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Examining the Rising Foreclosure Rate

Home ownership nationwide has reached a record level: 68 percent of households now own their homes. The latest recession, unlike those of the past, has seen strong home sales, rising home prices, and a generally buoyant housing market. Nonetheless, despite these encouraging trends, foreclosures on home loans are also reaching record highs.

Although the current weak economic conditions might be expected to lead to increased foreclosures, what is surprising is that foreclosures have been steadily escalating for the past twenty years—despite two strong expansions, rising incomes, and generally decreasing unemployment during the same period. The foreclosures involve only a small part of the overall housing market—less than one percent—but they likely signal serious difficulties for a significant segment of homeowners. Moreover, foreclosures raise special concern when they are concentrated in specific areas, particularly central cities, where they may be destabilizing—leading to vacancies and demolitions, damage to neighborhoods, and decline in housing values.

In this issue of *The Regional Economy of Upstate New York*, we examine the foreclosure rate in the U.S. economy and outline factors that may be contributing to its rise. We also investigate the behavior of foreclosure rates in New York State and six of its major metropolitan areas. Particular attention is given to Buffalo, where foreclosures increased fourfold in the 1990s.

While the causes of the escalating foreclosure rates remain unclear, we suggest a link to the increasing number of residential mortgages in which the amount of the loan is high relative to the value of the property. Our analysis of foreclosure rates in New York State indicates that the state rate, though below the national average during the 1980s, exceeded that average in the 1990s. Foreclosure rates in New York's metro areas were also high compared with other metro areas in the 1990s. Finally, our more detailed look at Buffalo's foreclosure patterns reveals a heavy concentration of foreclosures in three "outer-ring" city neighborhoods and a possible connection between the city's declining property values and the sharp increase in foreclosures.

The Foreclosure Process

The record level of home ownership has brought a significant increase in the number of mortgages used to finance home purchases. Not all mortgages, of course, are steadily repaid. When a borrower misses a scheduled payment, the lender cannot know whether the borrower is delinquent—temporarily delaying payment—or in default, stopping repayment altogether. In this situation, the lender must decide whether to work with a delinquent borrower, possibly renegotiating the terms of the loan so that payments can be resumed, or pursue legal foreclosure proceedings to take possession of the property. Thus, the borrower's actions determine if a loan is delinquent, but the lender decides whether to consider the loan in default and initiate foreclosure.

U.S. Foreclosure Trends

The percentage of home loans in foreclosure has generally risen over the past twenty years and, in 2002, reached a record high (Chart 1). Foreclosure rates differ, however, among the three main categories of mortgage loans: Federal Housing Authority (FHA) loans, Veterans Administration (VA) loans, and conventional loans. FHA loans, which account for approximately 14 percent of outstanding mortgages,[1] are insured by the government within specified loan-size limits. Lenders are, by and large, guaranteed against losses. VA loans are insured by the Veterans Administration for qualified veterans, and, like FHA loans, offer lenders protection from losses. Because VA loans account for less than 1 percent of mortgages, however, they are not examined further in this study. Conventional loans, although not insured by a government agency, may be covered by private mortgage insurance purchased by borrowers. Lenders typically require such insurance for loans when borrowers make a down payment of less than 20 percent.

The foreclosure rate on FHA loans has long been higher than that on conventional loans, and the gap between them has widened markedly (Chart 1). The fact that FHA loans tend to be made to a population with a higher

Chart 1

U.S. Foreclosure Rate

Source: Mortgage Bankers Association, National Delinquency Survey.

Notes: The National Delinquency Survey covers 25 million residential mortgage loans. The Mortgage Bankers Association defines the foreclosure rate as loans that entered the foreclosure process during the quarter as a percentage of all loans.

risk profile helps to explain this difference.[2] From 1980 to 1992, the foreclosure rates for conventional and FHA loans climbed steadily, increasing in economic expansions and contractions alike. During these years, the FHA rate doubled, while from 1979 to 1992, the conventional rate quadrupled. Thereafter, however, the rates diverged. While the conventional rate remained flat up through 2002, the FHA foreclosure rate doubled again between 1992 and 2002. Although the percentage of mortgages in foreclosure overall may appear small, the impact of foreclosure can be significant when concentrated in particular neighborhoods. Research on neighborhood effects is scant, but two recent studies in the cities of Buffalo and Rochester have uncovered neighborhood foreclosure concentrations (see box).[3]

Why the Rise in Foreclosures?

The reasons for the long-term increase in the aggregate foreclosure rate are not well understood—no significant studies explain this steady climb. There is, however, a large body of research that addresses the causes of delinquencies and defaults, and to a lesser extent foreclosures, on individual loans.

These studies have focused primarily on the relationship between delinquency or default and the mortgage's loan-to-value (LTV) ratio. The LTV ratio is the amount of the loan divided by the property value. An LTV of 100 percent indicates a loan amount equal to the property value; an LTV of 80 percent indicates that the mortgagee has borrowed 80 percent of the value of the home. LTV ratios may also exceed 100 percent—in particular, when second mortgages or home-equity loans push loan amounts over the value of the mortgaged property.

Virtually every loan study finds a positive relationship between LTVs and loan payment delinquencies, defaults, and foreclosures.[4] The higher the LTV, the less equity a borrower has in the property and therefore the less to lose by defaulting on the loan and losing possession. Moreover, when borrowers with high-LTV loans—particularly loans whose LTV ratios approach 100 percent or more—experience serious financial difficulties or have to move, they may find that default is an economically attractive alternative to selling their property. They may not raise enough funds from the sale of the property to pay off the mortgage, and they will need additional cash to cover the transaction costs of the sale. If these borrowers cannot cover their losses, default may be the only viable option.[5]

Some studies have also posited a link between borrowers' economic difficulties and increased rates of delinquency and default. Foremost among these difficulties are financial crises: interruptions to income, job loss, the death of a spouse, divorce, unforeseen medical expenses, and other emergencies. In addition, high loan payments relative to income have been associated with a higher likelihood of default. Some research also points to increased default rates for low-income borrowers, although other studies fail to confirm this relationship.[6]

Another strand of the literature suggests that foreclosure rates may be influenced by the costs of foreclosure for lenders. After all, the lender ultimately decides whether or not to foreclose, and lenders who choose to take this step will incur expenses for legal proceedings as well as the transaction costs of selling the property. Studies indicate that foreclosure rates tend to be higher in states where laws make the foreclosure process faster and less expensive, such as those states that allow bypassing court-supervised foreclosures for a more streamlined process.[7]

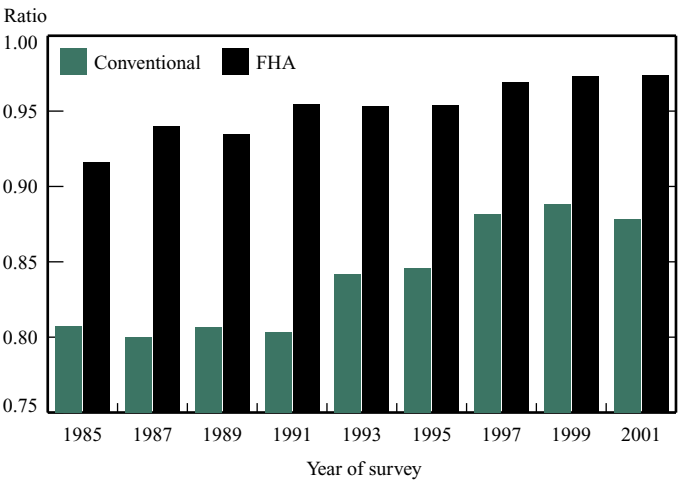
Yet even though these studies offer much insight into the causes of individual foreclosures, none examine the change in the aggregate foreclosure rate over time. Indeed, existing research leaves the long-term increase in the foreclosure rate unexplained. Nonetheless, the findings from loan-level research suggest some preliminary hypotheses about the reason for the rise in aggregate foreclosures.

First, LTV ratios have generally been increasing nationwide over the past twenty years (Chart 2). Loans with low down payments or no down payments and other high-LTV loans have proliferated over the past decade and increased average LTV ratios. Because studies strongly suggest that higher LTV ratios lead to increased foreclosures, it is likely that high-LTV loans have contributed to the burgeoning foreclosure rate.

Explaining the rising foreclosure rate in terms of borrowers' economic circumstances, however, is much more problematic.

Chart 2

Median Loan-to-Value Ratio for U.S. Residential Mortgage Loans

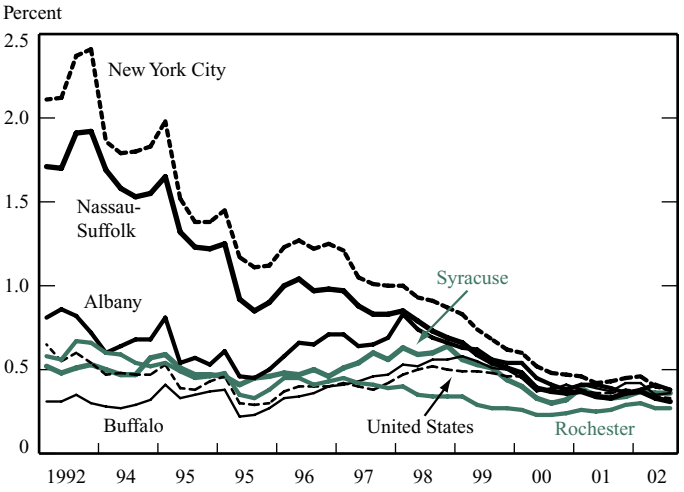


Source: American Housing Survey.

Notes: The loan-to-value (LTV) ratio is calculated as the amount of a loan divided by the value of the property. The ratios plotted are based on loans made in the year of the survey and the year just prior to it. Pre-1985 data matching our criteria were not available. FHA loans are those insured by the Federal Housing Authority.

Chart 3

Foreclosure Rates on Conventional Residential Mortgage Loans: New York State Metro Areas and the Nation



Source: Loanperformance.com.

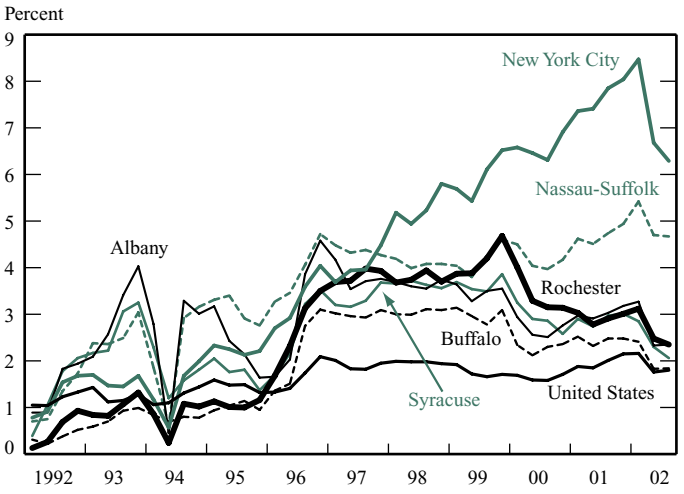
Notes: Loanperformance.com calculates the foreclosure rate as the inventory of loans that are in foreclosure as a percentage of all loans. Data are for prime loans only; subprime loans are excluded. Except for New York City, the metro areas are those defined by the Bureau of the Census; New York City is defined as the five boroughs.

Some factors related to borrower economic status may contribute to increased delinquency and default, but it is difficult to determine precisely how these factors affect the aggregate foreclosure rate without knowing more about the circumstances of those who are delinquent. For example, although economic expansions in the 1980s and 1990s have improved economic circumstances for the broad population, some segments may not be faring as well. Moreover, it is not clear whether a segment of the homeowning population is facing an increased number of economic crises. Another factor may be the increase in low-income home ownership, which rose most significantly in the 1990s. As we have seen, some research suggests that the low-income segment of the homeowning population may be more prone to delinquency and default.[8]

Thus, although research sheds some light on the determinants of individual defaults and foreclosures, extending that analysis to explain the long-term increase in the aggregate foreclosure rate is difficult. Rising LTV ratios have probably contributed to the increase, but we cannot readily evaluate how borrower economic circumstances are changing, and how these changes are affecting loan repayment. Furthermore, the causes of the higher LTV ratios are themselves complex and not well studied. Clearly, careful and comprehensive research is needed to control and isolate the effects of a multitude of factors on the foreclosure rate to better understand the forces behind its rise.

Chart 4

Foreclosure Rates on FHA Residential Mortgage Loans: New York State Metro Areas and the Nation



Source: Loanperformance.com.

Notes: Loanperformance.com calculates the foreclosure rate as the inventory of loans that are in foreclosure as a percentage of all loans. FHA loans are those insured by the Federal Housing Authority. Data are for prime loans only; subprime loans are excluded. Except for New York City, the metro areas are those defined by the Bureau of the Census; New York City is defined as the five boroughs.

Table 1

Foreclosure Rates for Selected Metropolitan Areas, 1992-2002

	Total	FHA Rank	Conventional Rank		Total	FHA Rank	Conventional Rank
Riverside	1.35	11	7	Sta Barbara	0.45	74	28
Newark	1.33	1	3	San Diego	0.44	71	36
Orange	1.32	3	1	Phoenix	0.44	61	45
New York	**1.26**	**2**	**2**	Dayton	0.42	41	50
Monmouth	1.24	8	4	Akron	0.41	21	51
Nassau-Suff.	**1.07**	**4**	**8**	Pittsburgh	0.40	44	46
New Haven	1.05	10	9	San Antonio	0.39	80	58
Berg-Passaic	1.04	13	6	Houston	0.39	72	42
Scranton	1.02	6	5	Richmond	0.39	40	80
Los Angeles	0.94	14	10	Tulsa	0.38	65	52
Philadelphia	0.93	5	16	Atlanta	0.38	45	61
Miami	0.88	16	14	Redding	0.38	58	43
Albany	**0.88**	**18**	**15**	Salt Lake Cty	0.38	59	57
Syracuse	**0.84**	**15**	**22**	Sta Rosa	0.37	69	39
Orlando	0.80	24	18	Chico-Yuba	0.36	76	49
Hartford	0.80	25	12	Greenville	0.36	46	53
Middlesex	0.80	27	11	Spokane	0.36	64	60
Allentown	0.79	9	17	Birmingham	0.35	52	75
Jacksonville	0.76	34	26	Nashville	0.35	53	79
Memphis	0.72	28	62	Oakland	0.35	66	38
New Orleans	0.70	29	29	Toledo	0.35	22	56
Rochester	0.68	12	25	Charlotte	0.34	51	65
Fairfield	0.68	20	13	Cincinnati	0.32	36	68
Fresno	0.68	42	31	St Louis	0.32	48	64
Norfolk	0.68	37	69	Louisville	0.29	62	70
Tampa	0.65	30	24	Tucson	0.29	81	67
W. Palm Beach	0.63	19	21	Kansas City	0.28	67	73
Baltimore	0.61	26	54	Minneapolis	0.27	68	77
Las Vegas	0.61	50	37	Greensboro	0.27	70	74
Honolulu	0.60	32	19	Monterey	0.25	79	59
Cleveland	0.60	7	35	Seattle	0.25	75	71
Modesto	0.59	49	27	Austin	0.24	82	78
Buffalo	**0.58**	**31**	**32**	Raleigh	0.22	63	83
Anaheim	0.53	43	20	Milwaukee	0.22	38	76
D.C.	0.53	35	47	Portland	0.21	78	72
Sacramento	0.52	56	33	Knoxville	0.21	77	85
Chicago	0.52	17	41	Denver	0.20	83	82
Columbus	0.50	23	44	San Jose	0.20	85	63
Boston	0.50	73	23	San Francisco	0.19	86	66
Indianapolis	0.50	33	55	Detroit	0.19	54	81
Okla. City	0.50	60	40	Omaha	0.18	84	84
Providence	0.47	39	34	Grand Rapids	0.16	55	86
Worcester	0.46	47	30				
Dallas	0.45	57	48	**U.S.**	**0.54**	**38**	**29**

Source: Loanperformance.com.

Notes: The foreclosure rate is calculated as the average of all quarterly rates from 1992 through the third quarter of 2002; data are collected on these 86 metro areas only.

Foreclosures in New York State

The foreclosure rate in New York State exceeded the national average for most of the 1990s, after remaining below average throughout the 1970s and 1980s. The rate rose dramatically during the 1990-91 recession—more than doubling between 1990 and 1992. That period saw a severe state recession that for some areas lasted into the early 1990s. Overall, New York State's foreclosure rate ranked forty-fourth in the nation in the 1980s, but ninth in the nation in the 1990s.

To examine foreclosure rates within New York State, we use local foreclosure data collected by Loanperformance.com, an agency that collects loan data covering approximately 70 percent of the aggregated U.S. residential mortgage market. Data are available from 1992 to 2002 for eighty-six metropolitan areas, including New York City, Nassau-Suffolk, Buffalo, Rochester, Albany, and Syracuse.[9]

Foreclosure rates for New York's metro areas were generally above the national rate during the ten-year period. The foreclosure rates for New York City and Nassau-Suffolk were among the ten highest rates for the eighty-six metro areas studied (see table). Albany and Syracuse also ranked high, with Rochester and Buffalo ranking lower but above the national rate. FHA foreclosure rates in New York State were higher than conventional rates—the same pattern observed at the national level. While FHA foreclosure rates increased during the period, conventional foreclosure rates fell (Charts 3 and 4).

Downstate, the conventional foreclosure rates for New York City and Nassau-Suffolk were more than double those for most of the upstate metro areas during the early 1990s, but they fell steadily throughout the decade (Chart 3). Foreclosure rates for upstate metro areas fell slightly from 1992 to 1995, increased from 1995 to 1998, then increased throughout 2002. Conventional foreclosure rates for upstate and downstate metro areas converged and were essentially equivalent by 2000.

FHA foreclosure rates have behaved quite differently than conventional rates, climbing throughout much of the 1990s (Chart 4). In particular, all areas showed a sharp increase in these rates beginning in 1996. And while foreclosure rates flattened in the late 1990s for upstate metro areas, they continued to climb in New York City and Nassau-Suffolk. In New York City, the FHA foreclosure rate in 2002 was four times the national rate

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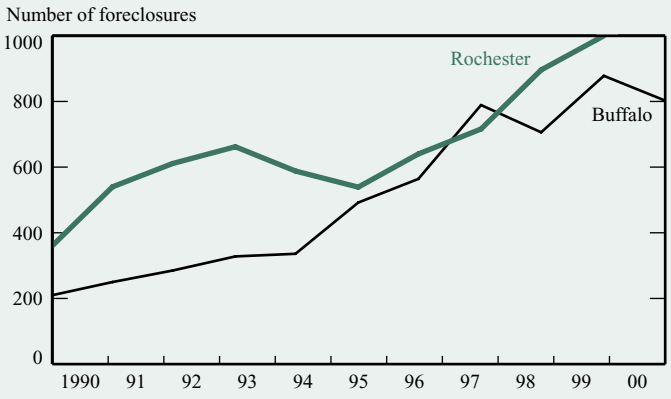
Foreclosures in the City of Buffalo

Although the percentage of home loans that end in foreclosure has remained relatively small, the trends underlying the national and regional rise in foreclosures are worrisome. Recent studies of foreclosures in Rochester and Buffalo, conducted by the Rochester Housing Council and the Buffalo Branch of the Federal Reserve Bank of New York, indicate that during the 1990s, foreclosures quadrupled in both cities (see chart). Moreover, these increases were heavily concentrated in particular neighborhoods. In this box, we look more closely at the key findings of our study of foreclosures in Buffalo.[1]

We detected two patterns in the geographic distribution of foreclosures in the city (Exhibits 1 and 2). First, foreclosures increased dramatically in all parts of the city from 1990 to 2000. Second, foreclosures tended to spread into the outer ring of the city in clusters. By the year 2000, foreclosures were densely concentrated in three outer-ring neighborhoods—the Northeast, East Delavan, and the West Side. To understand the genesis of these patterns, we matched neighborhood foreclosure rates with housing market characteristics and socioeconomic data and examined loan-level data in a sample of foreclosures.

Residential Foreclosures in Buffalo and Rochester, 1990-2000



Sources: *Buffalo Law Journal*; Rochester Housing Council.

Declining Property Values

Like many cities, Buffalo has some of the oldest housing in its metropolitan area and shows little growth in new homes.[2] The city has 28 percent of the metro area's housing, yet more than half of the region's pre-1939 housing stock and half of its housing vacancies. The city and metro area are losing population, and the city's share of the metro area's population has been declining. While the region has gained housing units, the city has experienced both a loss of housing units and an increase in vacancies.

An important consequence of the reduced demand for city housing is a broad decline in property values (Table 1). Between 1998 and 2002, the median home price for existing-home sales dropped in most Buffalo neighborhoods and, in the city overall, fell 13 percent.

Such declining property values have, in turn, led to higher loan-to-value (LTV) ratios, an outcome strongly associated with a rise in foreclosures**.** In 2000, the median LTV of a foreclosed property in the city of Buffalo at the time of foreclosure was 119 percent.[3] In other words, the amount of the loan exceeded the value of the property by a significant margin. Homeowners in this predicament find that if they attempt to sell their homes, the funds raised will not cover the balance of the loan. Foreclosure will likely leave the homeowner in a better financial position than selling and may be the only viable option if there are no other funds available to cover the balance due.

Socioeconomic Characteristics of Foreclosures

In the Buffalo study, we examined foreclosure patterns in 2000 in relation to a number of neighborhood socioeconomic characteristics. We found that foreclosure rates were generally highest in city areas with higher incomes—although these

areas had incomes well below the metro area overall. Fifty-nine percent of all foreclosures were in higher-income census tracts. The foreclosure rate for stable higher-income tracts—meaning those that saw no significant change in income level from 1990 to 2000—was 0.64 percent, somewhat higher than the 0.44 percent rate for stable lower-income tracts. In addition, tracts that experienced a large decline in income experienced relatively high foreclosure rates.

Sixty-three percent of foreclosures occurred in minority census tracts, with the remaining 37 percent taking place in nonminority tracts. Furthermore, the highest foreclosure rates occurred in areas undergoing a change in racial composition, particularly a change from a white to a minority population. In these areas, the foreclosure rate was nearly double the citywide average. Census data indicate that the minority population is generally moving outward, with the greatest increase in minority population occurring in a concentric ring around the outer edges of the city. These foreclosure patterns mirror the patterns identified in a Fannie Mae study of New Orleans home loans.[4]

Characteristics of Foreclosed Loans

We also examined detailed loan records to determine the specific characteristics of foreclosed loans. We found that 38 percent of foreclosures were on homes with Federal Housing Authority (FHA) mortgages, even though FHA loans account for only 14 percent of mortgages nationwide. This result reflects both more FHA lending in the city than the nationwide average and the higher foreclosure rate on FHA loans. Most of the foreclosures were on mortgages that were used for a direct purchase, with only about one-third on mortgages used for refinancing loans. Most foreclosures occurred on relatively young loans; the average age of the loans when foreclosure proceedings were started was 5.6 years. In addition, we found that foreclosures were nearly evenly split between owner-occupied and investor-owned properties. Owner-occupants, however, foreclosed at approximately a 50 percent faster rate, and new homeowners accounted for the majority of foreclosures.

The Buffalo study will be published by the Buffalo Branch of the Federal Reserve Bank of New York in June. Visit www.newyorkfed.org for more details.

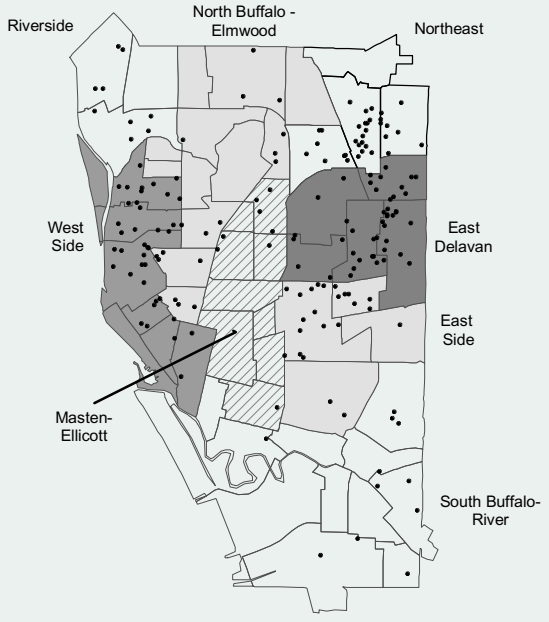
Table 1
City of Buffalo Housing Market, 1998-2002

	Existing Home Sales Percentage Change	Median Home Price Percentage Change	Median LTV in 2000 (Percent)	Foreclosure Rate in 2000 (Percent)
N. East	26	-11	119	1.03
E. Delavan	14	-37	125	0.96
East Side	44	-25	159	0.56
Riverside	46	-6	124	0.49
S. Buffalo-River	33	-15	110	0.48
W. Side-Central	75	-54	105	0.47
Ellicott-Masten	103	0	153	0.32
N. Buffalo-Elmwood	41	5	112	0.22
Buffalo total	35	-13	119	0.53

Sources: Buffalo Association of Realtors' City of Buffalo.
Notes: Because overall loan data were unavailable for the city, we defined the foreclosure rate as total foreclosures divided by total housing units. The first year that data on median home prices by neighborhood were available was 1998, see footnote 3 regarding the computation of LTV.

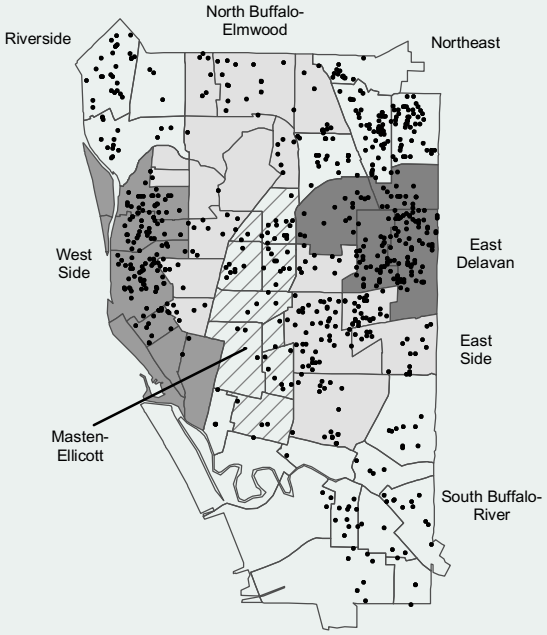
Notes:
[1] Foreclosure data were gathered from individual records from the *Buffalo Law Journal*, the Erie County Clerk's office, and the City of Buffalo; some of the results presented are based on samples. For further details on methodology, see the complete report.
[2] The Buffalo metropolitan area consists of Erie and Niagara counties.
[3] Technically, our measure is not the median LTV ratio but the median judgment relative to the value of the foreclosed property. The judgment is the amount homeowners owed on their mortgages at foreclosure, and includes the outstanding balance on the loan's principal, plus interest, attorney and court fees.
[4] See Mickey Lauria, "A New Model of Neighborhood Change: Reconsidering the Role of White Flight," *Housing Policy Debate* 9, no. 2 (1998): 395-424.

Exhibit 1
Foreclosures by Neighborhood, Buffalo, 1990



Sources: City of Buffalo, Division of Planning, Buffalo Law Journal

Exhibit 2
Foreclosures by Neighborhood, Buffalo, 2000



Sources: City of Buffalo, Division of Planning, Buffalo Law Journal

and, in Nassau-Suffolk, double the national rate. Overall, during the period from 1992 to 2002, New York City had the second-highest average FHA foreclosure rate of the eighty-eight metro areas studied. FHA foreclosure rates for New York State's metro areas ranked in the top quartile during the period from 1992 to 2002—with the exception of Buffalo.

Given the lack of research explaining the increase in foreclosures at the national level, it is difficult to assess the causes and pattern of New York State's relatively high foreclosure rates. Nonetheless, studies of foreclosures in Buffalo and Rochester suggest that property values have declined in the central cities of upstate metro areas. This decline has contributed to high LTV ratios and, in some cases, negative equity (see box). More detailed data on the geographic location and specific characteristics of foreclosures in individual metro areas, however, will be necessary to understand the sources and behavior of foreclosures in New York State.

Conclusion

The U.S. foreclosure rate has been rising steadily for the past twenty years, reaching a level of 0.37 percent in 2002. Our analysis indicates that New York State has had an above-average foreclosure rate since the 1990-91 recession, with New York City and Nassau-Suffolk ranking particularly high among a peer group of metro areas from 1992 to 2002.

While research addressing the causes of rising foreclosure rates is negligible, the importance of understanding these causes is great, because foreclosures may well affect particular segments of homeowners disproportionately. Foreclosure studies in the cities of Rochester and Buffalo, for example, have uncovered significant concentrations of foreclosures in specific neighborhoods. Further research into the causes and impacts of these trends is surely needed to identify effective responses to the clustering of foreclosures and the continued rise in the foreclosure rate.

Notes:

[1] U.S. Census Bureau, American Housing Survey, 2001.

[2] FHA borrowers tend to be younger, more credit-constrained, and live in areas with below-average incomes; see Harold Bunce et al., An Analysis of FHA's Single Family Insurance Program (Washington, D.C.:, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 1995).

[3] For an example in New Orleans, see Mickey Lauria, "A New Model of Neighborhood Change: Reconsidering the Role of White Flight," Housing Policy Debate 9, no. 2 (1998), 395-424.

[4] For a comprehensive review of these studies, see Roberto Quercia, "Residential Mortgage Default: A Review of the Literature," Journal of Housing Research 3, no. 2 (1992): 341-79.

[5] Default likely affects credit history, however. Borrowers who choose this course must reckon with this additional cost.

[6] See Nicolas Retsinas and Eric Belsky, eds., Low-Income Homeownership: Examining the Unexamined Goal (Washington, D.C.: Brookings Institution, 2002); and Roberto Quercia, "Residential Mortgage Default."

[7] See Terrence Clauretee, "The Impact of Interstate Foreclosure Default Differences and the Value of Mortgages on Default Rates," American Real Estate and Urban Economics Association Journal 15, no. 3 (1987). New York State does not allow such nonjudicial foreclosures.

[8] See, for example, Belsky and Duda, "Anatomy of the Low-Income Homeownership Boom in the 1990s," in Low-Income Homeownership: Examining the Unexamined Goal.

[9] The data from Loanperformance.com cover only prime loans; subprime loans, made to those with poorly established credit or banking histories, are excluded. In this regard, the data differ from the Mortgage Bankers Association (MBA) foreclosure data. Moreover, Loanperformance.com tracks the inventory of loans in foreclosure, while MBA tracks only those loans that entered the foreclosure process during the immediate quarter. For this reason, the foreclosure rates calculated by Loanperformance.com will tend to be higher than those estimated by MBA.

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