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Stabilizing Communities-Addressing the Negative Impacts of Foreclosure

Good afternoon everyone. It is a pleasure to be here today. On behalf of my colleagues at the San Francisco Fed, I would like to thank you for taking the time to participate in this symposium, and more specifically, to engage in a discussion of what strategies are needed to stabilize communities in the wake of foreclosures. This discussion is critical: not only to minimize the negative impacts of foreclosure on borrowers and neighborhoods, but also to help promote local and regional economic recovery and growth.

The rapid rise in mortgage delinquencies and foreclosures has had significant negative ripple effects, and not just at the neighborhood level. My colleagues and I have been assessing the impact of these trends on the financial markets and the U.S. economy. Last week, in both San Diego and Portland, I shared my views on how the current credit crunch, the downturn in the housing market, and rising commodity prices are affecting the economic outlook. From my perspective as a monetary policymaker, these developments pose serious challenges and will require vigilance both in monitoring events going forward and in acting as needed to achieve our dual mandate of low and stable inflation and maximum sustainable employment and economic growth.

In my remarks today, I will take a broader perspective, reflecting not only some of the other responsibilities of a Reserve Bank president, but also a more personal perspective. I have been, and remain, deeply concerned about the impact that foreclosures are having on families and neighborhoods, and the long-term implications of foreclosure for low-income communities, particularly within the Federal Reserve's 12th District.

They say “a picture is worth a thousand words,” so let me begin with a few slides that illustrate the scale of foreclosures in our District. While some communities have been struggling with high rates of foreclosure for some time,[1] the recent rise in delinquencies and foreclosures in Arizona, California, and Nevada has been sudden and substantial. Data from the Mortgage Bankers Association show that at the start of 2006, these states had among the lowest foreclosure rates in the country; by the first quarter of this year, they were among the top five states in the nation in overall foreclosure rates

Moreover, as the following national maps show, the number of communities affected by foreclosures has grown dramatically in a very short time. In September of 2007, data at the zip code level on the percent of loans in foreclosure, as well as properties held by lenders or servicers as "real estate owned," or "REOs," showed high foreclosure rates in some areas, particularly in Midwestern states, but also in some distinct hotspots in California’s Central Valley, Florida, and Colorado. Data from April of this year, however, show that the crisis has intensified significantly. This map paints a daunting picture for many regions of the country, but it is hard to ignore the wave of foreclosures and REOs in California’s Central Valley and Inland Empire, as well as in the cities of Las Vegas and Phoenix. At a more localized level, cities such as Los Angeles are also struggling with areas of concentrated foreclosures and REOs, while other neighborhoods seem less affected by the crisis.

The impacts of these foreclosures are devastating on a number of levels. For borrowers, foreclosures can exact significant costs and hardships, involving not only the loss of home equity and impaired credit, but also potentially limiting access to stable, decent housing and disrupting labor market participation.

In addition, as foreclosures have become increasingly concentrated in certain neighborhoods, they threaten to have significant negative spillover effects on the wider community. Research indicates that foreclosures tend to reduce the value of nearby properties significantly, especially when vacancies drag out and the local housing market is weak. In such neighborhoods, “For Sale” signs become bad omens of a self-reinforcing cycle of decline—more homes for sale put downward pressure on the local housing market that in turn can lead to yet more defaults and

foreclosures. While more research is needed to get a better handle on the size of these impacts, there is no doubt that the mortgage crisis is contributing to a loss of equity for a large number of homeowners in low-income communities, and that it threatens to undermine ongoing neighborhood revitalization efforts.

We are also beginning to see direct impacts from foreclosures and the concurrent decline in house values on municipal budgets. For example, there's the loss of tax revenue associated with vacant properties, and there are rising costs associated with foreclosure-related services, such as increased policing to deter crime around abandoned properties. As declining property taxes and transfer fees shrink local government revenues, vital services to low- and moderate-income families may also suffer.

What this means is that the foreclosure crisis is likely to have profound impacts on low-income communities, with effects that go well beyond the housing sector. And countering them will require more robust and direct responses—at both the local and federal level.

Before turning to the issue of how to respond to rising neighborhood foreclosures, I would like to emphasize that the Federal Reserve views the high rate of mortgage foreclosures as an urgent problem and preventing unnecessary foreclosures should be a key priority for both the private and public sectors. Our goal should be to keep existing owners in their homes wherever possible as a way of avoiding the significant costs of foreclosure. Over the past year, much emphasis has been placed on improving borrower outreach through public service announcements and community events, developing systematic and streamlined approaches to restructuring adjustable rate loans, and creating new refinance options to help borrowers shift into more sustainable loan products. These efforts are having some success. To use California as an example, according to data reported by the HOPE NOW Alliance, in the 1st quarter of 2008, approximately 11,500 borrowers received a modification to their loan terms, while another 20,500 entered into formal repayment plans.[2] While these efforts are important and reflect significant progress, I would note that in the state we had about same number of foreclosure sales, 32,000 in the 1st quarter, according data from HOPE NOW. Also, the scale of the loan modifications and repayment plans to date are small compared to the volume of loans that are 60 or more days delinquent—an

estimated 186,000 loans in California alone. It is critical that we continue to explore a broader range of interventions that would help keep families in their homes, including efforts to give servicers more flexibility in the loan modification process.

At the same time, we need to maintain a perspective on what can be achieved in terms of foreclosure prevention, and many communities are already grappling with large numbers of foreclosures. The reasons for this jump in foreclosures are complex and intertwined, yet research at the San Francisco Fed finds that house price declines have been the most important determinant of mortgage delinquencies and foreclosures.[3] Areas of Arizona, California, and Nevada have all seen dramatic adjustments in house prices. By one index (Standard & Poor's Case Shiller House Price Index), house prices here in Los Angeles are down over 25 percent from the peak in late 2006 (September). While there likely has been some feedback from foreclosures to house prices in various markets, most of the decline in house values to date reflects a realignment of prices that had risen sharply relative to fundamentals during the earlier housing boom. The potential for further realignment and, thus, lower house prices will make it that much more difficult to limit foreclosures.

That is why this symposium on responding to the foreclosures that have already occurred and will occur is so important. The central question driving this symposium is: how can we best minimize the negative impacts of these foreclosures on cities, neighborhoods, and families?

There are no easy answers to this question, and our hope is that this symposium will give you the opportunity to discuss emerging strategies and develop solutions that can help to overcome the challenges that nonprofits, municipalities, and lenders face in responding to this still unfolding, multi-faceted crisis. Let me just raise a few of the issues that the symposium will help to address.

The first issue—and perhaps the most formidable—is identifying sources of funding to allow either nonprofits or local governments to acquire and rehab foreclosed properties where needed. Several of the workshop panelists will be describing their efforts to leverage investment and subsidies—both public and private—for the redevelopment of foreclosed properties. Some are

diverting existing funds for housing to respond to rising foreclosures, while others are tapping into financing tools such as equity equivalent, or EQ2 investments, New Markets Tax Credits, and loan pools to generate much needed capital. In addition, many of you have been involved in developing federal and state legislation that would direct funding to help communities reduce downward pressure on local housing markets. Given the significant negative spillover effects of foreclosures, I believe that there is a strong case for directing public funding to the acquisition and rehab of REO properties.Yet questions remain regarding the targeting of these types of funds, and determining how they can best be directed to neighborhoods most in need of public subsidy. One particularly important question is how to respond to foreclosures that are occurring in suburban neighborhoods in areas like the Central Valley, which saw rapid construction and growth during the housing boom. How will interventions in these areas need to differ from those in older, low-income neighborhoods within the urban core?

The second objective of this symposium is to help foster the partnerships that will be needed to implement comprehensive acquisition and redevelopment strategies. The complexity and scale of the foreclosure issue calls for broad cross-sectoral partnerships among nonprofits, community development financial institutions, lenders, real estate professionals, and government agencies, both locally and nationally. In addition, local organizations and government agencies will need to develop new capacities to manage and redevelop large numbers of foreclosed properties. Changes in institutional structures within financial institutions will be necessary as well, especially to promote flexibility in working with nonprofits and the public sector on this issue. The current nature of pooling and servicing agreements—which often include a variety of levels of authorization and interests—can not only thwart loan modification efforts, but also limit the ability of servicers to negotiate with governmental agencies and nonprofits for discounted sales of REO properties.

Third, the symposium sets out the ambitious goal of thinking about how the current crisis can be used as an opportunity to expand the supply of affordable housing. Despite recent price declines, housing affordability remains a critical issue in many parts of the12th District.[4] During this symposium, we'll ask you to be creative in wrestling with a number of issues related to expanding affordability. How can we convert foreclosed properties into affordable rental or homeownership opportunities? Is it possible to develop strategies that can keep delinquent

borrowers in their homes—perhaps under lease-to-purchase agreements— thereby avoiding foreclosure and contributing to family and neighborhood stability at the same time? The current environment of tighter credit and underwriting standards means that we also need to develop new products and programs that can help low-income families access responsible loans going forward. We should not view the current crisis as justification to abandon the goal of expanding access to credit among low-income households, since access to credit, and the subsequent ability to buy a home, remains one of the most important mechanisms we have to help low-income families build wealth over the long term.[5]

Conclusion

Let me close by emphasizing the Federal Reserve's commitment to addressing the mortgage and foreclosure crisis on multiple fronts as part of our Homeownership and Mortgage Initiatives. On Monday, the Federal Reserve Board issued its new Home Ownership and Equity Protection Act, or HOEPA regulations, which are designed to strengthen protections for borrowers and to prohibit unfair and deceptive practices in the mortgage market. Importantly, the new regulations establish a new category of "higher-priced mortgages, and prohibit a lender from making a loan without regard to borrowers' ability to repay the loan from income and assets other than the home's value. Moreover, to show that a lender violated this prohibition, a borrower does not need to demonstrate that it is part of a "pattern or practice." In addition, the rules place tighter restrictions on prepayment penalties.[6]

The Federal Reserve is also leveraging its strengths in data analysis and research, and many of the Reserve Banks are publishing new papers that can help us to understand the multi-faceted nature of the current mortgage crisis. Finally, in addition to our regional outreach events that aim to educate stakeholders about foreclosure trends and support local foreclosure prevention efforts, we have also launched a System-wide partnership with NeighborWorks America to share best practices from across the country for mitigating the impact of foreclosures on communities.

This symposium is one part of the Fed's efforts in this area, and is part of a Federal Reserve System conference series, *Recovery, Renewal, Rebuilding,* that seeks to develop and disseminate innovative strategies and policies that can help to address the broad range of challenges related to

the rise in mortgage delinquencies and foreclosures. At the San Francisco Fed, we decided that, given the scale of foreclosures in communities in Arizona, California, and Nevada, it would be most important to focus the discussion primarily on the issue of redeveloping foreclosed properties into affordable housing. Over the next day and a half, practitioners from across the country have agreed to share the models that they are developing; some are already well on their way to acquiring and redeveloping REO properties, while others are still figuring out how to raise capital or structure holding companies. The goal of this symposium is to provide all of you with the chance to share your ideas, your successes *and* your failures, and to learn from your colleagues in other cities. We hope that you find that these discussions are productive, and we look forward to disseminating the best practices that emerge from this symposium through our website and publications, so that others grappling with foreclosures in their communities can benefit as well. Thank you for your time, and I hope you enjoy the rest of the conference.

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[1] For example, cities such as Chicago and Minneapolis were experiencing high levels of foreclosure well before the current national increase in foreclosure rates.

[2] HOPE NOW Alliance (2008), *April State Data Tables,* accessed online on July 8, 2008 at http://www.hopenow.com/upload/data/files/April%20State%20Date%20Tables.pdf.

[3] See, Doms, Mark, Frederick Furlong, and John Krainer. 2007. "Subprime Mortgage Delinquency Rates." Federal Reserve Bank of San Francisco Working Paper 2007-33., and "House Prices and Subprime Mortgage Delinquencies." *FRBSF Economic Letter* 2007-14 (June 8); and FRBSF 2007 Annual Report (2008).

[4] *The State of the Nation's Housing 2007* (Joint Center for Housing Studies, Harvard University, Cambridge, MA, 2007).

[5] This assumes responsible lending and that homeownership is sustainable. Research has shown that low-income homeowners build more wealth than low-income renters, both through accumulated equity in the home as well as a greater propensity to save. See Edward M. Gramlich, *Subprime Mortgages: America's Latest Boom and Bust* (Washington, D.C., The Urban Institute, 2007), pp. 70 – 77 for an analysis of the 2004 data from the Survey of Consumer Finances on this topic.

[6] http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm