a leading global provider of consumer, financial and property information, analytics and services to business and government. We combine public, contributory and proprietary data to develop predictive and decision analytics and provide business services that bring dynamic insight to our customers in the mortgage-backed securities market, other private sector institutions and government.¹

Our data sets cover all communities in the United States, but today we have been asked to focus specifically on the Sacramento market. We are particularly honored to do so given that the original "CoreLogic" was founded in the Sacramento area in 1997 and today employs over 170 people here. Although we are now part of a larger organization that has assumed the CoreLogic name for a broader range of businesses, our ties to Sacramento remain an important part of who we are.

At the Commission's request, I, together with our other economists and analysts, have reviewed our proprietary databases -- including those reflecting real property values, real estate transactions, mortgage loan characteristics and performance, liens, tax status, delinquency and foreclosure. In addition to CoreLogic data sources, Bureau of Labor Statistics (BLS) and Mortgage Bankers Association (MBA) data sources were also used. Sources are cited along with each figure. Unemployment and Construction trends are from the BLS. Mortgage origination and application trends are from MBA. We analyzed the data with a view to providing insight into the following key questions:

¹ CoreLogic's information resources include:

- 98.7 percent of U.S. residential real property records;
- 80 percent of mortgage applications;
- 85 percent of mortgage loan servicing performance information;
- 97 percent of loan-level, non-agency mortgage-backed securities;
- Over 500 million historical [real property and mortgage?] transaction records;
- The nation's largest contributory mortgage fraud database; and
- More than 88 percent of the nation's property parcels digitally mapped.

- What are the mortgage demographics in Sacramento and the performance of those mortgages throughout the financial crisis and economic downturn?
- What are the sales transaction demographics and the influence of housing policy?
- What drove the large price increases as well as the large price declines in Sacramento and the resulting high levels of negative equity which will have implications for the Sacramento market for a number of years to come?
- What is the state of the economy in Sacramento, particularly the labor market because of its key role in providing mortgage homeowners the capacity to pay their mortgages?

The First Signs of Distress

At the beginning of the decade, low interest rates and policies intended to stimulate homeownership allowed consumers more effectively to leverage their incomes to finance housing. House price levels responded to this increased leverage capability by increasing in search of the market equilibrium. Furthermore, increasingly popular Alt-A and subprime loans often included lower down payments or were originated with simultaneous seconds that left little equity with the homeowner². Lower initial interest rates, payment options, negative amortization features, and low or no documentation features were also more common than on prime conforming loans. These loan features, collectively described as “affordability features,” allowed borrowers to further leverage their income to finance housing. Affordability products and low interest rates gave borrowers the ability to further extend their buying power and buy their first home or a bigger home as well as use home equity for non-housing consumption. As a result, households increased their debt burdens, their susceptibility to payment shock, and their exposure to a declining house price environment. The “underwriting tightness,” the difference in volume between mortgage applications relative to mortgage originations, is a good proxy for the availability and liquidity of mortgage debt (figure 1). In addition to the large increase in applications and originations from 2000 to 2007 one can see the underwriting tightness rise dramatically due to the refinance boom of 2002 and 2003, as many borrowers sought refinancing but not all qualified. After the

² There are no clear delineations between Alt-A, subprime, and prime in terms of credit quality, loan to value ratio, or overall loan risk. For the purpose of this analysis Alt-A and subprime is determined by the generally accepted levels of documentation, credit quality, and the self reported characterization of the originating lender.

refinance boom subsided, underwriting tightness declined dramatically in 2006, indicating a high degree of mortgage credit liquidity and looser underwriting guidelines.

As prices began to fall in 2007, the financial crisis set in and underwriting tightness rose dramatically. The first types of loans that exhibited distress were Alt-A and subprime (figure 2). The share of loans in foreclosure began to rise in early 2007 while the largest loan type in the overall market, prime conforming loans, showed no signs of distress. Furthermore, the overall share of Alt-A and subprime loans in foreclosure has remained consistently higher than other loan types. Alt-A and subprime loans “ran off” either through (i) refinance into more traditional loan products for those with equity and the capacity to pay a traditional loan or (ii) foreclosure for those unwilling or unable to refinance or make the continuing payments. What is left in markets that have experienced significant price declines is a substantially reduced share of Alt-A and subprime loans in the overall market, but a population that is heavily distressed.

Mortgage Performance in Sacramento

In the first half of the decade, California in general and Sacramento in particular experienced below average serious delinquency rates (figure 3), in large part benefiting from the significant house price appreciation that was occurring. Borrowers with capacity constraints paying their mortgages likely had the ability to refinance or sell their home rather than accept serious delinquency or foreclosure. The rising tide lifted all boats.

As price appreciation turned into depreciation in the second half of 2006 and into 2007, the delinquency rate among all active California and Sacramento loans rose quickly and moved beyond the national level. The national, state, and Sacramento serious delinquency trends all reached their peak at the end of 2009. The moderation in the serious delinquency rates is in part because the newer vintages of loans from 2009 and 2010 are faring much better than the older vintages which have experienced higher prepayments, foreclosures, short sales and modifications.

Early payment defaults (figure 4), defined as 90 days delinquent within the first year, rose slightly at the onset of the decade due to the recession but then declined below 0.5 percentage points as price levels increased. As with serious delinquencies, early payment defaults (EPDs) rose dramatically as house prices declined. This became an early indicator of distress that borrowers faced at the height of the crisis. More recently EPDs have fallen dramatically back to pre-crisis levels. Under the more conservative underwriting standards of the 2008-2010 era, individuals are being more rigorously qualified for

sustainable loans and therefore serious delinquency in the early stages of a loan's life is less likely. When it does occur it, is most likely due to the unfortunate timing of an individual losing his or her job.

The Commission staff requested data on first payment defaults (figure 5). FPDs declined from an elevated level as the recession at the beginning of the last decade waned, but then rose again dramatically during the real estate boom, a period marked by house price growth, low interest rates, and a healthy economy. FPDs have declined precipitously with the waning availability of affordability products and dramatically increased underwriting tightness.

Poor Mortgage Performance Drives the Housing Market

The overall level of sales transaction activity (figure 6) in Sacramento contracted very quickly from 2005. The year-over-year growth rate in January 2005 was close to 20%. A year later, in January 2006, the annualized growth rate had turned into a *contraction* of 40%. This was a significantly more abrupt contraction than either the nation or California experienced. Over the course of 2006 and 2007 sales transaction volumes continued to contract, but then in late 2008 and early 2009, during the height of the financial crisis, actually rebounded briefly and dramatically. One can also see in this chart the influence of the tax credit causing short bursts of sales transaction activity in the fall of 2009 and again in the spring of 2010, yet the effect is not as dramatic as observed nationally, in part likely due to large shares of negative equity muting the supply and demand (discussed below).

What caused the large increase in sales volumes in Sacramento and California, but not nationally, in 2008? While the overall levels of sales activity rebounded in 2008, the types of sales were very different (figure 7). REO and Short Sales, collectively "distressed sales", accounted for 62% of all the sales in September 2008. While the overall volume had returned to 2006 pre-crisis levels, the composition was very different. These were the distressed assets that had gone delinquent in 2006 and 2007 being resolved and moved back into the market. Distressed sales remain a major component of the market today. Sacramento is ranked 4th among major metropolitan areas for its current distressed sale share (figure 8), at 51%, only eclipsed by Las Vegas, Riverside and Phoenix.

Not all seriously delinquent loans will result in distressed sales. A small share will cure, others will be modified, and some will refinance. Nonetheless, monitoring the potential "upper bound" of distressed sales serves as a simple proxy that we believe will also be a leading indicator of stabilization and improvement in the shadow inventory. The upper bound of the pipeline or "shadow inventory" of distressed sales, expressed as the months' supply of distressed homes, can be approximated by dividing the amount of seriously delinquent loans by the current monthly pace of sales (figure 9). Prior to the

crisis, the months supply of distressed homes in Sacramento was lower than nationally and in line with California as a whole. But as delinquencies rose in 2007 and sales volumes fell, the months supply rose dramatically in Sacramento to a January 2010 peak at more than 18 months. The moderate increase in the sales volume and the stabilization of delinquency levels has caused the months supply of distressed homes to decline to 12.5 months, slightly below California, but still well above the national level.

Prices Stimulated by Excess Demand and Depressed by Distressed Supply

Taking the long view, from 1976 when our house price indices begin, one can easily see the unprecedented increase in price levels in the 2001 to 2007 period (figure 10). California and Sacramento significantly outpaced the national increase in price levels. The ensuing correction in price levels resulted in a 45% decline in prices from the peak to the current level in Sacramento. Most recently prices have remained relatively stable, in part because of housing policy action such as the first-time homebuyer tax credit, federal reserve MBS purchases maintaining low mortgage rates, and the impact of government programs to prevent foreclosure (HAMP, HARP, HAFA).

It should be noted that California, and Sacramento more specifically, is not unfamiliar with residential house price volatility (figure 11). Year-over-year growth rates exhibit much more variation in California and Sacramento than nationally. In fact prices rose dramatically in the late 1980s and 1990, followed by moderate declines in the early 1990s, only to recover their prior price peak in the late 1990s (figure 10). Even so, the current decade has the largest boom and bust cycle in residential house prices observed since our tracking began in 1976.

Over the last three months, after the expiration of the tax credit, sales transaction volumes have withered and the minimal growth in prices in Sacramento has waned. It would not be surprising to see further moderate declines in prices as the real estate market awaits the return of buyers, works off the overhanging excess supply of homes for sale, and mortgage servicers bring to resolution the supply of distressed assets through modification, short sale, or foreclosure.

Because real estate market activity is highly localized, the gains or losses in prices are not typically distributed uniformly throughout the metropolitan area (figure 12). Mapping peak to current declines in price levels by zip code shows the clear variation. Interestingly, the pattern that emerges is that the newly developed zip codes in the desirable foothills east of downtown Sacramento as well as the zip codes around and north of Davis, the location of the University of California at Davis, fared better than the zip codes in and around the core of Sacramento. This pattern is atypical compared to other major metropolitan areas where the exurban, newly developed areas, had sharper declines compared to the urban

core. The difference in the spatial variation observed in Sacramento may be explained by the unique amenities that the exurban zip codes of Sacramento have to offer. The eastern zip codes offer view amenities as well as better access to activity destinations around Lake Tahoe. The western zip codes offer access to the college town of Davis as well as shorter commutes to the San Francisco bay area.

The Enduring Problems of Negative Equity

One of the most persistent and troubling effects of the financial crisis is the high level of negative equity many communities now face (figure 13). Negative equity is measured on properties with mortgages by estimating the current value with an automated valuation model, and comparing that to the total of all the liens on the property, accounting for utilization of HELOCs and loan amortization. This provides an estimate of the “true” LTV of the property. Nationally, as of the end of the second quarter of this year, the share of mortgaged homes with negative equity was 23%. The average LTV of mortgaged properties was 70%. In California the share of underwater properties was 33% and in Sacramento the share was 43% -- almost every other mortgaged home. Sacramento’s higher negative equity share has resulted in an average LTV of mortgaged properties of 88%.

Because many properties are significantly underwater and expectations for future price appreciation are low, we expect that negative equity will persist in Sacramento for many years to come. Negative equity reduces mobility -- the ability of homeowners to sell their homes and move for job opportunities or other household reasons. In the short term, this helps the Sacramento housing market as it reduces the supply of homes for sale. But in the long term, it can be detrimental as it reduces the mobility of labor to migrate to locations where jobs are available. Therefore, negative equity can be a drag on the ability of the unemployment rate to fall.

Strategic default is also a more prevalent risk given high levels of negative equity. Borrowers clearly have a stronger incentive to consider strategically defaulting when their home is significantly underwater. Additionally there are clear contagion effects that increase the likelihood of strategic default if others in the local area are doing so. Therefore, areas with high concentrations of deep negative equity such as Sacramento are more susceptible to strategic default.

The Economy is Now the Driving Force of Mortgage Performance and the Real Estate Market

Alt-A and subprime were the first loan types to show distress in the crisis and will continue to contribute to the shadow inventory. As of June 2010, California has twice the national average share of Alt-A loans outstanding (10.1%), while Sacramento has an 8.9% Alt-A share (figure 14). The current

subprime share, on the other hand is actually lower in California and Sacramento than nationally. Both market segments have had significant share declines over the last three years as (i) very few new Alt-A and subprime originations have occurred and (ii) these two loan types have experienced significantly higher delinquency and foreclosure levels. The current serious delinquency rate on Alt-A loans in Sacramento is 31% and for subprime loans 40% (figure 14).

Prime loans, on the other hand, did not show stress initially, but as the economic conditions deteriorated the foreclosure rates for this loan type increased also (figure 2). While the underwriting tightness has declined from the crisis peak in 2009, it remains elevated relative to historical norms (figure 1). The more restrictive underwriting and regulatory environment will likely prevent the re-emergence of “affordability” products, so the new driver of mortgage performance and the real estate market will be the economy.

One of the best, readily available measures of economic health is the unemployment rate. It not only measures broadly the local economy’s ability to provide residents jobs, but is also an important reference point for the mortgage finance markets as it correlates closely to the ability and capacity of homeowners to service their mortgage debt. Unemployment, together with divorce and medical events, remains one of the principal causes of mortgage delinquency.

The July 2010 Sacramento unemployment level (figure 15) was 12.7%, compared to 12.3% in California and 9.5% nationally. During the first half of the decade, Sacramento unemployment levels were typically in line with the national trend, ranging between 4% and 6%. In the summer of 2006, as the housing market slowed, unemployment levels began to rise at a faster rate than the national trend. During the recession the unemployment rate rose to an apex of 13% in the first quarter of 2010 and has since moderated slightly. While the *trend* of Sacramento and California as a whole is very similar to that of the nation, the *level* remains a few percentage points higher. The general consensus nationally is that unemployment will remain stubbornly high throughout 2010 and into 2011 as economic recovery is muted and driven by productivity gains more than rehiring or new job creation.

Another important indicator of a region’s overall economic health is the pace of residential construction. Nationally, residential permits, an indication of new construction starts, are less than 29% of the pre crisis levels in 2005 (figure 16). In California and Sacramento the levels are 20% and 16% respectively of the pre crisis levels in 2005. Additionally, investment in residential construction is typically one of the first industries to lead the economy out of recession. This is not happening in this recovery as the high levels of excess housing supply will continue to depress residential investment in the

near term. Conversely, the lack of new residential units entering the market will help the excess inventory of residential units to decline to more reasonable levels and reduces downward pressure on current house prices.

Conclusions

Among other factors, declining mortgage rates and policies intended to increase homeownership in the early part of the decade allowed borrowers to leverage their incomes and afford more expensive homes. House prices responded to increased leverage by rising in response to the increased demand. Furthermore, loan products that allowed borrowers to leverage incomes even more effectively and increased speculative behavior further added to the upward price pressures. Once affordability was no longer possible given interest rate increases and more restrictive loan terms, speculators began to exit the market and price growth slowed. Over-extended borrowers became delinquent and the shadow inventory rose. As the first wave of delinquencies became foreclosures and REO sales increased, downward pressure on prices increased. This in turn caused the share of borrowers in negative equity to increase and created a feedback loop to more foreclosures. Private demand for homes declined because housing was viewed as a deflationary asset and many who would move could not because their existing home was underwater. As the economy worsened more traditional mortgage borrowers also felt the stress of capacity constraints and negative equity, further adding to the shadow inventory. House prices have responded to these pressures.

In Sacramento, low mortgage interest rates and affordability-based loan products played a role in the stimulation of house price growth that, once ended, also caused overall mortgage performance to be more susceptible to price declines. The resulting high levels of serious mortgage delinquency and increases in the share of sales activity that was either REO or short sales further pressured house price declines. Now the influence of high unemployment rates and negative equity will likely be the driving forces of distress going forward in Sacramento and throughout the country.

Thank you again for the opportunity to contribute CoreLogic's data and insights to the important work of the Commission.

Exhibits

The accompanying exhibits are provided as references for the written testimony above.

Exhibits to Statement of

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Figure 1

Mortgage Underwriting Tightness

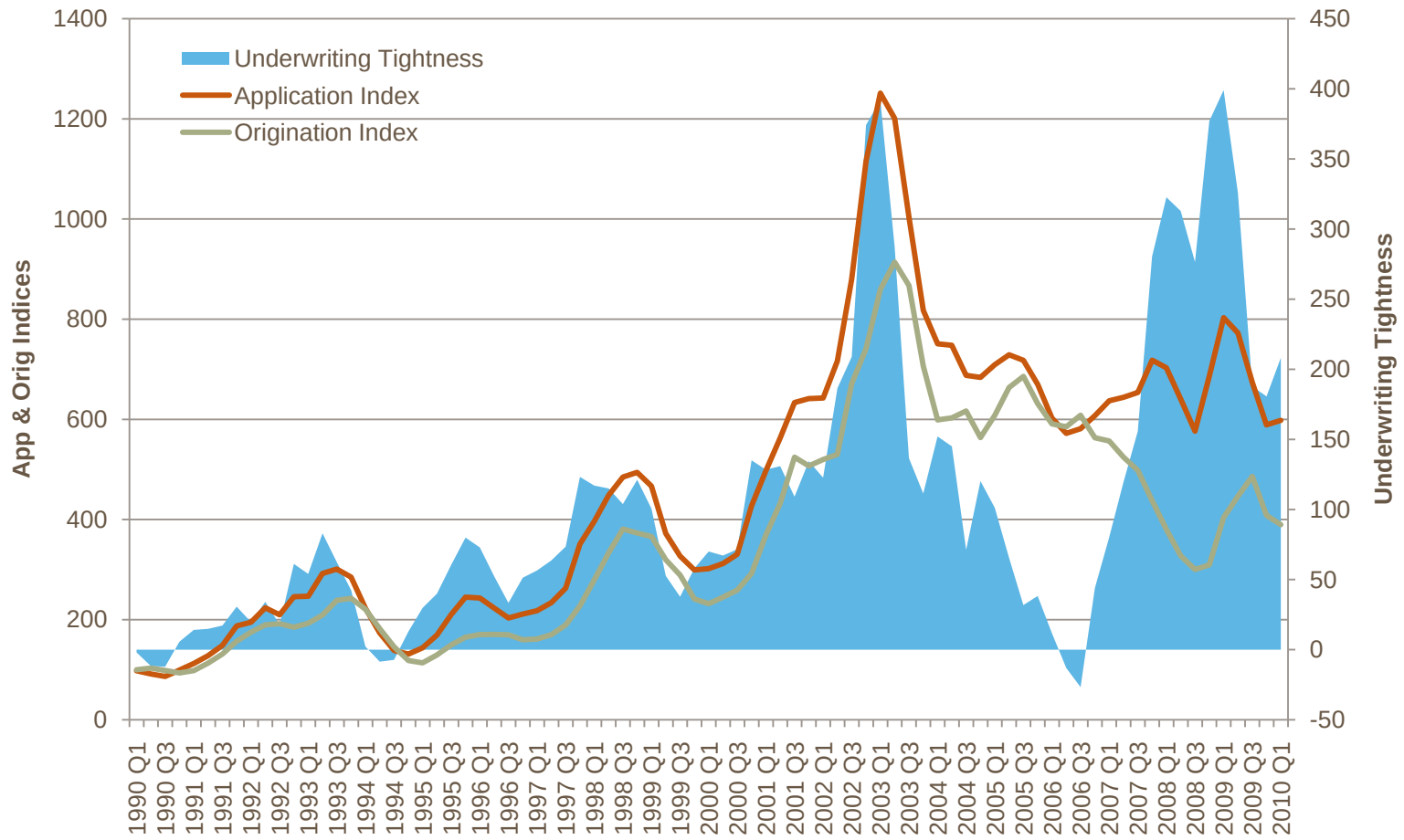


Figure 2

Mortgage Foreclosures

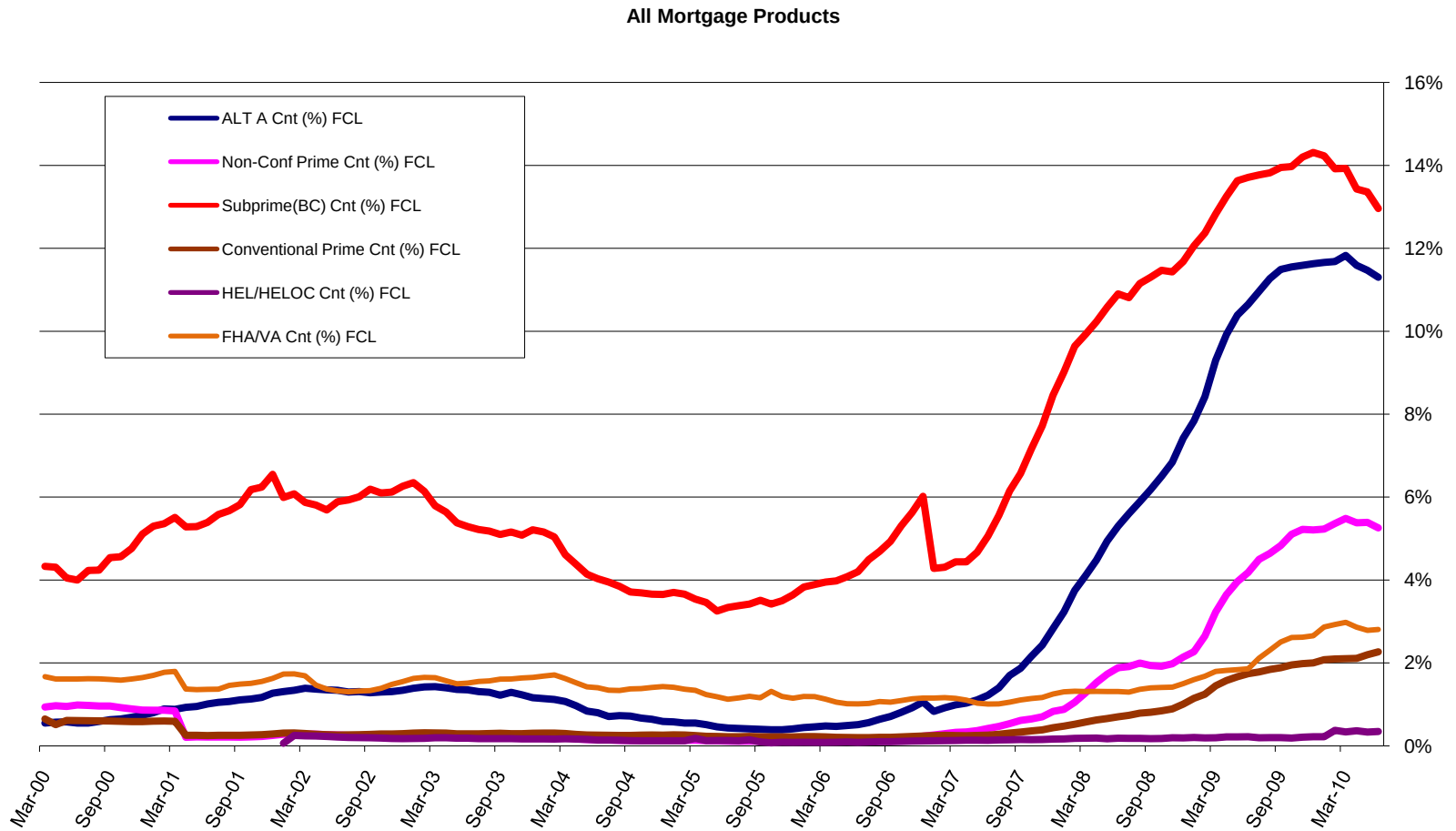


Figure 3

Mortgage Performance Trend

90+ Day Delinquency Rate

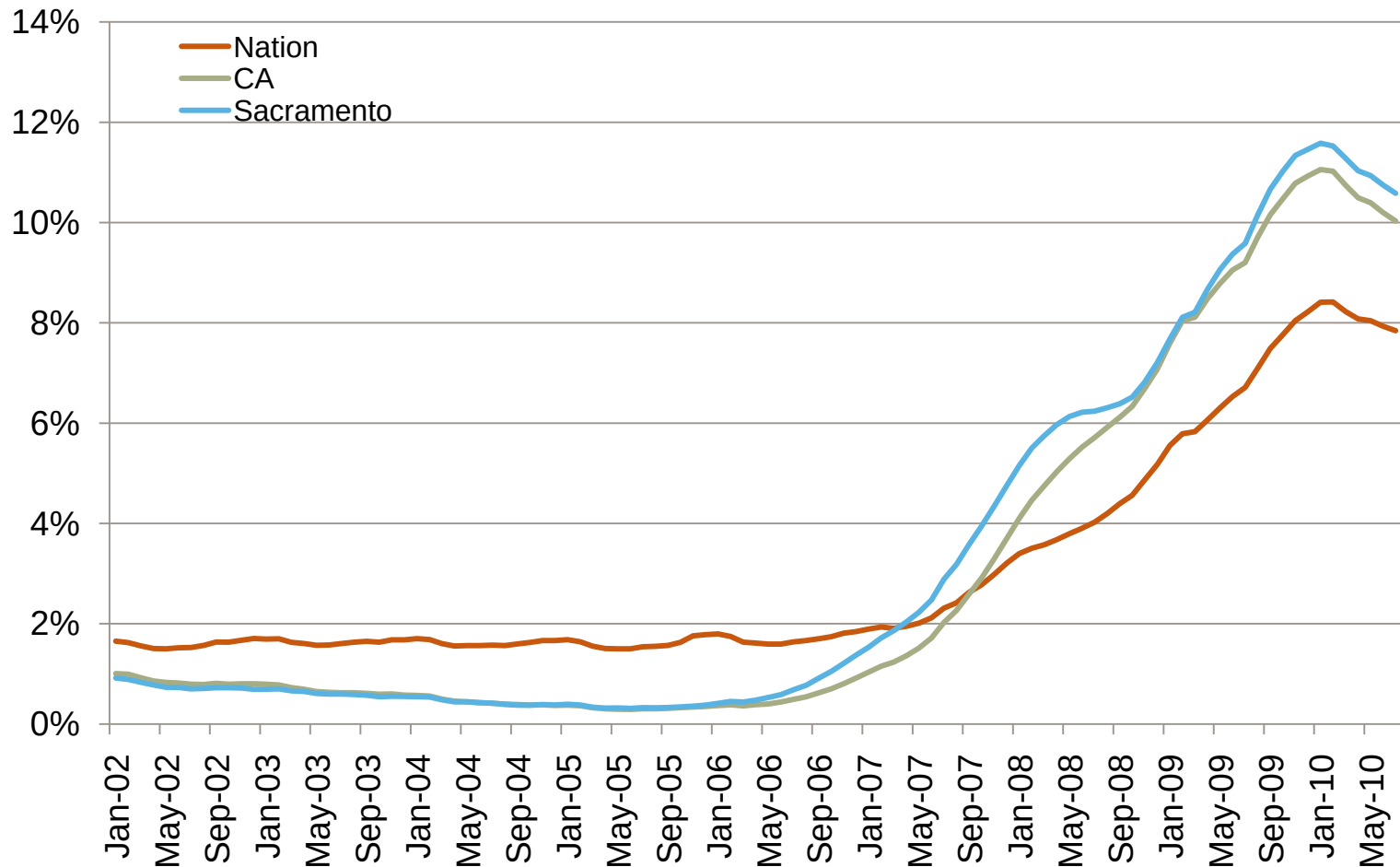


Figure 4

Mortgage Performance Trend

Early Payment Default (EPD) Rate

(EPD Rate of Loans Less than 12 Months Old)

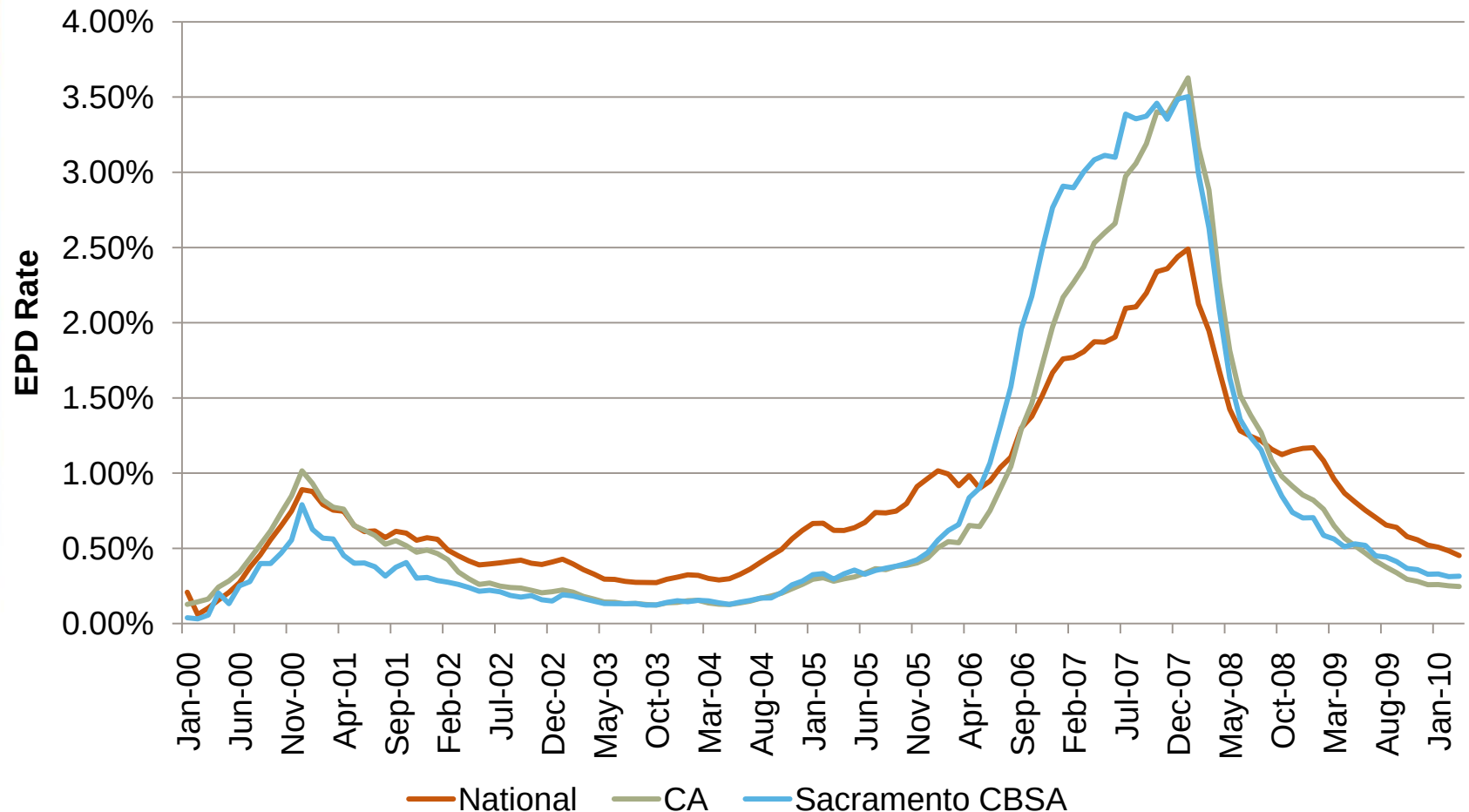


Figure 5

Mortgage Performance Trend

First Payment Default (FPD) Rate
(3 Month Moving Average FPD Rate of Loans 1 Month Old)

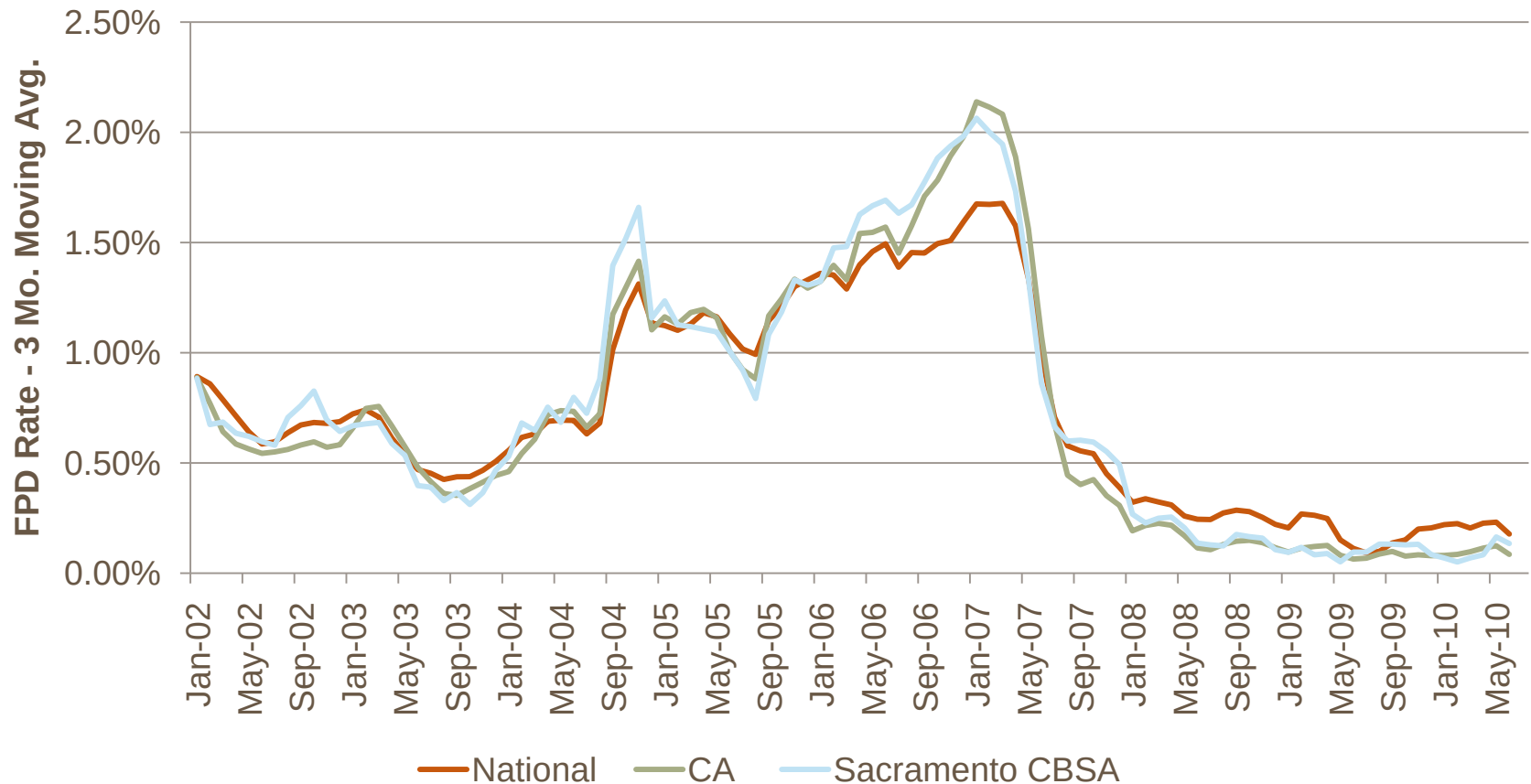


Figure 6

Sales Transaction Growth

Total Home Sales

Percent Change from Year Earlier

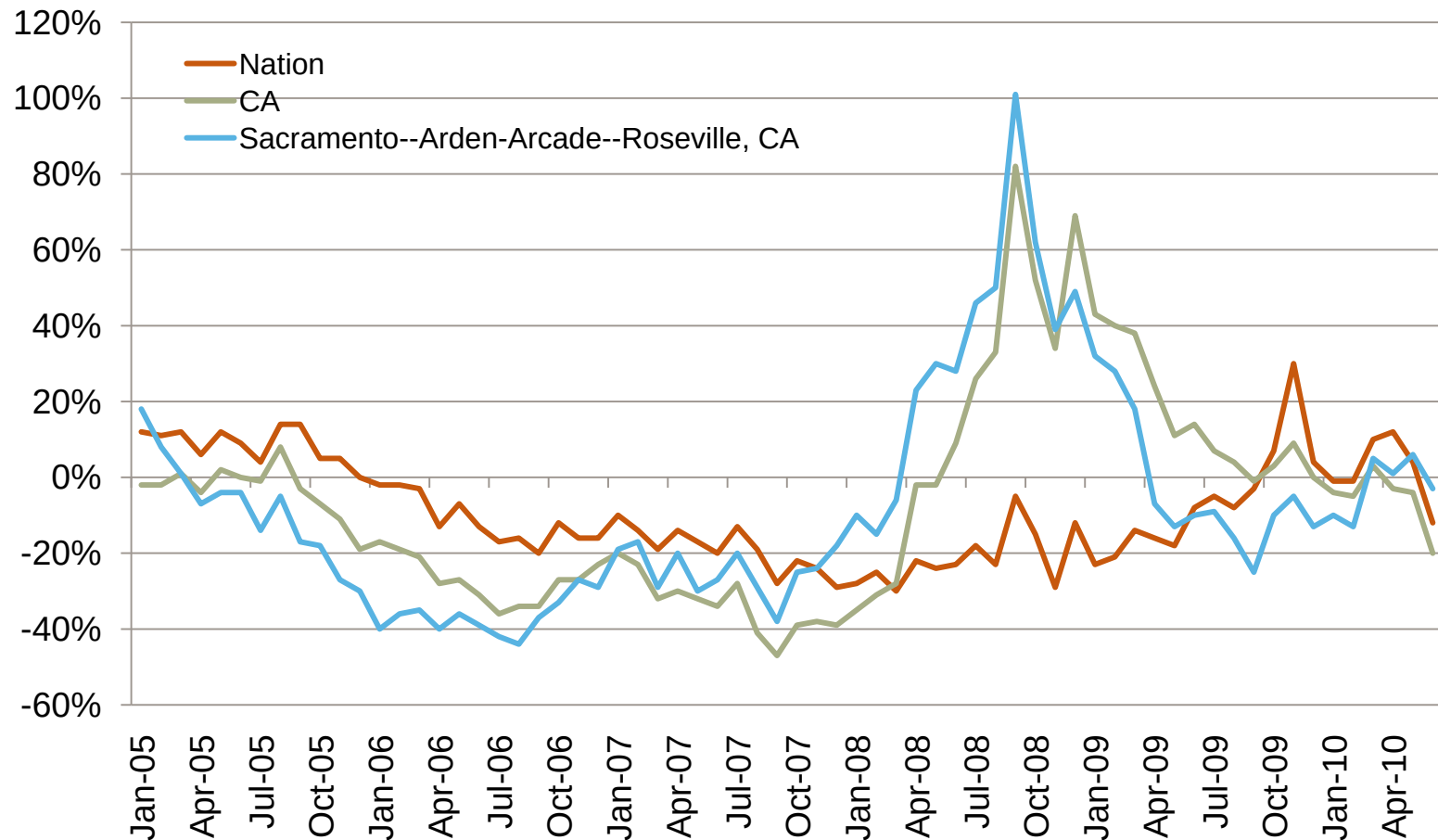


Figure 7

Non-Distressed Sales Remain Very Low

Sacramento Home Sales

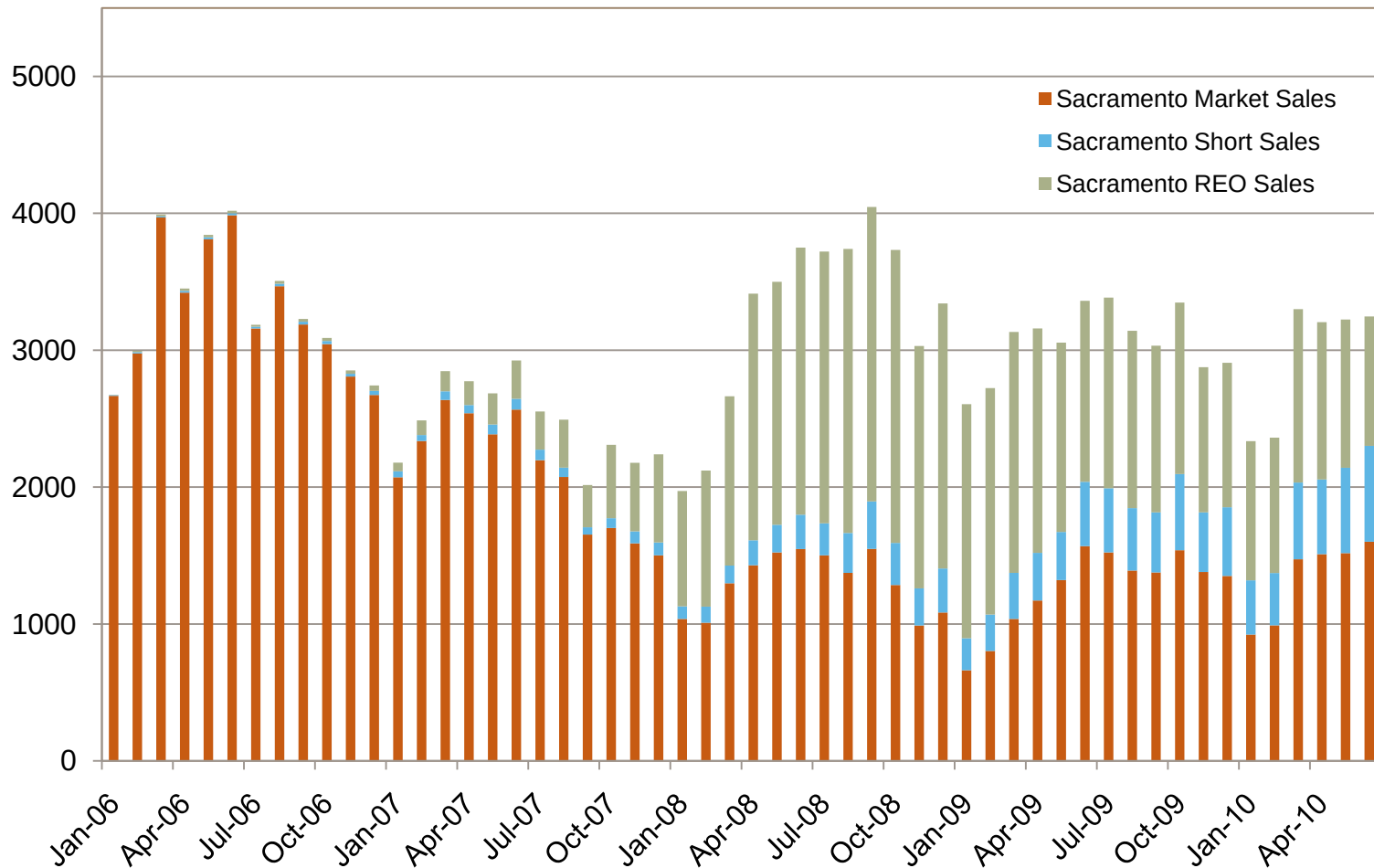


Figure 8

Distressed Share By Core Based Statistical Area

Distressed Sale Share by Market

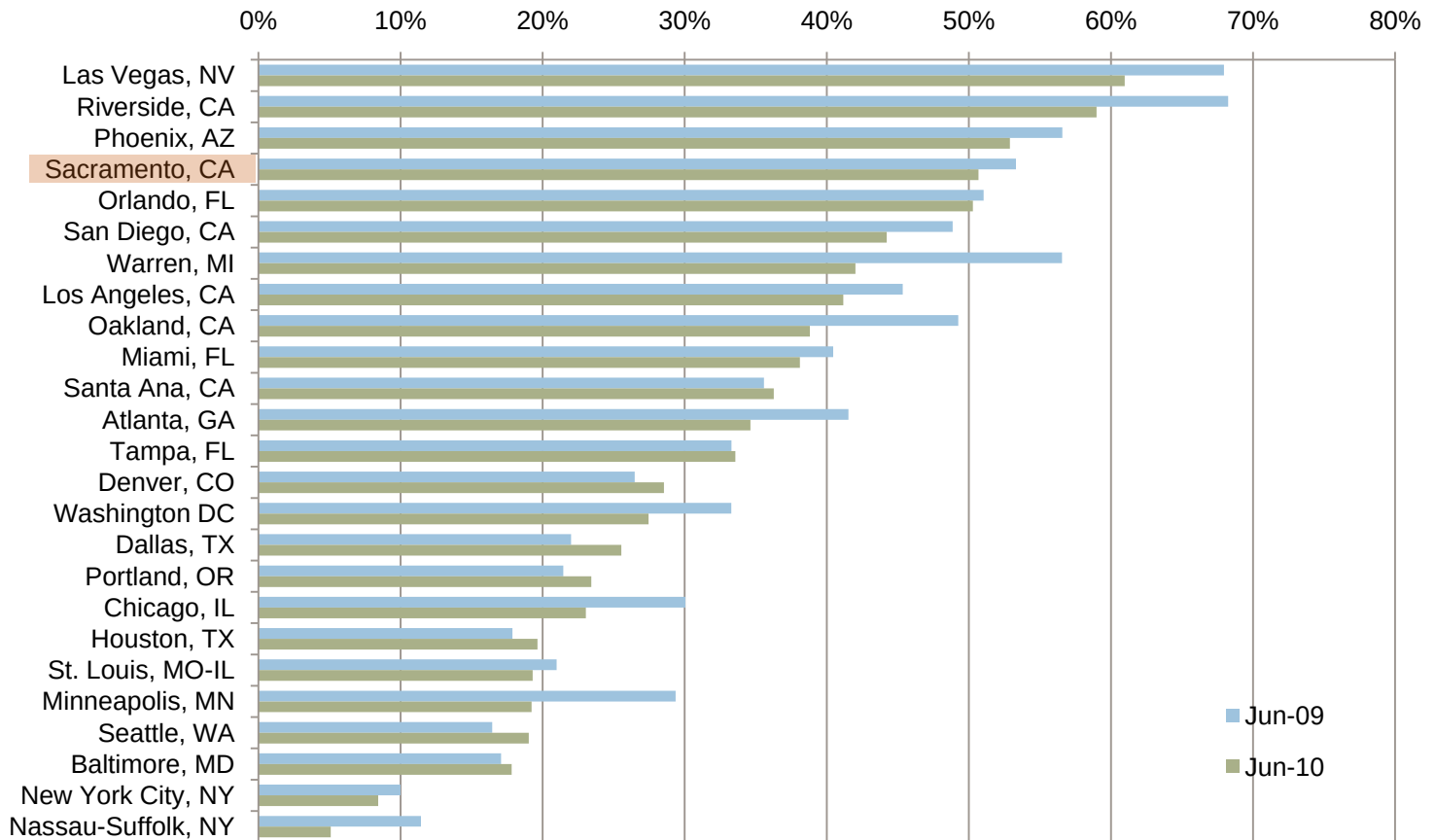


Figure 9

Distressed Supply-Shadow Inventory

Months Supply Distressed Homes

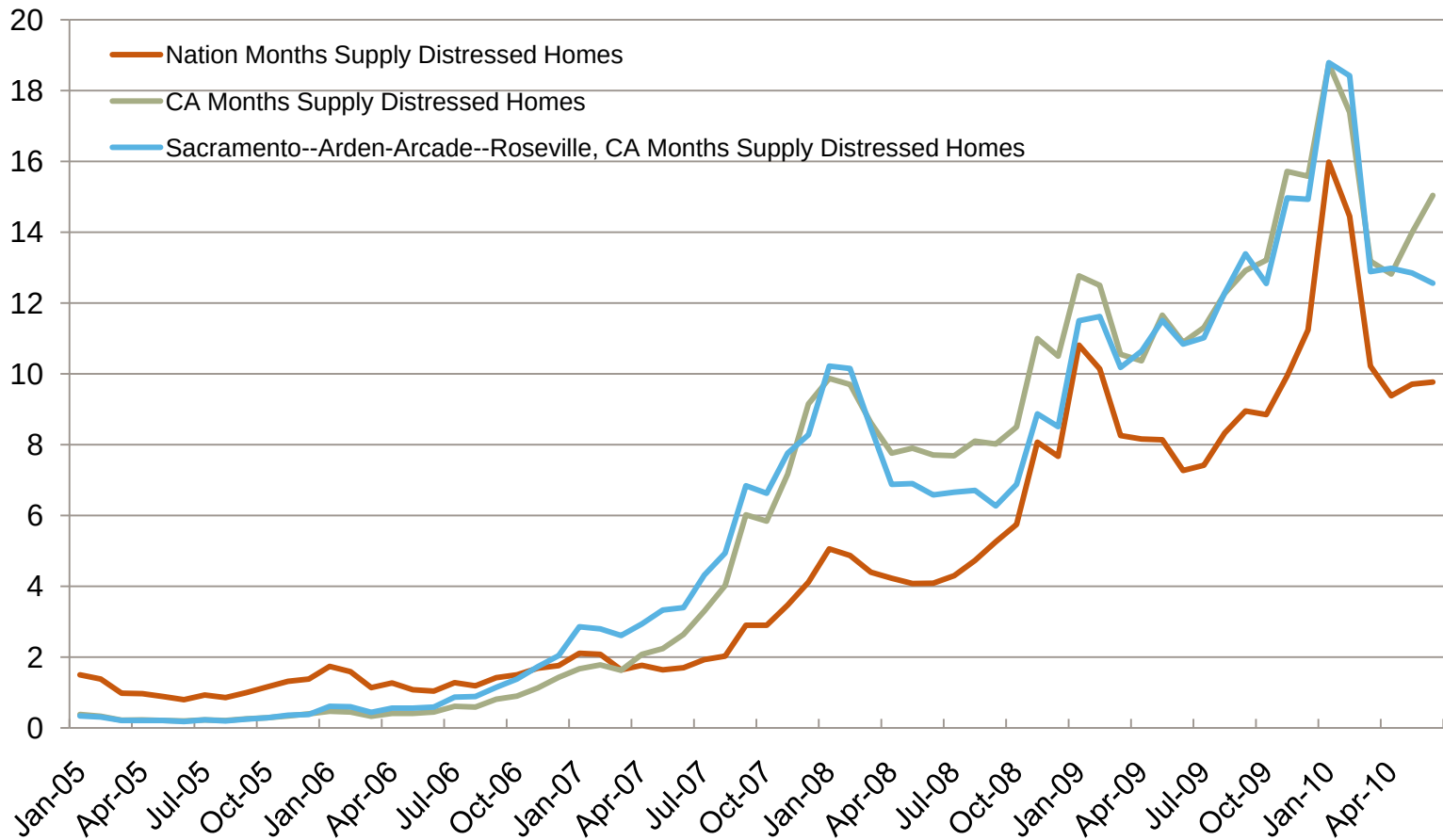


Figure 10

House Price Levels

Home Price Index: All Residential Single-Family Properties

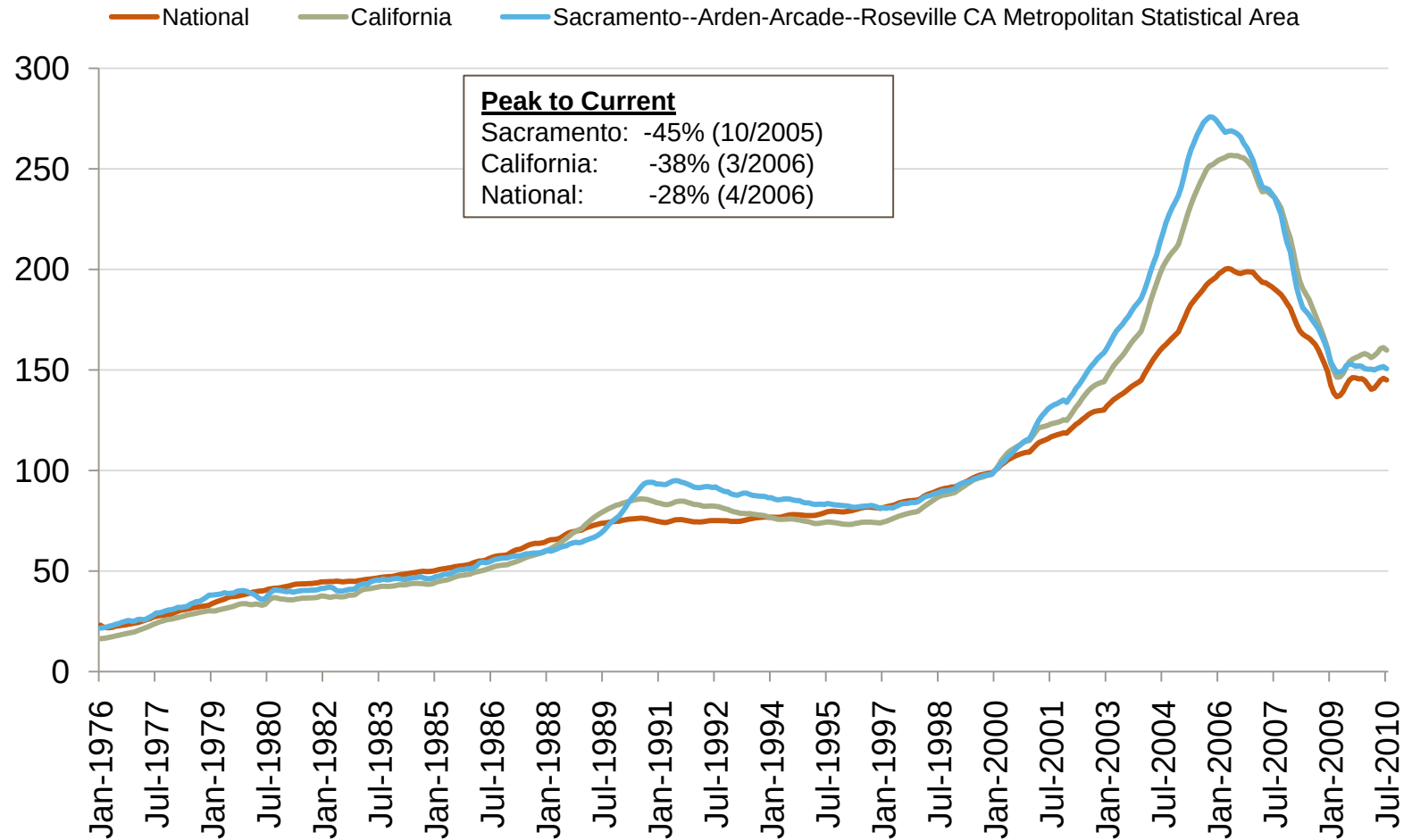


Figure 11

House Price Growth

Year-Over-Year Change in Home Price Index

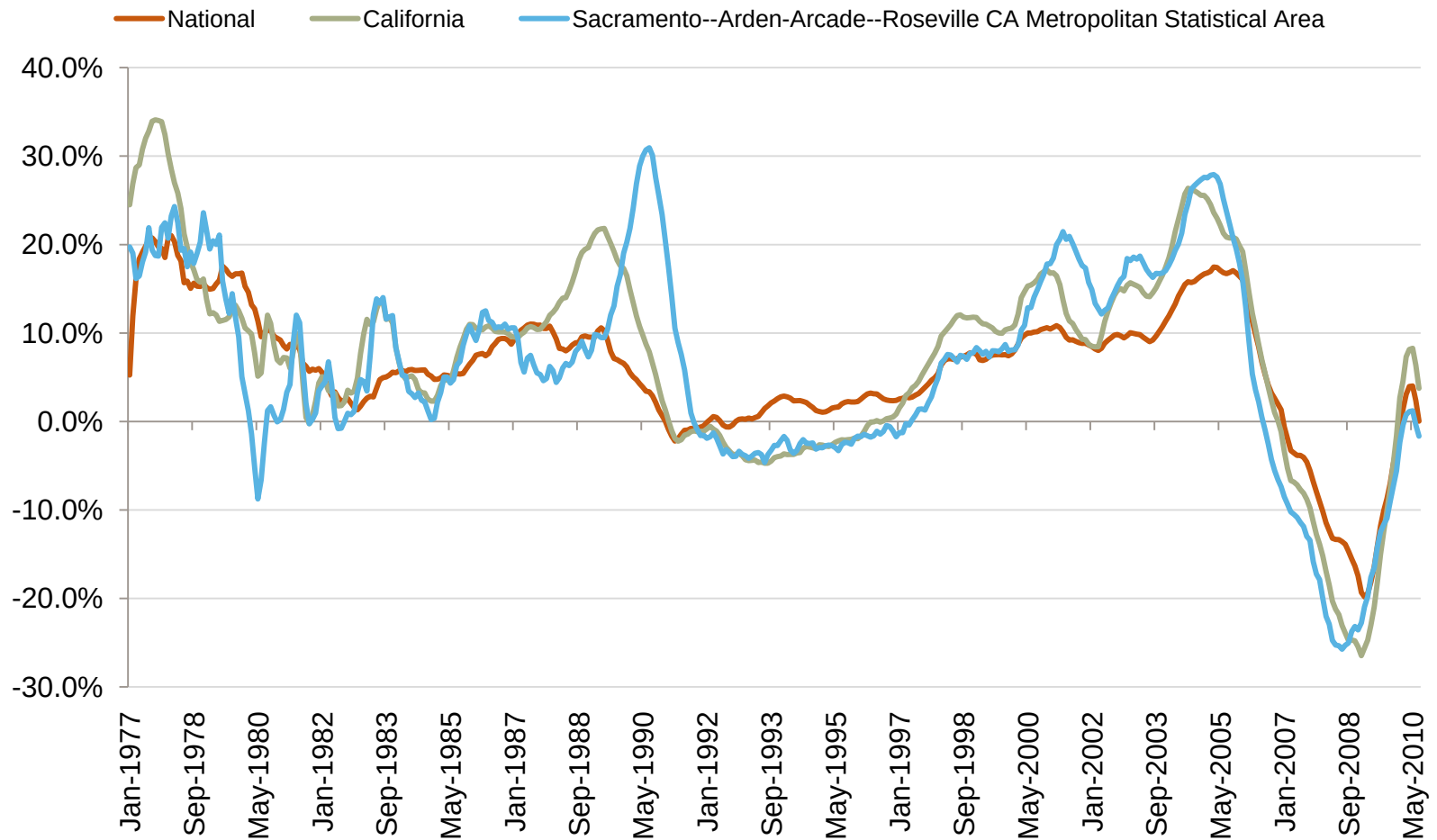


Figure 12

Peak to Current Percent Change by Zip Code

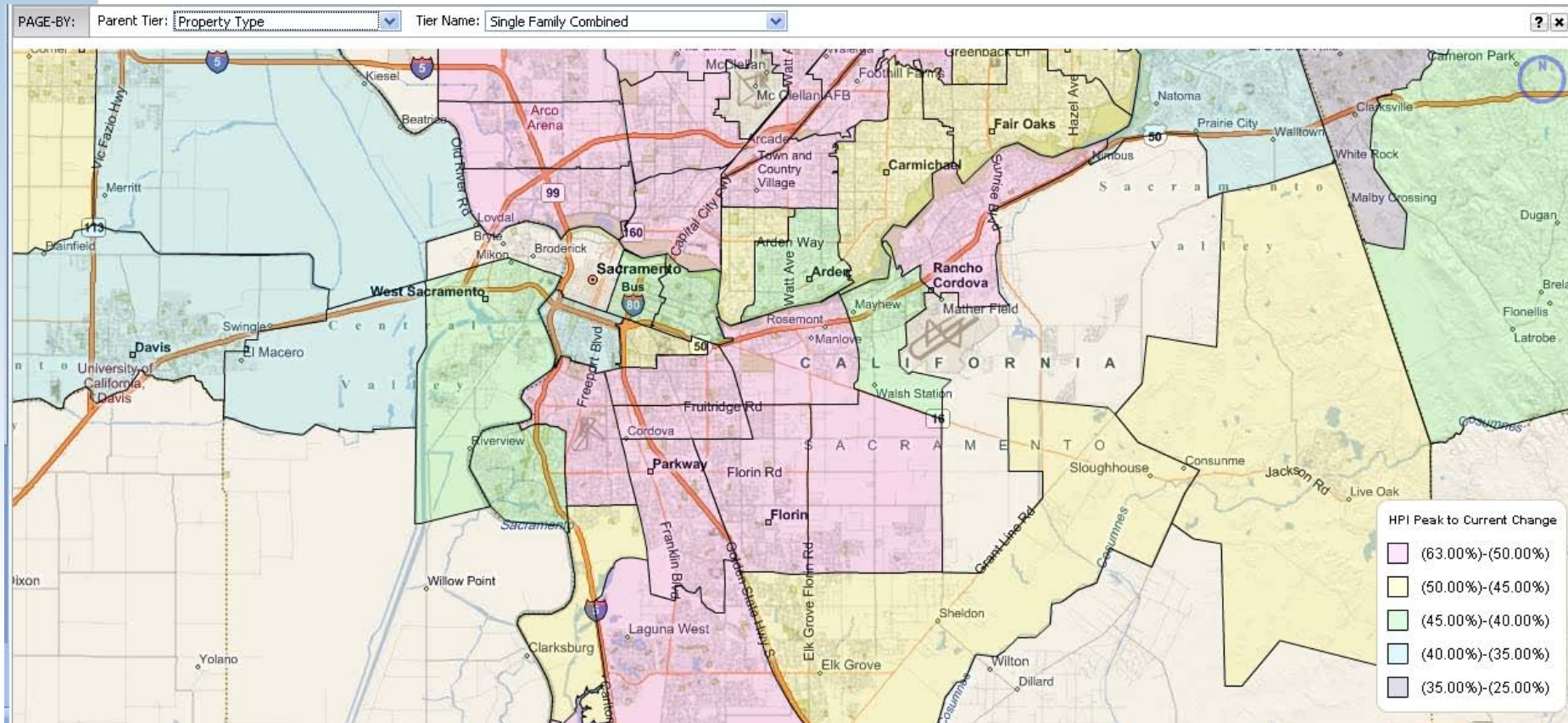


Figure 13

Negative Equity and LTV

Negative Equity and LTV

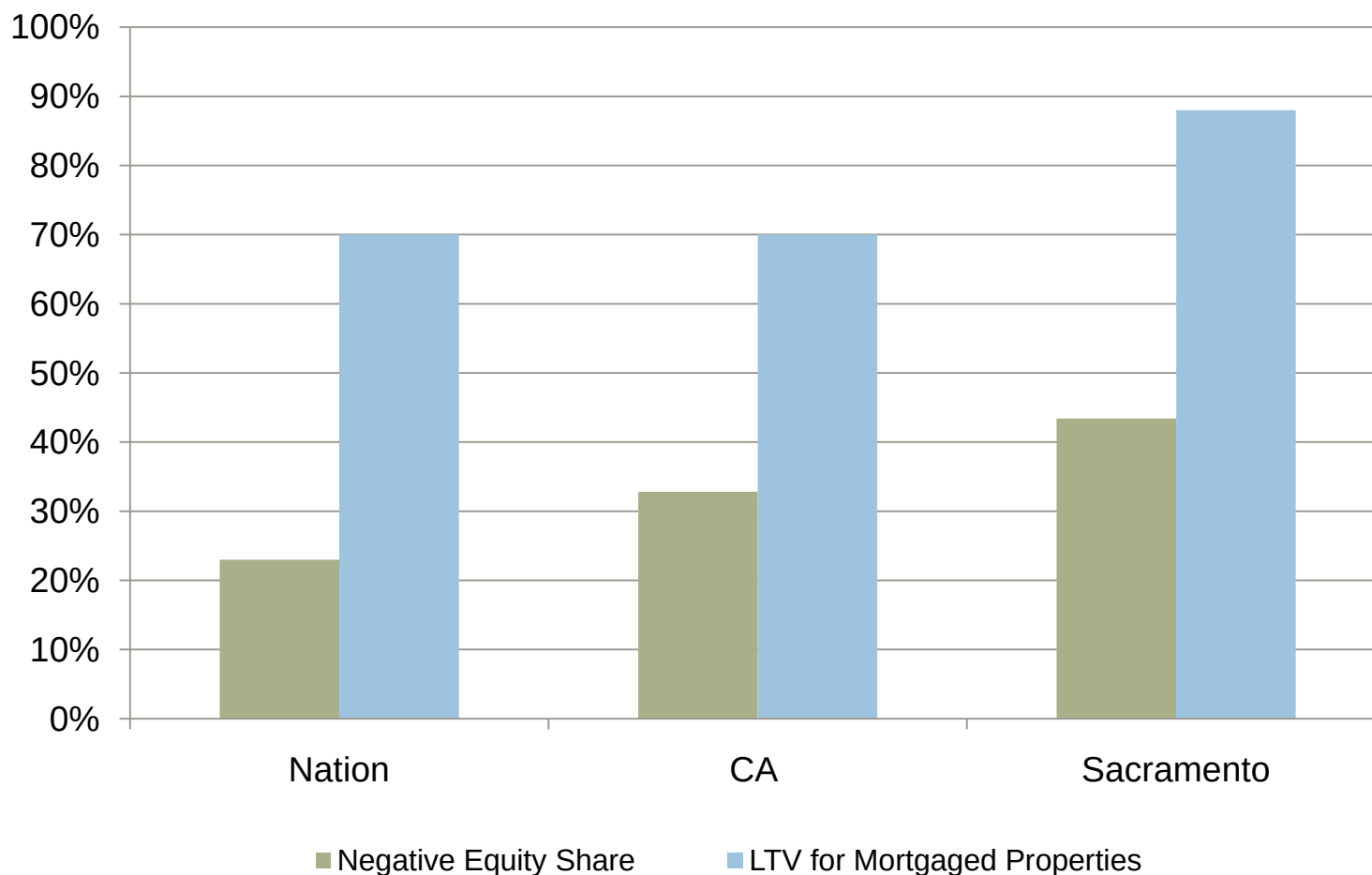
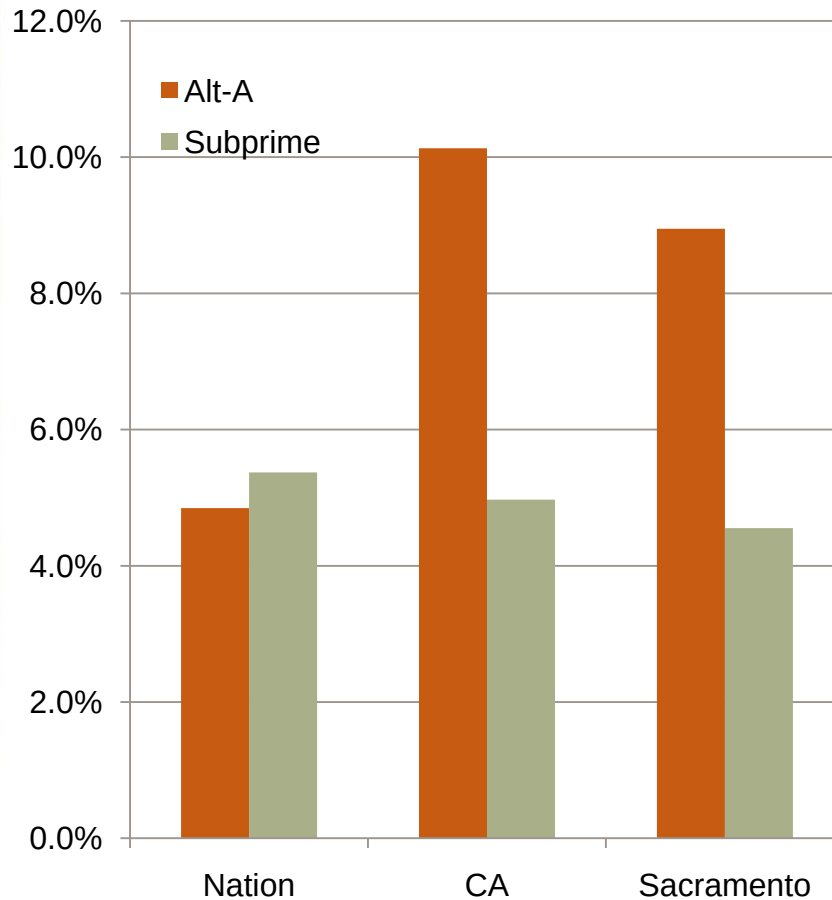


Figure 14

Current Mortgage Performance

Mortgage Market Shares



90+ Delinquency Rate

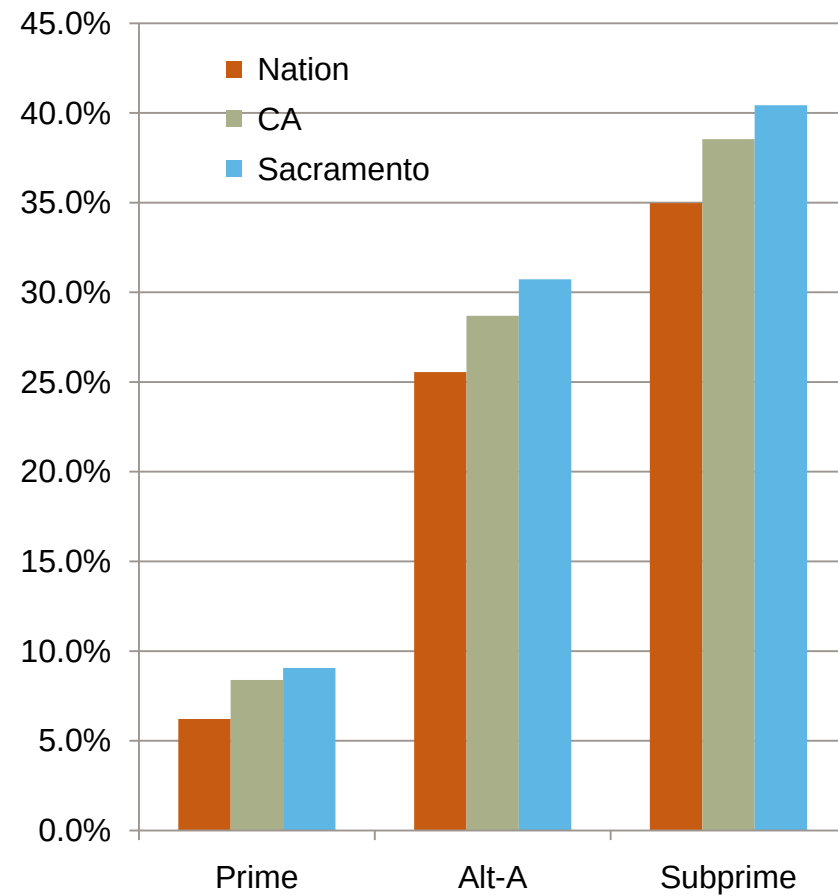


Figure 15

Labor Market

Unemployment Rate

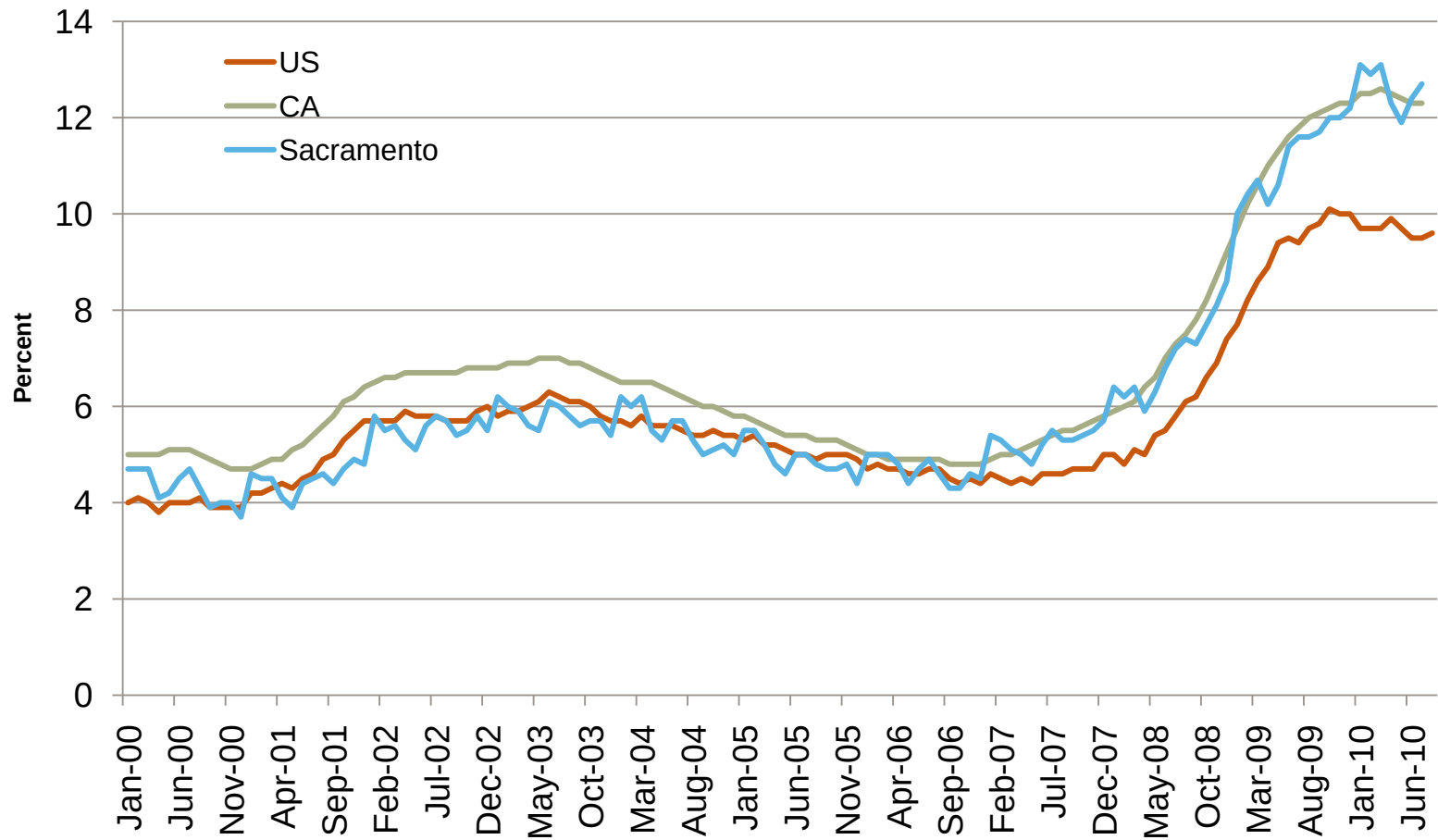


Figure 16

Construction Activity

Residential Building Permits (2005 = 100)

