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What Does Foreclosure Entail?

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"Foreclosures create substantial social costs…[R]educing the number of preventable foreclosures would not only help families stay in their homes, it would confer much wider benefits."

—Federal Reserve Chairman Ben Bernanke

Foreclosure is the forced sale of a property to pay off a delinquent mortgage; legal procedures for foreclosure vary by state. The number of foreclosures has increased since the subprime mortgage crisis began in 2007. According to the latest data from RealtyTrac, there were 274,399 foreclosure filings in January 2009, a staggering 18 percent increase from the same month last year. The Federal Deposit Insurance Corporation estimates that 4 to 5 million mortgages could enter foreclosure over the next two years.

The slide in housing prices is one major cause for the increased foreclosures. During the 2001-2006 housing boom, the Federal Housing Finance Agency House Price Index shows that housing prices increased by more than 51 percent. Dell' Ariccia, Igan, and Laeven (2008) found some evidence linking rising house prices with increasing subprime mortgage originations, which allowed borrowers without strong credit history to purchase homes. Because most of these borrowers could not have qualified for a conventional mortgage, the subprime mortgage was designed to allow them to purchase a home, and then refinance later or resell their homes for a profit under the assumption that house prices would continue to rise. When housing prices began to fall in mid-2006, these options became less viable. Consequently, more borrowers defaulted on their mortgages and their houses were eventually foreclosed. In states such as California, Florida, and Nevada, where housing prices dropped 20 percent or more in 2008, total rates for foreclosures started that year were 6.3 percent, 8.7 percent, and 9.3 percent, respectively[1] (see table). Not only are these figures among the highest in the nation, they are more than five times higher than they were in 2006.

Deteriorating macroeconomic conditions (e.g., decreasing personal income and higher unemployment) also contributed to the high number of foreclosures. Subprime borrowers, who spent on average over 50 percent of their income on debts including mortgages (Fabozzi, 2006), were particularly vulnerable. The high debt-to-income ratio implies these borrowers had limited ability to cover essential living expenses after deducting the monthly mortgage payment. Therefore, even a slight drop in income could make them susceptible to mortgage defaults, which eventually leads to foreclosure. Some states, such as Illinois and Michigan, had only a relatively moderate drop in housing prices in 2008, but their rates of subprime mortgage foreclosure proceedings started that year reached 17.3 percent and 15.9 percent, respectively, just slightly lower than California, Florida, and Nevada. Not surprisingly, all these states had above-average unemployment and declines in personal income.

Foreclosure is costly for lenders and borrowers. Borrowers lose their homes and seriously damage their credit history. Lenders are forced to sell foreclosed homes at a loss. The loss, which includes direct costs of foreclosure, missed mortgage payments before the foreclosure sale, and the shortfall between the sale price and unpaid loan balance, is great, particularly for subprime mortgages. According to Cordell et al. (2008), the average total loss of a foreclosed subprime mortgage was about 55 percent of the unpaid loan balance between December 2007 and May 2008. The same figure for prime mortgages ranges from 20 percent to 40 percent—less severe but still substantial. Foreclosure also incurs substantial social costs. When foreclosed homes cannot be sold quickly, they are left unoccupied and often induce undesirable activities. Lee (2008) shows that the short-term negative impact of foreclosure on nearby home values could reach almost 9 percent.

The Obama administration has initiated the Making Home Affordable program to reduce the number of foreclosures and help distressed borrowers. The program's goal is to assist 7 to 9 million homeowners by making their mortgages more affordable. It remains to be seen whether the program will work as intended.

—By Yu Man Tam, Senior Research Associate, Federal Reserve Bank of St. Louis

REFERENCE: Fabozzi, Frank J. *The Handbook of Mortgage-Backed Securities*. New York: McGraw-Hill, 2006.

[1] This is the percentage rate of loans for which a foreclosure has been initiated during the year.

Recent Articles and Further Reading on the Foreclosures

"Housing, Mortgage Markets, and Foreclosures," speech by Ben Bernanke at the Federal Reserve System Conference on Housing and Mortgage Markets, Board of Governors of the Federal Reserve System, Washington, DC, December 4, 2008.

Bernanke discusses developments in the housing sector and the interactions among house prices, mortgage markets, foreclosures, and the broader economy. He reviews steps taken to date and suggests some additional measures that could support housing and the economy by reducing the number of avoidable foreclosures.

"Mortgage Foreclosure Resources," by the Board of Governors of the Federal Reserve System.

This site provides helpful information and links to agencies and organizations that may provide assistance to consumers experiencing difficulty making their mortgage payments.

Free Data Sources and Reports

Data: S&P/Case-Shiller Home Price Indices
Description: The S&P/Case-Shiller Home Price Indices measure the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States.
Published by: Standard & Poor's, a division of McGraw-Hill, Inc.
Location: http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/2,3,4,0,0,0,0,0,0,0,0,0,0,0,0,0.html

Data: FHFA House Price Index
Description: The HPI is a broad measure of the movement of single-family house prices. It is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales or refinancings on the same properties. The HPI includes house price figures for the nine Census Bureau divisions, for the 50 states and the District of Columbia, and for Metropolitan Statistical Areas (MSAs) and Divisions.
Published by: Federal Housing Finance Agency
Location: http://www.fhfa.gov/Default.aspx?Page=14

How does the HPI differ from the S&P/Case-Shiller Home Price Indices?

Data: Dynamic Maps of Nonprime Mortgage Conditions in the United States
Description: These maps show conditions and density of owner-occupied subprime mortgage loans for the states, counties, and zip codes in the United States.
Published by: Federal Reserve Bank of New York
Location: http://www.newyorkfed.org/mortgagemaps/

Data: HUD Neighborhood Stabilization Program Data
Description: Estimated foreclosure/abandonment risk score, high-cost loans, income-eligible status, and predicted foreclosure rates according to the U.S. Department of Housing and Urban Development, as of 2008, mapped in multiple geographic divisions, including state, city, Metropolitan Statistical Areas, zip code, and so on.
Published by: The Reinvestment Fund (TRF) Policy Map
Location: http://www.policymap.com/map

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