

## Flawed Report Further Fuels Subprime Misconceptions

The November 2007 Center for Responsible Lending (CRL) “Subprime Spillover” report on the potential effect that subprime mortgage foreclosures could have on neighborhood property values adds to public misinformation regarding loan foreclosures. The report presents a misleading and inaccurate assessment of the changes in property values currently underway, and by ignoring crucial facts, encourages short-sighted policymaking.

The report confuses numbers of foreclosures with rates of foreclosure; mixes total foreclosure data with subprime foreclosure data; is unclear regarding the basis for its subprime foreclosure rate predictions; and generalizes the results of a local and outdated property valuation study to predict nationwide property value declines. These deficiencies are compounded by the incorporation of assumptions about nationwide foreclosure effects and subprime borrower behavior that contradict current observed and expected trends.

### Confusion About Market Dynamics

The CRL report ignores the basic economic principle that prices are fundamentally driven by supply and demand. In today’s market the major drivers of price declines in the upper Midwest are job loss and population outmigration; both create reductions in demand. House prices will fall when supply is constant and demand falls. This has nothing to do with a spillover effect from subprime or any other kind of lending and everything to do with local economies.

In California and Florida, and to some extent in other states, such as Arizona and Nevada, current price declines are due to the bursting of property speculator expectations, which created a significant oversupply of real estate in these areas. Significant oversupply necessarily leads to price declines. Subprime lending provided some funding for speculators. This contributed at the margin to the supply side problem by supporting additional speculative overbuilding.

Home price declines drive foreclosures, not the other way around, except in some local areas where foreclosures cluster. When such clusters occur, the additional supply of foreclosures can put additional downward pressure on home prices in a spiraling process. With about five million properties on the market, the addition to supply (above the normal foreclosure rate) from subprime foreclosures is marginal in most areas.

Another critical fact the CRL report ignores is that even in periods when home prices are rising there are a flow of foreclosures. The relevant consideration in evaluating whether foreclosures of subprime loans have a “spillover” effect is the addition to foreclosures above the normal rate, not total foreclosures.

### Basing Subprime Foreclosure Rate Predictions on Higher, Overall Foreclosure Rates

CRL multiplies the number of subprime loans originated in counties located in Metropolitan Statistical Areas (MSAs) during 2005 and 2006 by the “predicted cumulative foreclosure rate” of each MSA to predict the number of subprime foreclosures anticipated in each MSA. This “predicted cumulative foreclosure rate” – because it includes all foreclosures, rather than just subprime foreclosures – dramatically overstates the expected subprime foreclosure rate.

Those numbers are then combined with 2000 U.S. Census data on MSA housing density to determine the total number of homes nationwide that “will experience devaluation because of subprime foreclosures” occurring in their neighborhoods – an estimated 44.5 million properties, according to the report. In addition to using an inflated estimate based on total foreclosures, the CRL report assumes that all homes in the market will be affected; something that is demonstrably false.

### Predicting Nationwide Property Value Declines Based on Declines of a Small Group of Properties in One City in 1998

The CRL report uses the 0.9 percent decline in value of 3,750 properties foreclosed in Chicago in 1997–1998 as the multiplier to determine the impact of all 2008 foreclosures throughout the United States. The derivation of that number and its subsequent generalized application to generate a national estimate is not scientifically supportable. There is no justification for the presumption that the declines in this single city nearly 10 years ago will be replicated in every MSA throughout the country in 2008.

Even if this were a more recent number, there is no reason to assume that property values in all MSAs will behave the same. CRL assumes every home falls in value everywhere at the same rate. Current house price data contradict that assumption. Currently, roughly the same number of states are experiencing house price increases as are those experiencing house price declines. Furthermore, some individual markets are seeing market segments increase in value at the same time that others are experiencing declines.

Subprime foreclosures do not occur with the same frequency or have the same impact on property values in all neighborhoods across the United States – those neighborhoods that do not experience significant changes in subprime foreclosures should be expected to retain property value and tax contribution levels.

## Flawed Assumptions

The assumption that subprime foreclosures will impact neighborhoods uniformly across the United States is only one of several flawed assumptions underlying CRL's conclusions. CRL also assumes that subprime borrowers will not move to fixed-rate loans in the short term, as they are being counseled to do by the FDIC and mortgage lenders. And perhaps most important, CRL assumes that all subprime loans are equally likely to default; however, subprime loans with positive equity that are amortizing generally have a better chance of withstanding short-term economic downturns.

## Ignored Accumulated Home Equity

Perhaps the most important fact ignored by the CRL study is that most homeowners who bought homes prior to 2005 have significant amounts of accumulated equity in their homes. There is no acknowledgement of the significant benefit to adjoining homeowners of the successively rising prices during the 2000-2004 time period and the increased tax collections resulting simply from the appreciation of home prices without requiring elected officials to go on record as supporting increased taxes. The combined value of property appreciation is magnitudes greater than the decline in property values or depreciation in prices.

## Conclusion

The CRL 'Spillover' report adds to current public misconceptions about the subprime mortgage market by overestimating the number of properties affected and then overstating the economic impact on those properties. More accurate information on subprime foreclosures, including subprime foreclosures by region, is available from MBA.

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