

STATE RESPONSE TO HOUSING WOES

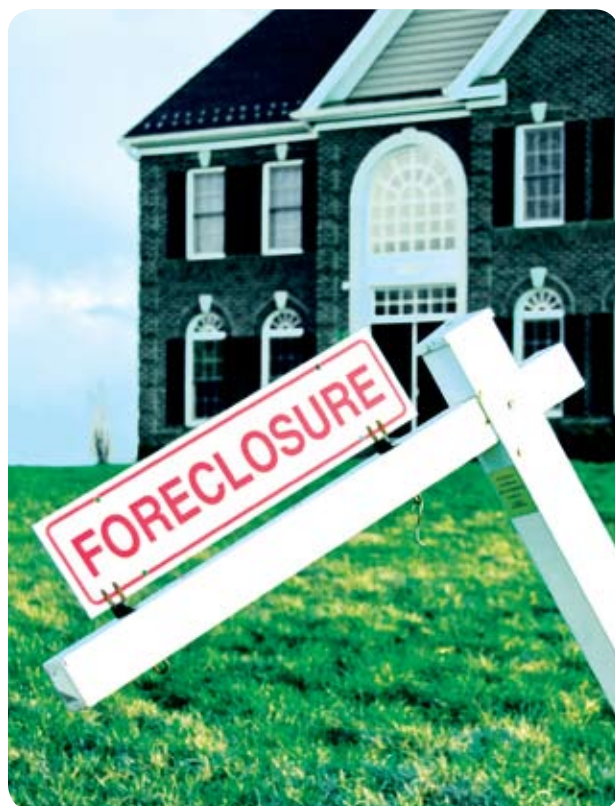
One in nearly 200—that's how many U.S. households received a foreclosure filing in just the first quarter of this year, according to RealtyTrac, a Web site that tracks foreclosures. And for the first time in at least 40 years, the national median price of a single-family home dropped last year. Several million homeowners now owe more on their mortgage than their home is worth. The downturn in the national housing market and the subsequent increase in foreclosures and instability in the financial markets have had a significant impact on state economies. Unfortunately, these trends are only adding to the already grim economic outlook for states.

For many states, the upcoming fiscal year may prove to be one of the most economically challenging in several decades. According to the spring 2008 Fiscal Survey of the States, a joint report from the National Association of State Budget Officers and the National Governors Association, the number of states experiencing revenue shortfalls has markedly increased in the 2008 fiscal year over the previous fiscal year. In 2007, eight states reported lower than expected revenue collections. In 2008, that number grew to 20 states. In July, the National Conference of State Legislatures reported that states face \$40.3 billion in budget deficits for the upcoming fiscal year.

Some states have fared better than others during the housing downturn, but no state has been completely immune to the fallout. Some states have seen huge losses in property values, while other states have remained fairly stable. For example, according to a housing price index published by the Office of Federal Housing Enterprise Oversight, Michigan, Arizona, Florida, Nevada and California experienced the greatest year over year drops in housing prices in the first quarter of 2008, ranging from 3 percent to 10 percent. Coincidentally, these five are also in the top 10 states with the highest foreclosure rates.

However, even in states with relatively stable home values—such as Ohio, Colorado and Georgia—foreclosure rates have skyrocketed due in part to risky lending practices, inflation and the stagnant labor market. In addition to falling home prices and high foreclosure rates, the states with industries that depend on housing—construction, lumber, wallboard, furniture, home appliances and flooring—are also taking a big hit. Many of these industries are concentrated in the Southeast, which, with the exception of Florida and Virginia, has remained comparatively unscathed by the national trend of falling home prices in overheated markets.

Considering the complexity and scope of the housing market issues, the question becomes: What can states do to ease the economic damage caused by the meltdown? Over the past year, legislators and executive branch officials have been busy trying to answer that question.



Key Terms

- ▶ **A subprime loan** is generally defined as one that does not conform to Fannie Mae or Freddie Mac guidelines and are often offered to those with poor credit history, low or unreliable income, or with other risk factors. Subprime loans are higher risk loans and are usually accompanied by high and/or variable interest rates and large fees. Some subprime loans are predatory loans, although not all subprime loans can be classified as predatory. Subprime loans are not necessarily a negative development—they have also enabled millions of Americans to purchase a home they otherwise would not have been able to obtain through traditional financing.
- ▶ **Adjustable rate mortgages** are loans whose interest rates may change, usually in relation to the Treasury Bill rate or the prime rate. These loans often start out with a lower interest rate than a traditional, fixed-rate loan and then adjust to a higher rate—making a homeowner's mortgage payment often significantly higher each month when the loan adjusts.

Housing Market Conditions

The unprecedented number of foreclosures represents one of the most visible components of the housing meltdown and foreclosures have been one of the primary targets of recent state action—and for good reason. There have been a record number of foreclosures during the last 12 months and this trend is not expected to reverse anytime soon. The latest foreclosure figures posted by the Mortgage Bankers Association (MBA) National Delinquencies Survey in June 2008 show the rate of homes going into foreclosure and the percent of loans in the process of foreclosure are at their highest point in 29 years. California, Arizona and Nevada continue to lead the nation in the number of foreclosure starts in the first quarter of 2008.

Although foreclosure rates are up for all types of loans, most of the increase in the national rate continues to be driven by the subprime market. Subprime loans and adjustable-rate mortgages

increased dramatically during and following the housing boom of 2003–2005, and are now a significant contributing factor to foreclosure rates.

Subprime loans and, more specifically, subprime adjustable-rate mortgages represent a disproportionate number of foreclosures. In a recent MBA press release, Jay Brinkmann, vice president for research and economics for the association, said, "... while subprime ARMs represent 6 percent of the loans outstanding, they represented 39 percent of the foreclosures started during the first quarter (of 2008)." Simply put, more foreclosures are occurring because many homeowners are now in the very tenuous situation of owing mortgage companies more than they can afford to pay.

The impact of foreclosures on the economic and social stability of a state can be immense. The Center for Responsible Lending estimates the current round of foreclosures could cost homeowners as much as \$164 billion. But the impact reaches far beyond the homeowners

themselves—foreclosures can, directly or indirectly:

- ▶ Increase the number of abandoned and vacant buildings, leading to neighborhood blight and higher rates of crime;
- ▶ Drive down the price of neighboring homes;
- ▶ Reduce the tax base, including decreased property taxes, state transfer fees, and deed and mortgage registration taxes;
- ▶ Deter current and future investment in communities; and
- ▶ Increase the total cost of state and local oversight of the foreclosure process.

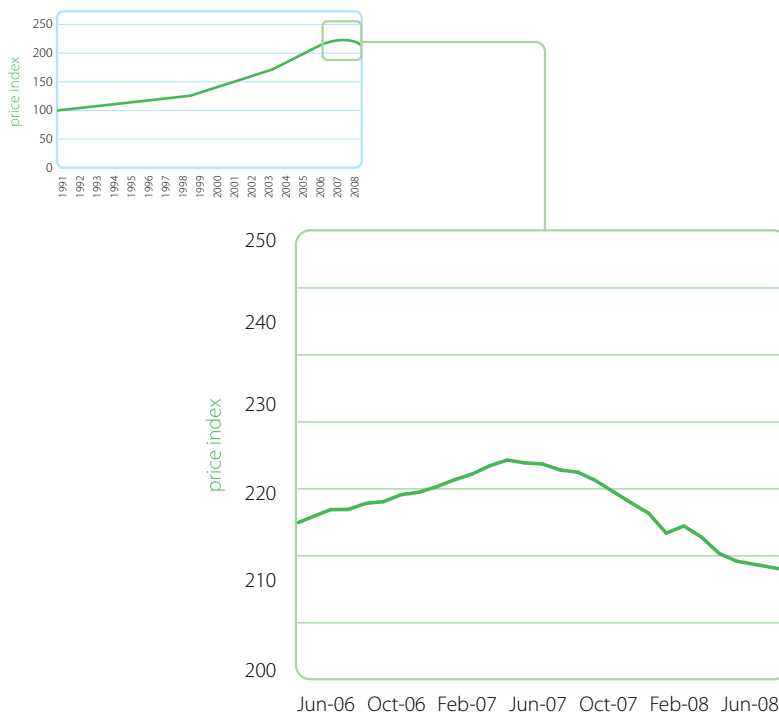
Although subprime lending is a major driving force behind the current situation, it is not the only cause. Even those borrowers who did not receive subprime loans may find themselves underwater—owing more on a home than it is worth—due to the steep price declines in housing markets across the U.S. The housing bubble that inflated home prices in the middle of this decade, the current state of the overall economy, and the recent havoc in the financial sector are also considerable—and interconnected—contributing factors.

Due to the devastating effects of these trends, much of the state response to the housing and foreclosure crisis has been aimed at the mortgage industry—both borrowers and lenders. While the federal government plays a significant role in the regulation of the banking and mortgage industry, states alone regulate nonbank lenders and mortgage brokers. These lenders and brokers originate more than 50 percent of all mortgages and refinance loans and represent up to 80 percent of subprime loans. This regulator role allows states to have a major impact on both prime and subprime lending by directing the ways these types of loans are made.

Recent State Action

More than 30 states passed legislation to ban predatory lending practices, strengthen lender oversight, regulate mortgage broker companies and loan originators, as well as educate homebuyers since the be-

Housing Price Declines



Source: Office of Federal Housing Enterprise Oversight, Seasonally Adjusted Monthly Purchase Only House Price Index, January 1, 1991 – May 1, 2008

ginning of 2007, according to the National Governors Association. The measures states have taken in recent years focus mainly on:

- ▶ Regulating the foreclosure process, including instituting mandatory grace periods between the start and end of the foreclosure process;
- ▶ Counseling and education for potential and current homeowners;
- ▶ Regulating mortgage brokers and loan originators, including banning certain types of predatory lending practices (more than 30 states now have anti-predatory lending laws);
- ▶ Offering mortgage payment assistance programs;
- ▶ Increasing consumer protections from mortgage rescue scams; and
- ▶ Increasing penalties for mortgage fraud.

In addition to the states themselves, many state organizations have recognized the need for greater state cooperation and input into the regulation of nontraditional and subprime mortgages and have developed initiatives to facilitate that coordination.

For example, the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators launched the Nationwide Mortgage Licensing System in January 2008. The system is designed to unify and streamline state license processes for mortgage lenders and brokers by providing a centralized and standardized system for mortgage licensing. By enhancing and streamlining what is currently a very disjointed and complicated system, the licensing system aims to improve the efficiency and effectiveness of state supervision of the mortgage industry, enhance consumer protection, fight mortgage fraud and predatory lending, and increase accountability among mortgage industry professionals.

"NMLS provides the underpinnings of a regulatory framework to address the weaknesses of our current fragmented and complex system of mortgage origination and supervision," John Ryan, executive vice president of the Conference of State Bank

Supervisors, said in a recent press release from the Conference of State Bank Supervisors. Currently, 42 agencies representing 40 states have committed to participating in the effort and, as of July 1, 14 states have begun to use the system.

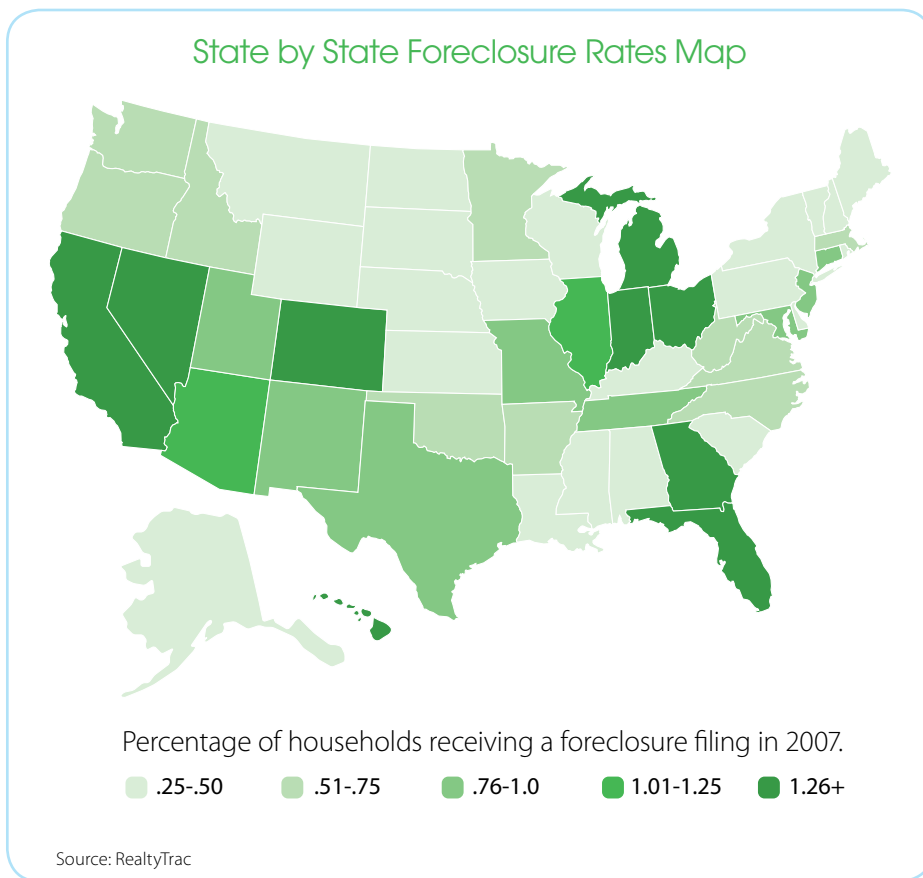
Recent Federal Action

The federal government has also been busy creating new legislation to address the housing downturn. The Housing and Economic Recovery Act of 2008 strives to prevent future foreclosures, creates new regulatory standards for mortgage brokers and originators, and will provide \$3.92 billion in Community Development Block Grant funds and another \$150 million in additional funding for counseling. According to Rep. Richard E. Neal, chairman of the Ways and Means Subcommittee on Select Revenue Measures, "the tax provisions in this bill are an appropriate mix of incentives for home purchasers, owners and renters, for builders, developers and lenders." The bill also reforms the Federal Housing Administration mortgage insurance program and

develops a new regulatory scheme for government-sponsored enterprises.

The current condition of two of those government-sponsored enterprises, Fannie Mae and Freddie Mac, further illustrates the magnitude of the housing crisis. Fannie Mae was created by Congress in 1938 to ensure a consistent supply of mortgage funding and liquidity for the housing market by buying loans from banks. It then repackages those loans and uses them as collateral for bonds called mortgage-backed securities. Freddie Mac was created in 1970 to serve essentially the same function. Together they own or guarantee almost half of the nation's outstanding home loan debt—\$5 trillion. These entities are now in serious trouble. Investors have lost faith in both institutions following mixed signals as to their financial condition and health. As of July 2008, shares of both firms were down approximately 75 percent for the year.

Although these two institutions may not be responsible for the housing and subprime mess, they are integral to any hope of a speedy recovery. If these financial giants were allowed to fail, the impact on the housing



market—and indeed the entire economy—would be devastating. For example, if Fannie Mae was taken out of the picture, the cost of home mortgages would skyrocket and their availability would plummet, thereby exacerbating the precipitous drop in house prices and stalling or reversing a return to stable housing market conditions.

Treasury Secretary Henry Paulson reiterated this sentiment in prepared testimony to the Senate Banking Committee on July 15: “Fannie Mae and Freddie Mac play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their support for the housing market is particularly important as we work through the current housing correction.” Therefore, in mid-July, Paulson made an emergency announcement and outlined a three-part plan to help prop up the two enterprises, including a temporary increase in their lines of credit with the Treasury, temporary authority for the Treasury to purchase equity in either institution if needed and strengthened regulatory reforms.

In addition, the Federal Reserve has become increasingly uneasy with the state of mortgage lending practices. In July, it also took substantial action to prevent another crisis like the current one by tightening lending standards, especially for subprime mortgages. The agency approved new mortgage lending rules that will apply to all mortgage lenders, and all but one requirement will take effect Oct. 1, 2009.

Conclusion

The condition of the current housing market and fallout from the mortgage meltdown will continue to impact communities around the nation for many years to come. However, the steps states are taking now will shape the oversight and regulation of mortgage lending practices in the future, which may pre-empt a crisis of this magnitude from reoccurring. States play an important role in the supervision and enforcement of mortgage regulations and will continue to be the first line of defense against predatory, irresponsible and unscrupulous lending practices.

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State Examples

Below is a sample of the actions taken by states during their most recent legislative sessions:

- ▶ **Virginia:** Legislators passed SB 797, which requires high risk mortgage lenders and servicers to give borrowers who ask for help a 30-day grace period.
- ▶ **California:** In July Gov. Arnold Schwarzenegger signed SB 1137 into law that he and legislators say will force mortgage lenders to talk with homeowners before foreclosing, giving tenants more time to vacate foreclosed property and helping to prevent neighborhood blight.
- ▶ **Hawaii:** Legislators passed two bills to regulate the type of information that troubled homeowners receive. HB 2326 requires mortgage foreclosure rescuers to disclose specific information to distressed property owners and SB 2454 ensures homeowners receive foreclosure information in a timely manner.
- ▶ **Connecticut:** The legislature has re-established through law the state’s Emergency Mortgage Assistance Program administered by the Connecticut Housing Finance Authority. The program will pay the monthly payment for qualifying participants on a special mortgage provided by the program for up to five years. The law also establishes a foreclosure mediation program and increases state regulation of the mortgage industry.
- ▶ **North Carolina:** HB 2623 requires mortgage servicers to give borrowers at least 45 days notice before initiating foreclosure proceedings and gives the state bank commissioner the authority to delay foreclosure for up to 30 days to give homeowners more time to work out a plan with their banks before losing their homes.
- ▶ **Pennsylvania:** Five bills were signed into law in July intended to protect homebuyers and strengthen the state’s oversight of the mortgage industry. The laws require loan salespeople to be licensed by the Department of Banking, restrict prepayment penalties, increase fines for violations by real estate appraisers, require loan officers to undergo a background check and training on state and federal mortgage laws, and make certain mortgage companies notify the state when they initiate the foreclosure process.
- ▶ **New York:** In June, Gov. David A. Paterson announced an agreement with the legislature to pass a subprime lending reform bill (S8143-A), focusing on existing homeowners facing foreclosure with elements to prevent future problems. The bill includes a requirement that lenders send a pre-foreclosure notice to borrowers at least 90 days before initiating foreclosure proceedings. The bill also creates a mandatory settlement conference for foreclosure proceedings involving some subprime loans, establishes stronger consumer protections and increases penalties for mortgage fraud.
- ▶ **Florida:** A new law (HB 643) aimed at protecting Florida residents from foreclosure rescue fraud will take effect Oct. 1, 2008. The law strives to ensure that mortgage holders are properly informed about their rights when they are signing a contract with a foreclosure rescue entity and provides them with a three-day right of cancellation period.
- ▶ **Kentucky:** HB 552, signed into law in April 2008, makes several changes to mortgage regulations. Provisions in the law include the establishment of the Kentucky Homeownership Protection Center, which will provide foreclosure counseling and education, and a reduction in prepayment penalties.
- ▶ **Nebraska:** The Nebraska Foreclosure Protection Act (LB 123) was signed into law by Gov. Dave Heineman in March 2008. The Act requires foreclosure consulting contracts to provide full disclosure to consumers and addresses a homeowner’s right to cancel such a contract.