Contagion Effects of Foreclosure

Moderator: *Welcome to another Federal Reserve Bank of Atlanta podcast. We're speaking today with Dr. Stephanie Rauterkus, a visiting scholar with the Atlanta Fed's community and economic development group. Dr. Rauterkus is an assistant professor at the University of Alabama Birmingham School of Business. As part of the Atlanta Fed's Foreclosure Resource Center, we'll be talking with Dr. Rauterkus about a paper she has written entitled "The Neighborhood Impact of Subprime Lending, Predatory Lending, and Foreclosure." Thanks for joining us today, Stephanie.*

Stephanie Rauterkus: You're welcome.

Moderator: *First off, what exactly is subprime lending? We've heard a lot about that, but what is it really, and why is it often blamed for the foreclosure crisis?*

Rauterkus: Well, as simple as it sounds, initially, in many circles, subprime lending was defined simply as loans made by subprime lenders. But then it became increasingly difficult to identify which lenders were subprime lenders and which lenders were not. So then we started redefining subprime lending as loans taken out by a subprime borrower. So then you have to define what a subprime borrower is, and so those are borrowers who cannot qualify for prime loans or the traditional loans, and that may be for a number of factors or combination of factors, such as a low credit score. Now the definition of "low" has changed across lenders and over time—but [it's] a lower than acceptable credit score, a higher than acceptable debt-to-income ratio. And then, as we got more and more into subprime lending, we started finding that there were subprime loans that had little or no documentation of income. And so a variety of factors would classify a loan as subprime.

Moderator: *Now, even before the foreclosure crisis, I think, we would hear the term predatory lending. Is subprime lending predatory lending, or are there differences?*

Rauterkus: Subprime lending is loans made by a subprime lender or loans taken out by a subprime borrower. Predatory lending is lending where there are fraudulent practices involved, so it is very difficult to pinpoint. So there are not common standards to identify predatory lending, but it's typically marked by victims who have been targeted, or they have been treated unfairly by the lender.

When it comes to identifying it for research purposes, or even from a legal standpoint, going after the predatory lenders and taking legal action against them, we don't have strict standards. And sometimes the predatory lending practices are so subtle that the borrower is scratching their head and asking themselves, "So, was this predatory? Was I taken advantage of?" For example, sometimes the borrowers do not receive all the disclosures that they are entitled to, or maybe they received them but they're not allowed to keep them or study them. And so there may just be subtle things where lenders have the opportunity to maybe change rates or change the terms of a loan without the borrower really realizing or understanding what's going on.

Moderator: *What is the relationship between subprime loans and foreclosure rates and, in turn, property values and which way they move?*

Rauterkus: What we've seen is that the incidence of foreclosure has been higher with subprime loans. And that's not all that surprising because, again, these subprime borrowers have higher debt-to-income ratios; maybe the lenders were maybe not able to verify their income, and so they do present a greater risk. And so, with that greater risk, the likelihood of default and subsequent foreclosure is going to be higher. And so we do see higher foreclosure rates related to subprime loans, and so that's the connection there. When you add in predatory lending, the connection between these three is that, again, it's difficult to prove predatory lending. Oftentimes the most that we have is a suspicion of predatory lending or maybe some anecdotal information. But what we find is that borrowers who are subprime borrowers, or not eligible for prime loans, are more frequently the targets of predatory lending schemes than prime borrowers. And so that's why we tend to see these three terms hand in hand. Predatory lending leads to subprime lending, which often leads to high foreclosure.

Moderator: *How can an individual's home loan affect their entire neighborhood?*

Rauterkus: Well, there tends to be this ripple effect, and we start to refer to this as contagion, or foreclosure contagion. Because what happens is that if a particular mortgage in a neighborhood, or a home that's covered by a mortgage in a particular neighborhood, defaults and goes into foreclosure, what we've noticed (and maybe if there's just one home in the neighborhood the impact is not as great) but what we've noticed is that, over time, we've found that the impact of that home on the other homes in the neighborhood can be as much as a 10 percent decrease in the value of the ...surrounding homes. On average, the impact is about 1 to 2 percent. But because we found that there are significant regional differences—so the impact of a foreclosed home in a neighborhood in Atlanta, Ga., may be very different from the impact of a foreclosed home in a neighborhood in Kansas City, Mo.—and so that's why we see this wide range of 1 to 10 percent. So there are some studies that have even gone so far as to extrapolate across the entire housing stock in the country, and so they've thrown out numbers such as $5,000, you know. So your question is, "Well, what's the impact of a foreclosed home on the neighborhood?" And so some studies have said it's $5,000. If a home in your neighborhood goes into foreclosure, that one home is going to drop the value of your home by $5,000—which means if ten homes in your neighborhood go into foreclosure, that's a $50,000 decrease in the value of your home.

Moderator: *Is there a tipping point as far as the number of foreclosures within a specific neighborhood that when you hit X number, then the entire neighborhood is threatened by that?*

Rauterkus: When we have high foreclosure, that means that you don't have residents there that are paying taxes, that are supporting the services and supporting the community. And so when you have no community support, the town can easily die. You can't afford garbage collection, you can't afford in a subdivision to have the common areas cared for, and so anecdotally we've seen that happen. And so as researchers then we go back and figure out, well, gosh, if we could quantify the point at which it makes a difference—the point at which foreclosure, or the foreclosure rate in a particular neighborhood, has gotten to the point that it's threatening the viability of that neighborhood—then maybe we can target resources to that neighborhood before it goes under. And so that's what we've been working on in research is to try to identify that tipping point.

So far, researchers haven't been able to do that. They've looked for it, and they've not been able to find evidence of it. But, again, there are a number of reasons for that. One is that it is entirely possible that we're just not able to do that. But another explanation is that, again, there are regional differences. And so you have to examine several areas of the country, you have to have an enormous amount of data, and you have to have the right research methods in order to actually figure out where the foreclosure rate starts to make a difference, where the foreclosure rate starts to increase at an increasing rate and jeopardize the viability of a neighborhood. And so we are continuing with that research now.

Moderator: *Are there specific next steps in that research that build on what's already been done?*

Rauterkus: Certainly, as I said, we need to examine the entire country, which is a huge undertaking, and not just looking at a particular city because what we've noticed is that the foreclosure rate patterns vary from city to city. So the first step that I and others have taken is to calculate foreclosure rates nationwide at a very low level, even at the ZIP code level, which is a little bit larger than a neighborhood, but it gets you down to a small enough geographic area that you can start to identify patterns. And so now if you're looking at the landscape of the country with respect to foreclosure in these very small pieces, then you can look at it over time and see how the foreclosure rates change over time. And what's interesting is that we do see patterns in the progression of foreclosure. And in fact, when you put these together on a map and you create somewhat of a movie, looking at foreclosure rates as they change, it almost looks like a virus. And so when you talk about contagion you get a very visual picture; you can see that foreclosure rates will start to increase from some center of a community and just spread outward. And so that's what we're working on now is to try to take those patterns and try to associate an equation or some number in terms of a tipping point to it so that we can suggest policy implications.

Moderator: *Are there things communities can do to maybe inoculate themselves, not only against this virus but also from other adverse effects of subprime and predatory lending?*

Rauterkus: I think we all wish that there were a magic potion or a magic formula to prevent foreclosure, at least foreclosure at this level in the future. And because of that relation between predatory lending, subprime lending, and foreclosure, the number one issue for prime victims of predatory lending is education. We need to make sure that borrowers are understanding the contracts that they're entering into. We're finding, again, foreclosure rates are very, very high in areas where the population has low education, low income; and there is a significant amount—a growing amount, frankly—of anecdotal evidence of predatory lending where these areas have been targeted. Fortunately, that wave is dying down, but in terms of preventing it, there's a lot of room for education.

Moderator: *Thank you very much. Stephanie. That was interesting.*

Rauterkus: You're welcome.

Moderator: *And thanks for listening. For additional podcasts, please look in the "tools" section on the front page of the Atlanta Fed's Web site. If you have comments, please send us e-mail at podcast@frbatlanta.org.*