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Housing Foreclosures in Kentucky

Research Report No. 365

Prepared by

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Housing Foreclosures in Kentucky

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Housing Foreclosures in Kentucky

Abstract

Foreclosure is a legal proceeding to end a borrower's title to and possession of a property when the borrower defaults on mortgage loan payments. In Kentucky, foreclosures are handled by the courts. Residential foreclosures have increased in recent years in Kentucky and the United States. During the fourth quarter of 2008, 0.78 percent of loans in Kentucky entered the foreclosure process, approximately four times higher than the percentage in the 1990s. About 7.5 percent of loans were past due on at least one mortgage payment, an indication of borrowers at risk for future foreclosure. Nationally, the higher rate of foreclosures in recent years appears to be due to a number of factors, including changes in real estate finance, volatility in house prices, changing interest rates, and weakening employment. In Kentucky, house prices have been more stable than in the nation overall. Kentucky had fewer adjustable rate mortgages than most states, but employment loss has been high. Borrowers, lenders, neighborhoods and governments are all affected by these foreclosures. State and federal programs aimed at reducing the number of foreclosures and minimizing the impact are focusing on refinancing and modifying loans and stabilizing neighborhoods.

Foreword

In January 2009, the Program Review and Investigations Committee directed staff to study home foreclosures in Kentucky. The resulting report was to address three major objectives:

- describe the foreclosure process in Kentucky, including how laws in Kentucky compare to those in other states;
- describe recent foreclosure trends in Kentucky, as well as factors that have contributed to these trends; and
- identify the effects foreclosures have on neighborhoods, local government, and state government, including house prices and tax revenues.

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Summary

In January 2009, the Program Review and Investigations Committee directed staff to study home foreclosures in Kentucky. This report covers the foreclosure process, the number and distribution of foreclosures in Kentucky, causes and effects of the increase in foreclosures, and government programs that have been implemented in response to the increase.

Courts Handle the Foreclosure Process in Kentucky

In Kentucky, foreclosures go through a judicial process, meaning foreclosures are handled by the courts. When it is determined that a borrower is in default on a loan, the lender files a foreclosure suit with the circuit court. Typically, the homeowner does not respond to the filing, so the court issues a default judgment for the lender. The property is then referred to a court official, the master commissioner, who will auction the property. The lender will usually buy the property at the auction and relist the property for sale.

Some states use a nonjudicial foreclosure process, which means the process is not required to go through the courts. Other differences between states include whether the homeowner retains the right for a period of time to repurchase the property, and whether the borrower can be sued for any portion of the loan amount not covered by the sale of the property.

Kentucky's Foreclosure Rate Has Been Increasing

Data from the Mortgage Bankers Association's National Delinquency Survey indicate that in Kentucky during the fourth quarter of 2008, 0.78 percent of loans entered the foreclosure process, approximately four times higher than the percentage in the 1990s. In the same quarter, about 7.5 percent of all loans were past due on at least one mortgage payment, an indication of borrowers at risk for future foreclosure. Nationally, rates were slightly higher. In the U.S., 1.03 percent of loans entered the foreclosure process and 7.8 percent were past due on at least one payment.

State data indicate that there are a higher number of foreclosures in the middle region of Kentucky. This could be due to a number of factors, such as a higher percentage of homeowners having a mortgage, and recent population growth increasing the demand for new mortgage loans, which have a higher probability of default. Foreclosure data collected from Daviess, Hardin, and Jefferson Counties show that some counties have experienced large increases in foreclosures in recent years, but other counties have not seen the same growth.

Causes of Increased Foreclosures

Nationally, the increased rate of foreclosures appears to be caused by a number of factors. Recent changes in real estate finance contributed to three main factors that led to more foreclosures: volatility in house prices, changing interest rates, and weakening employment. In recent years, an increasing number of loans have been sold to investors. This creates an incentive for lenders to issue more mortgages. The result has been that many lenders began to offer mortgages that had low initial interest rates, required little or no documentation of income, and required little or no equity. When interest rates increased and housing prices decreased, many borrowers could no longer pay their mortgages and were unable to sell their homes.

According to the Federal Housing Finance Agency, house prices in Kentucky have not been as negatively affected as in other states. An index that tracks property purchases and refinance appraisals shows a 3.4 percent national decline in house prices over the past year. In Kentucky, house prices increased 0.8 percent over the past year.

Rising interest rates increase the monthly payment for borrowers with an adjustable rate loan. The Federal Housing Finance Board reported that in 2006, 12 percent of the loans in its survey in Kentucky were adjustable rate loans, lower than the median of 15 percent for all states.

As of April 2009, the unemployment rate in Kentucky was 9.8 percent, higher than the national rate of 8.9 percent. Home prices most impact individuals trying to sell their homes, and interest rates impact borrowers with adjustable rate loans, but increasing job losses potentially impact all borrowers.

Effects of Foreclosures

In addition to losing the equity in the home, the loan default hurts a borrower's credit score, making it more difficult and costly to get credit in the future. Borrowers not involved in a foreclosure also can be affected by difficulty accessing credit and paying higher interest rates.

The costs of foreclosures to mortgage lenders, servicers, and investors vary depending on the type of loan and contractual arrangements between lending institutions. Historically, loans are insured against mortgage losses through private mortgage insurance, and some of the losses are eventually recouped. Local sources estimated that a foreclosure costs lenders $25,000 to $30,000 on average.

Foreclosures negatively impact property values for homes nearby. This is primarily because the properties are not adequately maintained and the crime often increases at vacant property. Twenty-two neighborhoods in west Louisville had a net decrease in property assessments from their last assessment to 2009.

The total impact of foreclosures on tax revenues cannot be determined. In the case of a foreclosed property, current and past due taxes are first liens on a property and are paid from the proceeds of the foreclosure sale. This means that property tax revenues may be delayed but will be received. In addition, because of foreclosures, property values might decrease or not increase

as quickly. However, lower property values do not necessarily result in reduced property tax revenues. Local property tax rates may be set so that the property taxes yield at least as much revenue as in the previous year. If property assessments increase less than 4 percent, state property tax revenues will not yield the 4 percent growth permitted under state law. Overall, state real property assessments and revenues are growing but at a lower rate than in previous years.

Federal, State, and Local Governments' Responses to Increasing Foreclosures

Federal programs include Making Home Affordable, which offers a loan modification and loan refinance components; and the Neighborhood Stabilization Program, which deals with the effects foreclosed homes have on neighborhoods. The Neighborhood Stabilization Program has granted Kentucky $37.4 million and Louisville/Jefferson County an additional $6.97 million.

State programs include the Kentucky Homeownership Protection Center, a central facility aimed at referring homeowners in need to certified counseling programs. On the local level, Jefferson County Circuit Court has implemented a foreclosure conciliation program that requires the mortgage holder to participate in a conciliation conference if the homeowner chooses. Some of these programs may have limited effectiveness. Evidence from loan modifications made by banks in prior years suggests that the redefault rate on loan modifications is high.

Chapter 1

Overview and Background

Foreclosure is a legal process that allows the holder of a mortgage loan to take possession of a property when the borrower is unable to meet the mortgage obligations. Prior to the formal foreclosure process, mortgage borrowers who are behind on their mortgage payments are said to be delinquent. In Kentucky and nationally, both delinquency rates and foreclosure rates have increased rapidly in recent years.

Major Conclusions

This report has six major conclusions:

1. Foreclosures have increased both nationally and in Kentucky. Kentucky's foreclosure rate in the fourth quarter of 2008, 0.78 percent, was about four times higher than in the 1990s.

2. In recent years, an increasing number of loans have been sold to investors. This created an incentive for lenders to issue more mortgages, so they offered mortgages that had low initial interest rates, required little or no documentation of income, and required little or no equity. When interest rates increased, many borrowers could no longer pay their mortgages. A decrease in housing prices meant that many borrowers owed more on their homes than the market value of the house.

3. Weakness in the housing market affected the rest of the nation's economy, and unemployment began to rise. As workers lost jobs, they had more difficulty paying their mortgages. Unemployment appears to be one of the factors contributing to the increase in Kentucky's foreclosures.

1. Each year from 2001 through 2007, the percentage of mortgage loans entering foreclosure in Kentucky exceeded the percentage for the nation. The national foreclosure rate has increased rapidly in recent years, passing Kentucky in 2007. In the fourth quarter of 2008, 1.03 percent of mortgage loans in the nation and 0.78 percent of mortgage loans in Kentucky entered the foreclosure process. The percentage of loans that entered foreclosure in Kentucky at this time was approximately four times higher than in the 1990s. Data on the distribution of foreclosures in Kentucky are limited but indicate that the middle region of the state has seen a higher foreclosure rate than other areas.

2. Traditionally, lenders who originated mortgages held onto them. In recent years, they have increasingly packaged and sold their mortgage loans to investors as securities. This created an incentive for lenders to issue more mortgages, so they increasingly offered mortgages that had low initial interest rates, required little or no documentation of income, and required little or no equity. When interest rates increased, many borrowers could no longer pay their mortgages. Many were unable to sell their homes because a decrease in housing prices meant that they owed more than the market value of the house.

3. As weakness in the housing market affected the rest of the nation's economy, unemployment began to rise. As workers lost jobs, they had more difficulty paying their mortgages. Unemployment appears to be one of the factors contributing to the increase in Kentucky's foreclosures.

4. Foreclosures can reduce the property values of other homes in the neighborhood.

5. If foreclosures were to cause total property assessments to be lower than they otherwise would be, property tax revenues could be impacted. Property assessments for the state as a whole have not decreased.

6. Federal, state, and local governments have responded to increases in foreclosures. Twenty-five states enacted 36 laws in 2008 or 2009 that deal with foreclosure issues relevant to this study.

4. Foreclosures can reduce the property values of other homes in the neighborhood.

5. If foreclosures were to cause total property assessments to be lower than they otherwise would be, property tax revenues could be affected. Property assessments for the state as a whole have not decreased.

6. Increases in foreclosures have resulted in responses from federal, state, and local governments. Twenty-five states, including Kentucky, enacted 36 laws in 2008 or 2009 that deal with foreclosure issues relevant to this study.

Legal Overview of the Foreclosure Process

Home foreclosure is a legal proceeding to end a homeowner's title to and possession of his or her home when the homeowner fails to make mortgage payments. This can happen with the original mortgage, a second mortgage, or a home equity loan. Often, the mortgage holder(s) contracts with a mortgage servicer to deal with borrowers.

Home foreclosure is a legal proceeding to end a homeowner's title to and possession of his or her home when the homeowner defaults on mortgage loan payments. A mortgage loan is a loan for which the borrower guarantees repayment by a mortgage or deed of trust on residential real property. A mortgage loan may also be any lien guaranteed by an interest in the residential real property (KRS 286.8-010(18)). For example, if a homeowner defaults on payments on the original mortgage, a second mortgage, or a home equity loan, any of those lien holders can bring a foreclosure action (Commonwealth. Home. About).

A mortgage payment is considered delinquent when the lender does not receive it by the due date set out in the loan documents. The timing and amount of late charges vary from servicer to servicer; 15 days is typical. A mortgage is usually considered to be in default when the borrower has not made a payment for 60-90 days, depending on the loan documents. The loan documents usually specify at what point default is considered to have occurred. It is possible for default to occur if payment has not been made after 30 days (U.S. Dept. of Housing. "Glossary"; Mortgage. Home).

When default occurs, the mortgage holder may begin the foreclosure process. The mortgage holder may be the original lender, a buyer of the mortgage on the secondary market, or the owner of mortgage-backed securities. Often, the mortgage holder contracts with a mortgage servicer to act for the mortgage holder in dealing with borrowers.

Foreclosure Law in Kentucky

Kentucky allows only judicial foreclosures, which means that a full court process must take place. A complaint must be filed that includes all interested parties. The homeowner must be given a chance to respond, and a hearing may be held.

Kentucky allows only judicial foreclosures, which means that a full court process must take place, as with any other civil lawsuit (KRS 426.525). The mortgage holder must file a formal complaint with the court; all interested parties, such as other lien holders, must be added to the complaint; the homeowner must be given a chance to respond to the complaint; and a hearing may be held. A court official, usually a master commissioner, oversees any foreclosure sale that occurs.

Kentucky is a lien theory state, which means the homeowner holds title to the property during the mortgage term. The homeowner has a right to live in the home until a foreclosure sale is completed. If the homeowner abandons the property, the mortgage holder may take possession and title immediately.

Kentucky is a lien theory state, which means the homeowner holds title to the property during the mortgage term. Thus, the homeowner has the right to live in the house until there has been a valid, completed foreclosure sale. However, if the homeowner abandons the property after defaulting on payment, the mortgage holder may move to take possession and title immediately. Abandonment means the homeowner has moved out of the property and further neglect or failure to attend to the property will decrease its value (KRS 426.525).

The Kentucky Homeownership Protection Center connects homeowners facing default or foreclosure with counseling agencies that can help them attempt to work out a settlement with the mortgage holder.

In 2008, the General Assembly authorized the Kentucky Housing Corporation to create the Kentucky Homeownership Protection Center, which it has done. The center's purpose is to be a central location that homeowners can contact if they are facing default or foreclosure. The center refers those homeowners to counseling agencies throughout the state that will work with them free of charge to contact the mortgage holder and attempt to negotiate a loss mitigation workout, if appropriate (KRS 198A.400). A loss mitigation workout is a negotiated settlement between the mortgage holder and the borrower that falls between having the mortgage repaid according to the terms of the original loan documents and enforcement of the mortgage through foreclosure (Stewart 5). These counseling agencies are members of the center and thus meet its standards that ensure they will work in the borrower's best interest (Commonwealth. Home. Counseling Agreement).

Loss Mitigation and Notice. Kentucky law does not require a mortgage holder to attempt a loss mitigation workout or other arrangement besides foreclosure, except for high-cost home loans (KRS 426.005(2); KRS 360.100). If the loan is not a high-cost home loan, the underlying loan documents determine if the mortgage holder is required to attempt a workout. Kentucky's rules of civil procedure allow a circuit court to order mediation in any civil litigation, including foreclosure cases, but it is not a requirement (CR 16).

High-cost loans are defined by Kentucky law.

In Kentucky, a high-cost home loan is one in which

- the principal amount of the loan is between $15,000 and $200,000;
- the borrower is a natural person and not a corporation;
- the total points and fees payable by the borrower upon the loan closing exceed a certain dollar amount or percentage of the loan amount set either by Kentucky or federal law, whichever is greatest, and
- the annual percentage rate exceeds the Treasury Security Yield of comparable maturity on a comparable type of loan during the month previous to the loan application date (KRS 360.100(1)(a)).

Also, unless the underlying loan documents require it, Kentucky statute does not require the mortgage holder to notify the borrower before a complaint is filed with the court, except for high-cost home loans (Stewart 13). According to several officials interviewed for this report, industry practice is to issue increasingly severe warning notices to the borrower for 3 months before filing a complaint with the court.

If the underlying loan documents contain an acceleration clause, the entire mortgage debt (along with accrued interest, fees, and taxes) becomes due immediately when the mortgage holder files a complaint with the court against the homeowner.

If the underlying loan documents contain an acceleration clause, which they virtually always do, the mortgage holder may accelerate the mortgage at the time it files a foreclosure complaint with the court. Acceleration means the entire mortgage debt becomes due immediately, along with all accrued interest, fees, and taxes. Acceleration is not mandated by Kentucky statute, so if the original loan documents do not contain an acceleration clause, courts often will not allow it (Stewart 12).

Sometimes, it may be in the mortgage holder's best interest to attempt a loss mitigation workout with the homeowner.

While not required by law, a loss mitigation workout may be in the mortgage holder's best interest. An example of a loss mitigation workout is a loan modification that changes the loan terms. Options include lowering the interest rate on the loan or extending the period of the loan, from 30 years to 40 years, for example. Another possible loan modification is re-amortizing the loan, which means the delinquent amount is added to the principal balance and the loan is brought current.

Several other possibilities to avoid foreclosure may also be available to the homeowner if the mortgage holder agrees. These include a short sale, in which the homeowner sells the house for less than the mortgage balance. The mortgage holder "forgives" the difference between the selling price and the mortgage balance. This option is sometimes available when property values have declined since the mortgage was issued. Another possibility is a

deed in lieu of foreclosure in which the mortgage holder accepts the deed to the property in exchange for dropping the foreclosure process. This means the homeowner gives back the property to the mortgage holder. To qualify, the borrower must have no other liens or mortgages on the property or any other mortgages in default. Most likely, a servicer will not accept a deed in lieu unless all foreclosure fees are paid (Commonwealth. Home. Alternatives).

The lender and homeowner can work out a solution at any time until the property is sold to a new owner.

At any time up until the property is sold to a new owner, the original homeowner and mortgage holder can still arrange one of the above workout solutions. If a workout solution is found, it is an informal process and does not go through the courts (Commonwealth. Home. "About").

For high-cost home loans, the lender must give the homeowner 30 days' notice before filing a complaint with the court and allow the homeowner to cure the default.

If the loan is a high-cost home loan under Kentucky law, the mortgage holder must give the homeowner 30 days' notice of default before filing a complaint with a court. Such a notice must include a statement of the amount to be paid by the homeowner to cure the default, which reinstates the mortgage and returns the homeowner to predefault status, and the date by which such a payment is due (KRS 360.100(2)(s)).

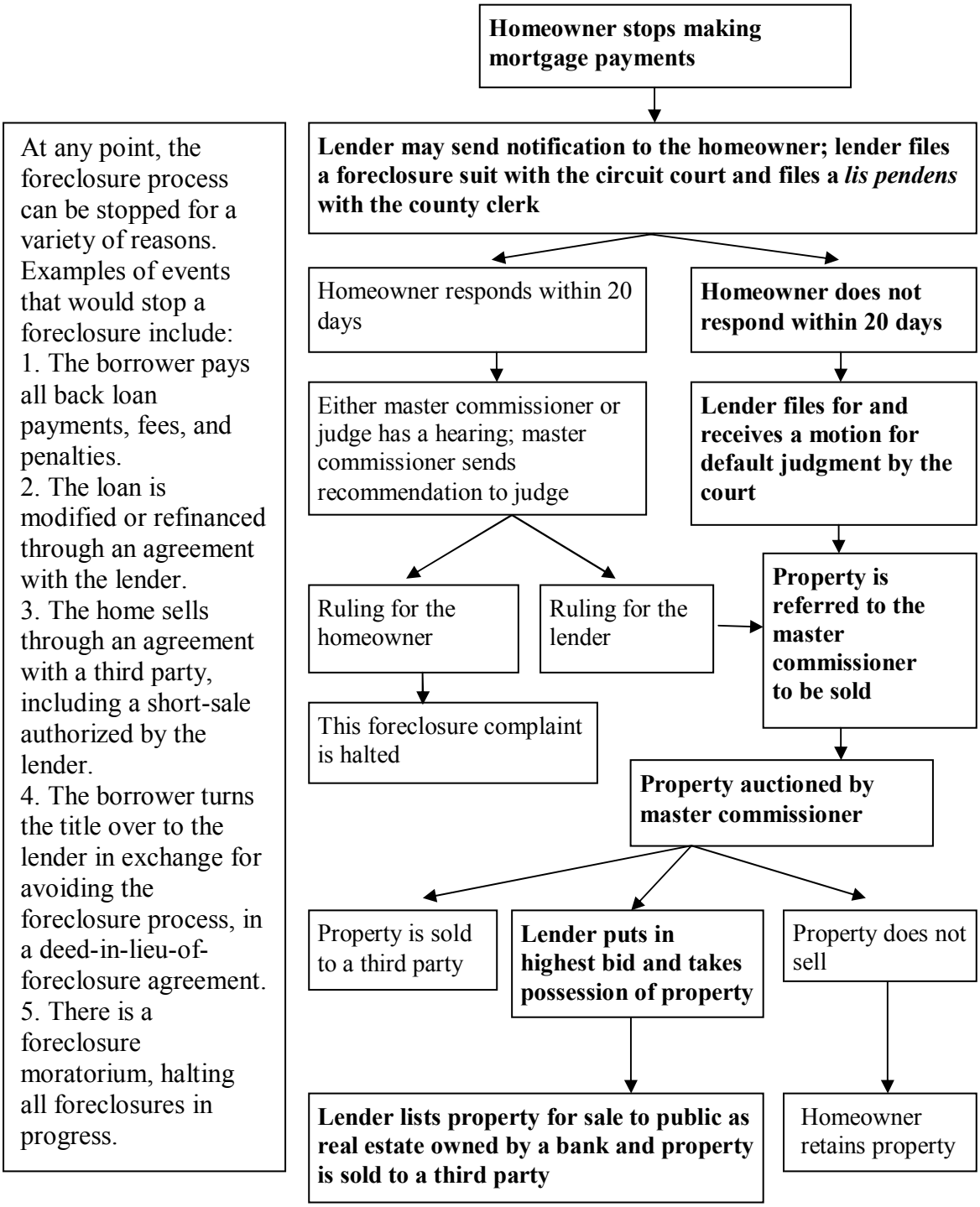
Lenders involved in a loss mitigation workout for a high-cost home loan may not charge fees for this workout unless the fees are less than one-half the fees that would be charged for a refinancing of the mortgage.

During a loss mitigation workout for a high-cost home loan, the mortgage holder may not charge the homeowner any fees to modify, renew, extend, or amend the loan or to defer any payment due under the terms of the loan, unless the fees are less than one-half of any fees that would be charged for a refinancing of the mortgage, or unless the borrower is in default and it is in the borrower's best interests (KRS 360.100(2)(g)). It has been suggested that this is to prevent mortgage holders from calling what really is a refinancing by some other term, thus continually reducing the homeowner's equity through the fees the servicer charges for changing the loan terms (Barnett 491).

Kentucky's Foreclosure Process

Described below is Kentucky's judicial foreclosure process for when a homeowner defaults on a mortgage payment but continues to live in the house, and when no workout has been arranged. The process is also summarized in Figure 1.A.

Figure 1.A
Foreclosure Process in Kentucky
(The most likely course of events is in bold)



Source: Compiled by LRC staff based on interviews.

To begin the judicial foreclosure process, the mortgage holder files a complaint for the amount due against the homeowner in the circuit court where the property is located. The claim must specify anyone else with a potential interest in the property.

To begin the judicial foreclosure process, the mortgage holder files a complaint for the amount due against the homeowner in the circuit court where the property is located (KRS 452.400(3)). In the complaint, the mortgage holder must show entitlement to relief and must demand judgment for that relief (CR 8.01). The mortgage holder must add anyone else to the complaint that has a lien on or some other potential interest in the property.

A filing of the record of a foreclosure complaint by the mortgage holder allows anyone who looks up the property to see that litigation is in process.

The mortgage holder also immediately files *lis pendens*, a memorandum of actions affecting real property, in the county clerk's real estate records in the county where the property is located. The *lis pendens* serves as a warning to anyone who looks up the property that litigation is being conducted. The *lis pendens* should state that the action is a foreclosure; the names of the parties who have a right, title, interest in, or claim to the property; and a description of the property (KRS 382.440).

The court serves a copy of the complaint and a summons to the homeowner. If the homeowner does not respond within 20 days, the matter is referred to the master commissioner of the circuit court, and a ruling is made that allows the mortgage holder to proceed with a foreclosure sale.

The court then serves a copy of the complaint and a summons to the homeowner. If the homeowner does not respond to the court in 20 days, the mortgage holder files a motion for a default judgment with the court (CR 12.01). A default judgment asks for an immediate ruling in favor of the mortgage holder so that the mortgage holder may proceed with a foreclosure sale of the property.

In most Kentucky circuit courts, if the homeowner does answer the claim within the 20 days, the matter is referred to the circuit court's master commissioner for a ruling. In some circuit courts, the judge continues to handle the complaint.

If the homeowner responds to the court within the 20 days, a hearing may be held. Valid homeowner defenses include that payments were made, that the homeowner is in bankruptcy, that the mortgage holder cannot produce the original loan documents, or that it is unclear who owns the mortgage and thus can bring suit.

There are several possibilities if the homeowner responds to the court within the 20-day period. If the master commissioner or judge decides that the homeowner's answer raises no valid points, he or she can rule for the mortgage holder, and the foreclosure may proceed. If the homeowner has raised a possibly valid defense to the claim, the master commissioner or judge will hold a hearing to determine its validity. Examples of valid defenses include the homeowner's claim that the payments were made, at which point the burden is on the homeowner to show this; the homeowner has gone into bankruptcy; the party suing is not able to produce the original loan documents; or the party suing does not have standing to sue, which is most common if the mortgage has been bundled with other securities and it is unclear who actually owns it.

If the court rules for the mortgage holder, the foreclosure sale process begins. The mortgage holder prepares an order of sale, notifies the homeowner and the county clerk, and pays a nonrefundable $100 fee for the master commissioner's office.

If the court rules for the mortgage holder, the foreclosure sale process begins. The mortgage holder prepares a judgment and order of sale for the court to sign (CR 58; Stewart 22). The judgment must contain the time, place, and terms of sale (KRS 426.700). The mortgage holder must also send a copy of the notice of the judgment lien to the homeowner and to the county clerk so that another *lis pendens* is entered in the records (KRS 426.720). The mortgage holder submits Administrative Office of the Courts form 141.S, "Order Referring Case to Master Commissioner for Judicial Sale," along with a $100 nonrefundable fee for the master commissioner's office (Commonwealth. Administrative Office. Form 141.S.).

A property referred to the master commissioner for sale may not actually be sold. Reasons for sale cancellations include homeowner bankruptcy, the homeowner making the loan current, a loss mitigation workout, or a moratorium.

According to Administrative Office of the Courts staff, referral of a property to the master commissioner for sale does not automatically mean it is sold. They estimated that about 60 percent of the referrals end up selling. Possible reasons for sale cancellations include that the homeowner may have gone into bankruptcy, which would put a stay on foreclosure proceedings; that the loan may have been made current; that a loss mitigation workout plan may have occurred; or that there was a moratorium on foreclosure sales.

Before sale, the house must be appraised and the sale must be advertised in appropriate newspapers.

Before a sale is held, the master commissioner must send two impartial appraisers to drive by the house separately and appraise its current market value under oath. If the two appraisers disagree, the officer selling the property, usually the commissioner, determines the appraisal value (KRS 426.520). Some of the rights of the purchaser and original homeowner later in the process will depend on the appraised value. The master commissioner's office also must advertise the sale of the property in appropriate newspapers and sometimes by displaying notices in appropriate places, depending on local court rules (KRS 426.200(2); KRS 426.560).

The master commissioner holds a public auction where anyone may bid on the property. A mortgage holder that wants to purchase the property must also bid because title is held by the homeowner until the property is sold.

The commissioner's office then holds a public auction at the circuit courthouse, where anyone may bid on the property, including the mortgage holder (KRS 426.200(1)). The mortgage holder must bid on the property if it wants the property because title is held by the homeowner until the property is sold. If the property does not sell, the borrower continues to hold it. According to one master commissioner, a property usually sells for at least a minimal amount.

Once a sale is confirmed with the court, the purchaser receives title to the property. If there is a surplus, it is used to pay off any other lien holders. The homeowner may file a claim for any surplus that is left. Otherwise, any remaining surplus reverts to a state fund.

If the property sells for more than the total of the taxes, mortgage debt, costs, and other fees, the surplus first goes to pay off any other lien holders, such as second mortgage holders or home equity loans. The original homeowner receives any remaining surplus (KRS 426.500). However, the homeowner must file a claim for the surplus funds because they are not automatically refunded. If the homeowner does not claim the surplus, the surplus money reverts to a state fund. As an example, the Fayette Circuit Court estimated that in the past 5 years about $40,000 from its circuit has gone unclaimed.

If the property sells for less than two-thirds of its appraised value, the original homeowner has a 1-year right of redemption, in which he or she can take back the home by paying the same price as the winning bidder plus 10 percent.

If the property sells for less than two-thirds of its appraised value, the original homeowner has a 1-year right of redemption. This means that if the original homeowner can arrange to pay the price paid by the winning bidder at the auction plus 10 percent, he or she has a right to take back the property (KRS 426.530). According to several master commissioners, this rarely happens.

If the property sells for less than the total debt due on the mortgage, the mortgage holder may bring a deficiency claim against the original homeowner to recover the difference in some circumstances.

If the property sells for less than the total debt that was due under the mortgage, the mortgage holder may sue the original homeowner to recover the difference. Such a deficiency judgment claim is a separate legal action from the foreclosure itself. A deficiency judgment allows a mortgage holder to recover the difference between the unpaid loan balance and the amount the property sold for through the attachment of the borrower's personal assets (Clauretie 223).

Kentucky law allows a mortgage holder to bring a deficiency judgment only against a borrower who was personally served with the mortgage holder's default complaint and summons with the circuit court, and the borrower did not answer the complaint (KRS 426.005(1)).

Other Types of Foreclosure Provisions Used in Other States

Nonjudicial Process

Some states allow a nonjudicial foreclosure process when a power-of-sale clause is in the loan documents. This preauthorizes the sale of the property to pay off the loan balance in the event of default. If a right to a power-of-sale is not mentioned in the loan documents, a judicial process may be used instead.

The nonjudicial foreclosure process is used when a power-of-sale clause exists in a mortgage or deed of trust that preauthorizes the sale of the property to pay off the balance on a loan in the event of default. A power-of-sale clause gives the mortgage holder the authority to sell the property.

A power-of-sale foreclosure has no judicial involvement. The property is sold at a public sale by the mortgage holder, a public official such as a sheriff, or a third party such as a trustee. States that allow power-of-sale foreclosures do so only if the language of

the original loan documents allows it. Even in nonjudicial states, if the right to a power-of-sale foreclosure is not mentioned in the original loan documents, a judicial process is used. In states that allow power-of-sale foreclosures, a homeowner may still request a judicial proceeding under certain circumstances.

Of Kentucky's contiguous states, Illinois, Indiana, and Ohio use the judicial process only. Missouri, Tennessee, Virginia, and West Virginia allow power-of-sale foreclosures.

Title Theory

In a title theory state, the mortgage holder retains legal title to the property until the mortgage has been fully paid. The homeowner may have to vacate when a foreclosure action begins.

In a title theory state, the mortgage holder retains legal title to the property until the mortgage has been fully paid or foreclosed. It is possible that the homeowner may have to vacate the property when a foreclosure action begins. Of Kentucky's contiguous states, Missouri, Tennessee, Virginia, and West Virginia are title theory states. Illinois, Indiana, and Ohio are lien theory states, in which the homeowner holds title during the mortgage term. Table 1.1 compares the law in Kentucky and contiguous states regarding judicial and nonjudicial foreclosures, lien theory and title theory, the right of redemption, and deficiency judgments.

Table 1.1
Comparisons of Foreclosure Law in Kentucky and Contiguous States

State	Type of Foreclosure Process	Lien or Title Theory	Right of Redemption	Deficiency Judgment
Kentucky	Judicial only	Lien	1 year if foreclosure sale price is less than two-thirds of appraised value	Allowed but only if borrower was personally served with complaint and did not answer
Illinois	Judicial only	Lien	3 months from the time a final foreclosure is entered; a foreclosure sale cannot occur until the time period expires	Allowed
Indiana	Judicial only	Lien	No	Allowed
Missouri	Nonjudicial is primary method; judicial is allowed	Title	Allowed for nonjudicial foreclosures; 1 year for judicial foreclosures	Not allowed
Ohio	Judicial only	Lien	Yes, must occur before confirmation of the foreclosure sale	Allowed; 2-year limit
Tennessee	Nonjudicial is primary method; judicial is allowed	Title	2 years, unless waived in the loan documents	Allowed
Virginia	Nonjudicial is primary method; judicial is allowed	Title	Not allowed for nonjudicial foreclosures: allowed in some judicial foreclosures for 240 days	Allowed
West Virginia	Nonjudicial is primary method; judicial is allowed	Title	No	Not allowed

Notes: Judicial means a full court process; nonjudicial usually means a power-of-sale foreclosure. The lien theory means the homeowner may stay in the property until the foreclosure sale is final; the title theory means the homeowner must move out upon initial filing of a foreclosure claim. Right of redemption is the original homeowner's ability to buy back the home after foreclosure. A deficiency judgment is brought by the mortgage holder against the original borrower for the difference between the sale price and the original mortgage amount.
Source: Compiled by LRC staff from United States Foreclosure Law and Foreclosure.com.

Effects of State Differences

Research has shown that a judicial foreclosure process, a statutory right of redemption, and restrictions on deficiency judgments extend the foreclosure process and increase losses to lenders.

Research has shown that the judicial foreclosure process and statutory right of redemption both extend the foreclosure and liquidation process and increase losses that lenders may face (Clauretie). Restrictions on deficiency judgments serve to increase these losses. There is evidence that lenders may require larger down payments as a result of these laws (Jones). As a result, these laws may cause a decrease of 4 percent to 6 percent in the dollar amount of loans (Pence). In general, lenders respond to losses by reducing the supply of loans.

Laws that place restrictions on the foreclosure process may cause potential borrowers to increase their demand for loans. Borrowers may also face higher interest rates and fees as lenders attempt to minimize their losses.

The legal environment of a particular state affects borrowers as well. Laws that place restrictions on the foreclosure process may cause potential borrowers to increase their demand for loans. There is some evidence that higher default rates arise as a result (Ambrose). Borrowers may be charged higher interest rates and fees even if they have no history of default because lenders pass higher costs to all their customers. These higher interest rates may further increase the probability of default, as the cost of making mortgage payments becomes higher.

Chapter 2

Trends and Distribution of Foreclosures

The foreclosure rate has no standard definition. There are multiple stages in the foreclosure process; and the number of homes, borrowers, and loans affected by foreclosure varies at each stage. This chapter discusses data that measure the foreclosure situation in Kentucky and the United States. The data demonstrate how foreclosures have changed over time and provide insight into the geographic distribution of foreclosures across Kentucky.

There are four main differences in how foreclosure rates are calculated. The first is whether the measure includes the number of legal filings or the number of properties receiving a filing. There are multiple filings for each property, and there could be multiple properties included in some filings.

The second difference is in the base being used to calculate the rate of delinquencies or foreclosures: as a percentage of housing units in the area or as a percentage of loans. Using the number of housing units does not take into account households that do not have mortgages. However, the number of loans in specific geographic areas is not readily available.

The third difference is whether foreclosures are counted by the number of new foreclosures or the number of foreclosures in process. Some measurements include a property as being in foreclosure from the moment a foreclosure filing is initiated until the property is sold to a third-party buyer. This number can be exaggerated by backlogs of properties in the system, by varying state laws or regulations that result in a longer foreclosure process, or by properties for sale as real estate owned by the bank.

Foreclosure data are often collected when the borrower becomes past due on the loan, when the foreclosure process is started, when the property is referred to the county master commissioner to be sold at auction, and when the property is actually sold at auction.

The fourth difference in how the foreclosure rate may be calculated is what stage in the process the count is made. Government agencies, businesses, and industry organizations often collect data related to foreclosures

- when the borrower becomes delinquent on a mortgage loan,
- when the lender files the initial foreclosure claim against the borrower,
- when the property is referred to the master commissioner to be sold, and
- when the property is sold by the master commissioner.

Many borrowers who miss payments or become seriously delinquent on their loans are able to recover and avoid foreclosure. For those who receive notice that the foreclosure process has begun, sources suggest that only about 40 percent to 50 percent of their homes are actually sold at auction (Hope Now). Therefore, the risk of counting loan delinquencies or initial foreclosure filings is that the number of borrowers who actually lose their homes is overstated. Likewise, evidence suggests that many of the property sales that are referred to the master commissioner are canceled before they are sold.

Counting the number of homes that are sold at auction does indicate the number of properties for which the foreclosure process is completed, but it may underestimate the severity of the problem. Foreclosure moratoriums or a backlog in the court system may result in a lower number of properties sold, even though more homeowners are entering the foreclosure process. This also does not count homeowners who engage in a short sale or deed in lieu of foreclosure, or who sell their homes for less than market value to a third party. These homeowners may have lost their homes due to a threat of foreclosure even though the final sale did not come through the court.

Foreclosure Trends

This study uses data from the Mortgage Bankers Association, which collects quarterly data from lenders on delinquencies and foreclosures for residential first mortgages.

Data on mortgage loan delinquencies and initial foreclosure filings come from the National Delinquency Survey of the Mortgage Bankers Association, which represents the real estate finance industry. This voluntary survey of mortgage lenders collects data on first mortgages for residential properties. Mortgage lenders report quarterly on the number of first mortgage loans that are either delinquent or in foreclosure. The association reports that nationwide, the survey covers about 80 percent to 85 percent of the mortgage loans outstanding (Mortgage. "National"). The National Delinquency Survey covered about 440,500 first lien residential mortgage loans in Kentucky during the fourth quarter of 2008, which is estimated to be about 50 percent of the mortgage loans in Kentucky. The survey covered a longer period of time than any other state-level data on foreclosures, collecting quarterly data since 1979.[1]

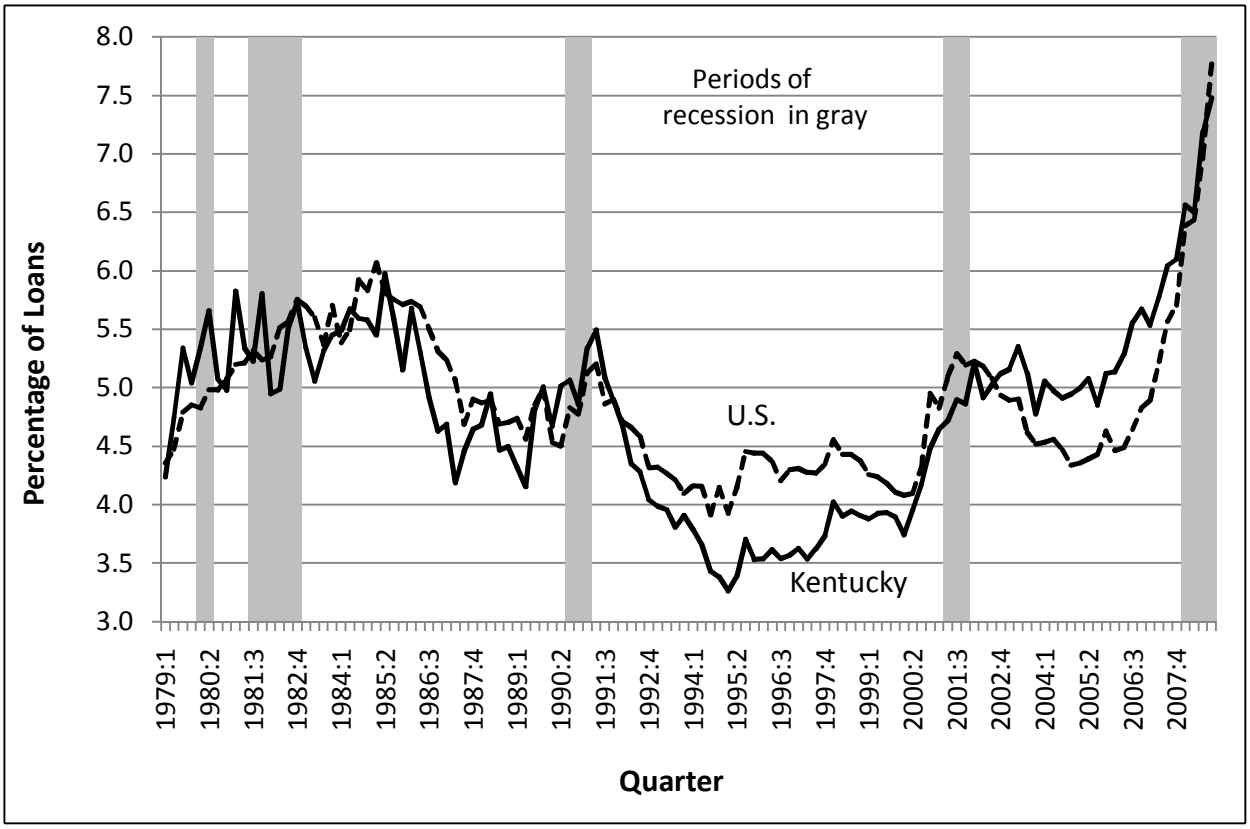
[1] In 2006, the Administrative Office of the Courts began collecting data on the number of cases referred to master commissioners in Kentucky. These data have not been collected long enough to accurately describe trends in foreclosures.

Mortgage Loan Delinquencies

The earliest indication of a potential foreclosure is when a homeowner misses a mortgage payment. Many borrowers who are behind on their monthly mortgage payments are able to avoid foreclosure. The number of delinquent mortgage loans does, however, provide an indication of the number of loans that are at risk of foreclosure.

Figure 2.A shows the percentage of all loans past due, or delinquent, in Kentucky and the United States since 1979. National recessions, as defined by the National Bureau of Economic Research, are shown in gray bands. The percentage of mortgage loans that were past due varied over time but was often higher before and during recessions.

Figure 2.A
Past Due Mortgage Loans in Kentucky and the U.S.
1979 to 2008



Note: Seasonally adjusted. Periods of economic recessions are indicated by gray bands. Data cover all quarters from first quarter 1979 to fourth quarter 2008. Due to space limitations, labels for only some quarters are shown.
Source: Mortgage Bankers Association National Delinquency Survey.

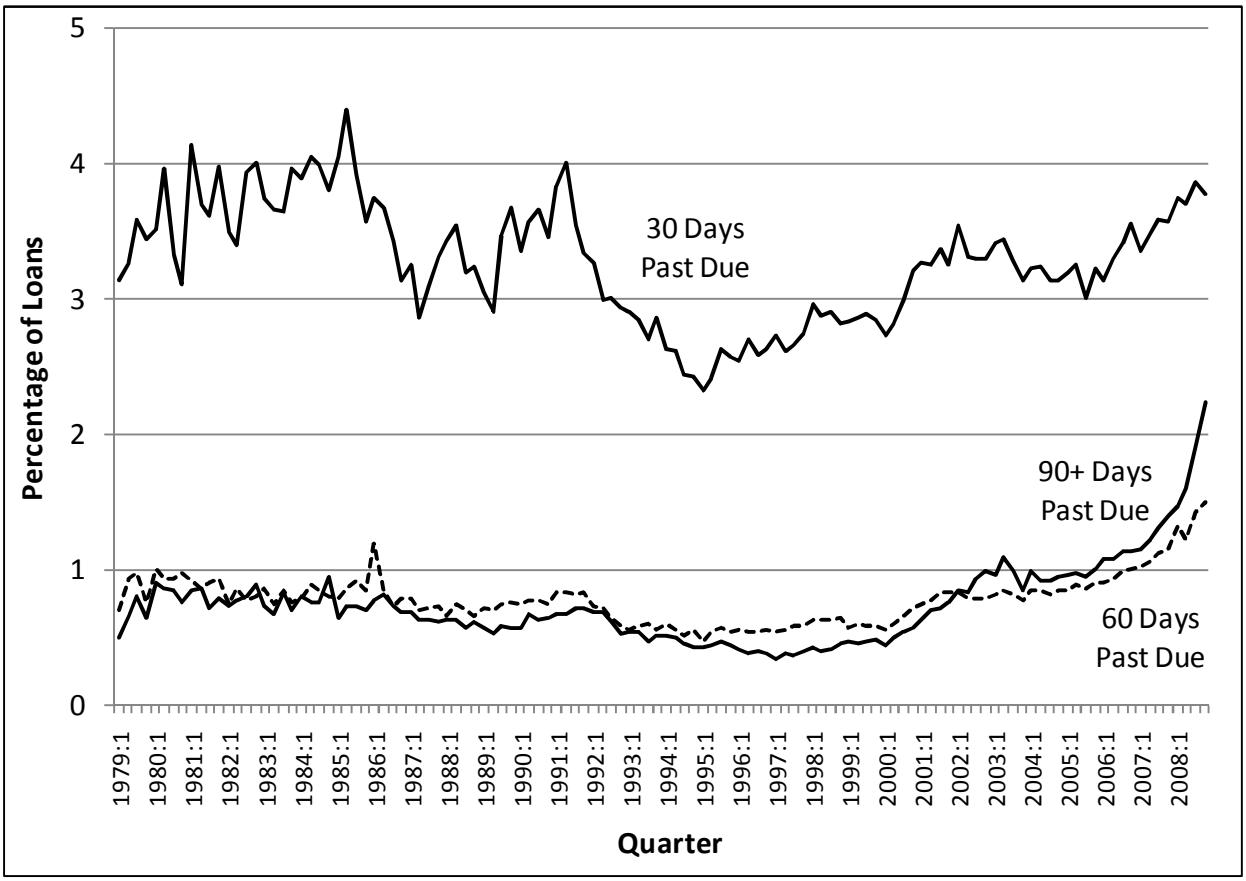
In the fourth quarter of 2008, about 7.5 percent of mortgage loans reported in Kentucky were past due on at least one payment but not yet in the foreclosure process, up from about 5 percent in 2005. The national rate was 7.8 percent of all loans reported.

As of 2002, the percentage of mortgage loans that were past due in Kentucky was higher than the national average. The percentage of past due loans increased sharply in recent years for both Kentucky and the United States, but the rest of the nation had a higher increase. During the fourth quarter of 2008, about 7.5 percent of mortgage loans reported in Kentucky were past due on at least one payment but not yet in the foreclosure process, up from about 5 percent in 2005. The national rate was 7.8 percent of all loans reported. The percentages of loans past due in Kentucky and the U.S. are the highest since 1979, the period covered by the Mortgage Bankers Association data.[2]

Loans that are past due on a payment vary by the severity of the delinquency. The National Delinquency Survey tracks whether loans are 30-59 days late, 60-89 days late, or 90 or more days late but not yet in foreclosure. Figure 2.B shows the percentage of Kentucky loans in the survey that fell into each of these categories. In the fourth quarter of 2008, 3.8 percent of loans were 30-59 days late, 1.5 percent were 60-89 days late, and 2.2 percent were 90 or more days late but not in foreclosure. Nationally, 3.5 percent of loans were 30-59 days late, 1.6 percent were 60-89 days late, and 2.7 percent were 90 or more days late but not in foreclosure.

[2] The Kentucky and U.S. data from the National Delinquency Survey were seasonally adjusted using the ARIMA X-12 procedure in SAS.

Figure 2.B
Past Due Mortgage Loans in Kentucky by Severity of Delinquency
1979 to 2008



Note: Seasonally adjusted. Data cover all quarters from first quarter 1979 to fourth quarter 2008. Due to space limitations, labels for only some quarters are shown.
Source: Mortgage Bankers Association National Delinquency Survey.

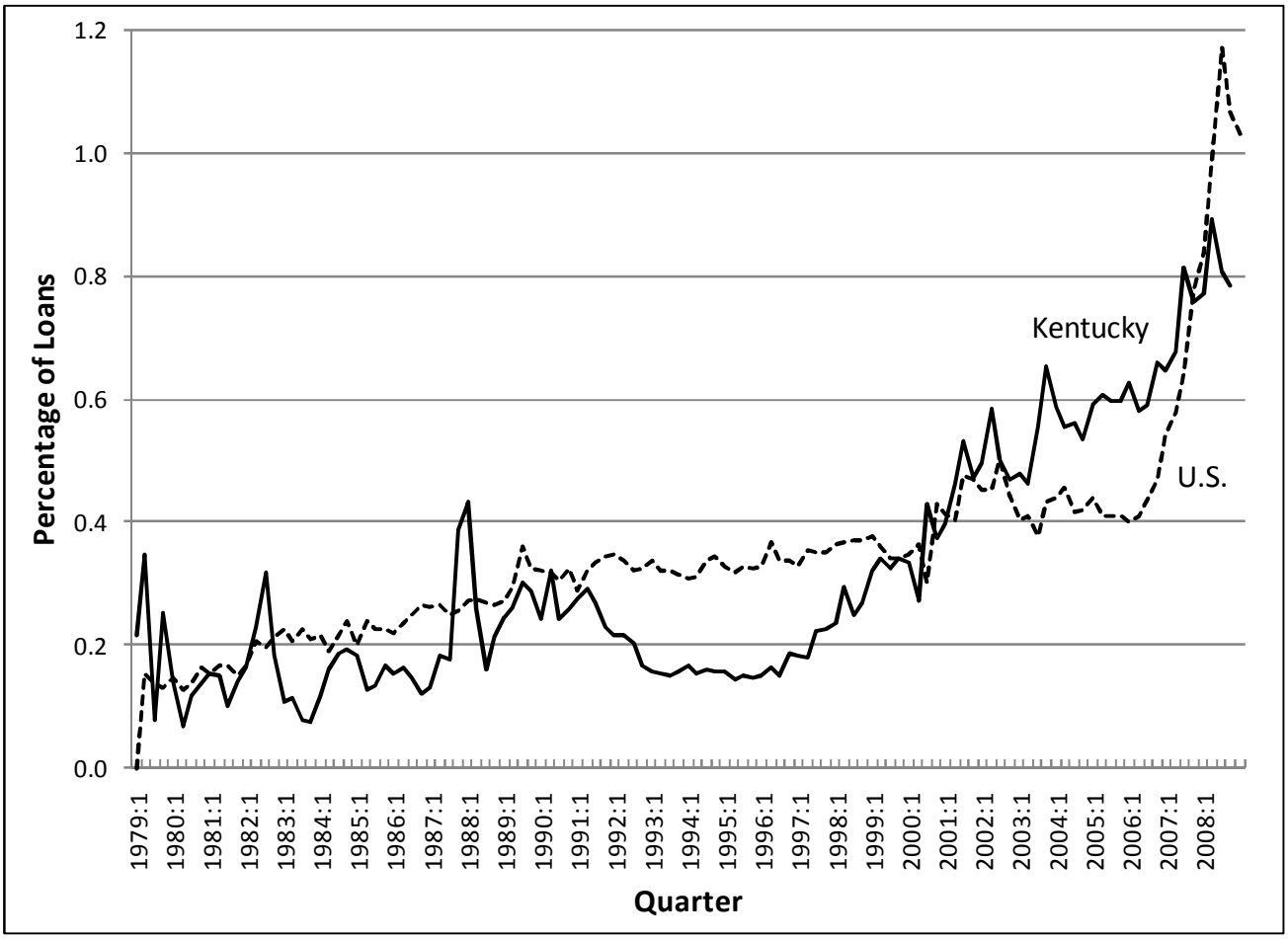
Initial Foreclosures

Many loans that become past due are resolved before the foreclosure process is started. Therefore, the rate of mortgages that enter foreclosure is much lower than the rate of delinquent loans. In Kentucky during the fourth quarter of 2008, 7.5 percent of loans were delinquent but less than 1 percent entered the foreclosure process.

In the fourth quarter of 2008, 0.78 percent of loans entered the foreclosure process in Kentucky, compared with 1.03 percent of loans in the U.S.

Figure 2.C shows the percentage of mortgage loans that entered the foreclosure process for both Kentucky and the U.S. since 1979. The percentage of mortgages that enter into foreclosure in Kentucky has steadily increased since the mid-1990s. Nationally, the percentage began to increase in 2005 and surpassed Kentucky's rate in 2007. In the fourth quarter of 2008, 0.78 percent of mortgage loans in Kentucky entered the foreclosure process, compared with 1.03 percent of mortgage loans nationally.

Figure 2.C
Percentage of Loans Entering Foreclosure in Kentucky and the U.S.
1979 to 2008



Note: Seasonally adjusted. Data cover all quarters from first quarter 1979 to fourth quarter 2008. Due to space limitations, labels for only some quarters are shown.
Source: Mortgage Bankers Association National Delinquency Survey.

Recent decreases in the number of loans entering the foreclosure process may be due to lender moratoriums on foreclosures or because lenders are unable to keep up with the pace of loan defaults.

Foreclosure starts have decreased slightly in the last two quarters. This decrease may be the result of foreclosure moratoriums as lenders and borrowers attempt to modify the terms of loans, or the inability of lenders to file foreclosures at the rate that borrowers are defaulting. In the last two quarters, a strong increase in loans that are more than 90 days past due indicates that some borrowers at risk of foreclosure are continuing to be classified as seriously delinquent because lenders are not officially starting foreclosure proceedings.

Distribution of Foreclosures in Kentucky

The Administrative Office of the Courts is able to count the number of foreclosure cases that are referred to each county's master commissioner to be sold.

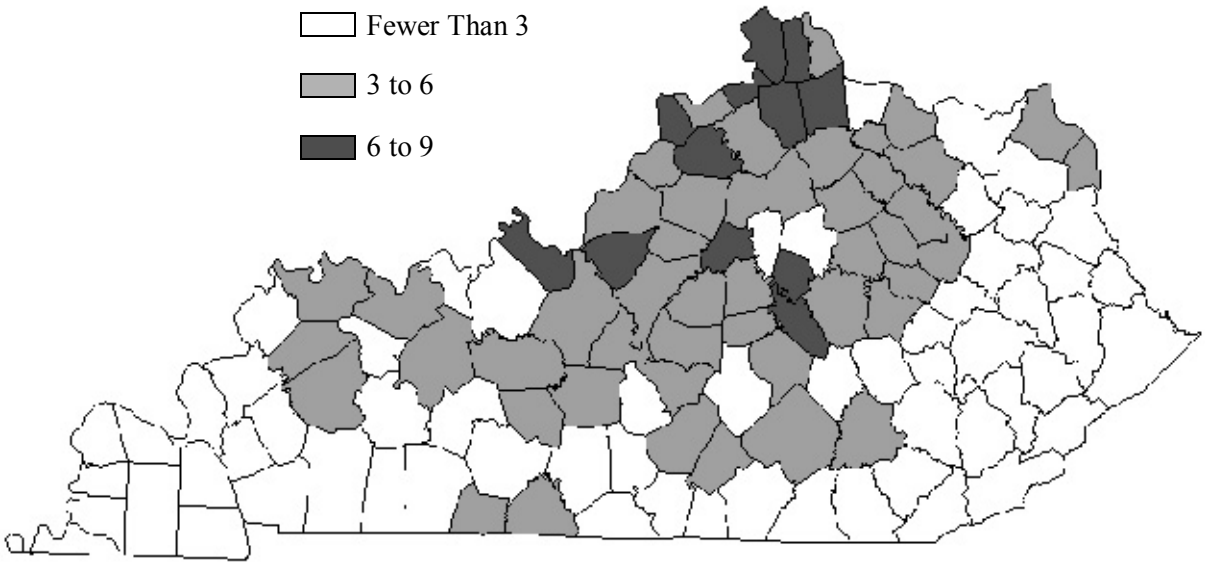
The Administrative Office of the Courts (AOC) collects data that can be used to describe the geographic distribution of foreclosures in Kentucky. When a foreclosure case is referred to a master commissioner for sale, the circuit court collects a $100 fee from the mortgage lender to cover the cost of selling the property. These fees are reported to the AOC quarterly.

The AOC data provide the only count of foreclosures that covers all counties, but the data have limitations. Some property that is referred for sale will not be sold. Recent evidence suggests that the number of properties withdrawn from sale may be increasing as federal loan modification programs are put into place and lenders become less willing to take on additional real estate. In addition, the fees represent cases, not properties. For example, one case might represent a builder that has defaulted on loans covering multiple properties. A case can also represent residential and commercial property, and the data do not indicate whether a case includes commercial property. Finally, if a sale is canceled and then referred again within 6 months, the fee is waived. Therefore, properties that are referred for sale multiple times before being sold may appear more than once in the AOC data.

In 2008, 16,665 foreclosure cases were referred for sale in Kentucky. These included residential and commercial foreclosure cases. The highest number of foreclosure case referrals per person is in the middle region of the state.

Figure 2.D shows the number of referrals per 1,000 people during 2008 by county. Statewide there were 16,665 case referrals to a master commissioner for property to be sold, or about 3.9 case referrals per 1,000 people. Elliott, Martin, Carlisle, and Magoffin Counties had the lowest referrals, with less than one referral per 1,000 people during 2008. Gallatin, Grant, Anderson, and Kenton Counties had the highest rate, with more than seven referrals per 1,000 people.

Figure 2.D
Number of Foreclosure Cases Referred to Kentucky Master Commissioners Per 1,000 People in 2008



Source: Staff analysis of data provided by the Administrative Office of the Courts and 2007 Population Estimates from the U.S. Census Bureau.

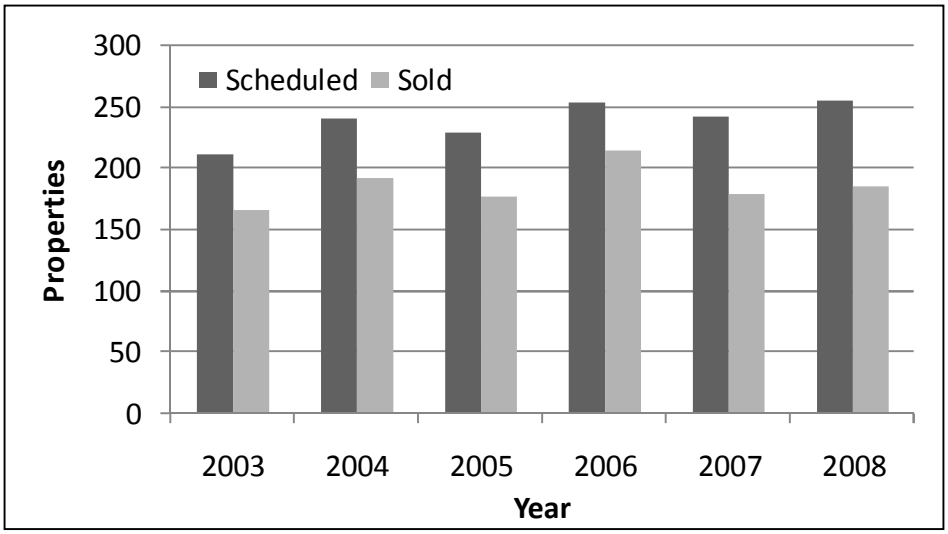
There are a number of factors that could contribute to more referrals being concentrated in the middle of the state. Homeowners are more likely to have a mortgage in this part of the state (U.S. Census. "Mortgage"). There also may have been more access to or more demand for some of the more nontraditional mortgage loan products offered in recent years. Finally, population growth has been greater in counties in the middle of the state in recent years (Univ. of Louisville). An inflow of new residents into an area would increase demand for new mortgage loans, and borrowers are most likely to default on a loan within the first few years (Phillips).

Some master commissioners maintain data on the number of foreclosure cases scheduled to be sold and the number actually sold. Of three counties for which such data were obtained, one had minimal change over recent years; the others had rapid increases.

Although they are not are not required to, some master commissioners maintain data on the foreclosed property they sell. Staff were able to obtain data from the master commissioners in Daviess, Hardin, and Jefferson Counties showing the number of properties that were scheduled to be sold and the number that were actually sold in recent years.[3]

Figures 2.E, 2.F, and 2.G summarize the data for these counties. These three charts show how counties have been affected differently by the foreclosure situation. The number of properties scheduled for sale and sold increased at a fairly rapid pace since 2006 in both Hardin and Jefferson Counties. Daviess County, however, did not experience that large increase. The number of properties scheduled for sale in Daviess County in 2008 was just slightly higher than in 2006.

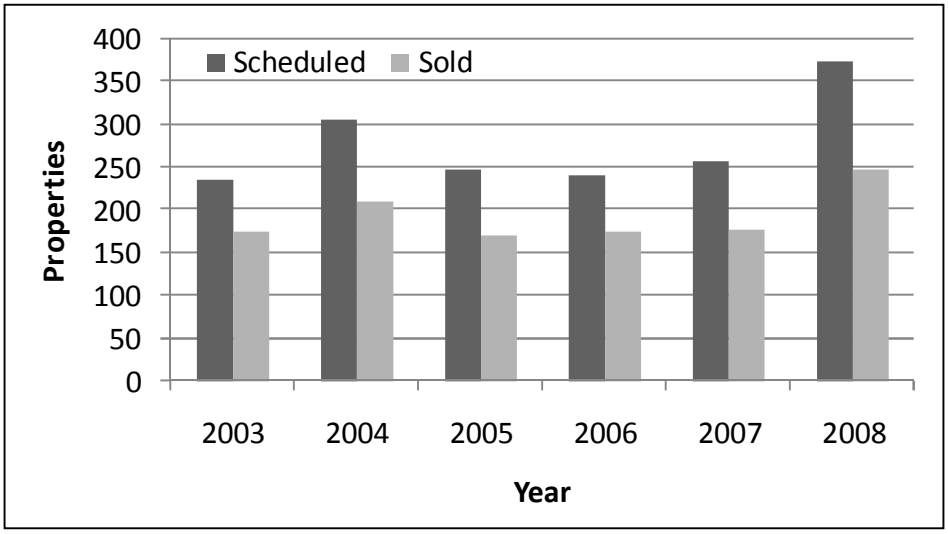
Figure 2.E
Number of Properties Scheduled for Sale and Sold Through the Master Commissioner
Daviess County
2003 to 2008



Source: Daviess Circuit Court, Office of the Master Commissioner.

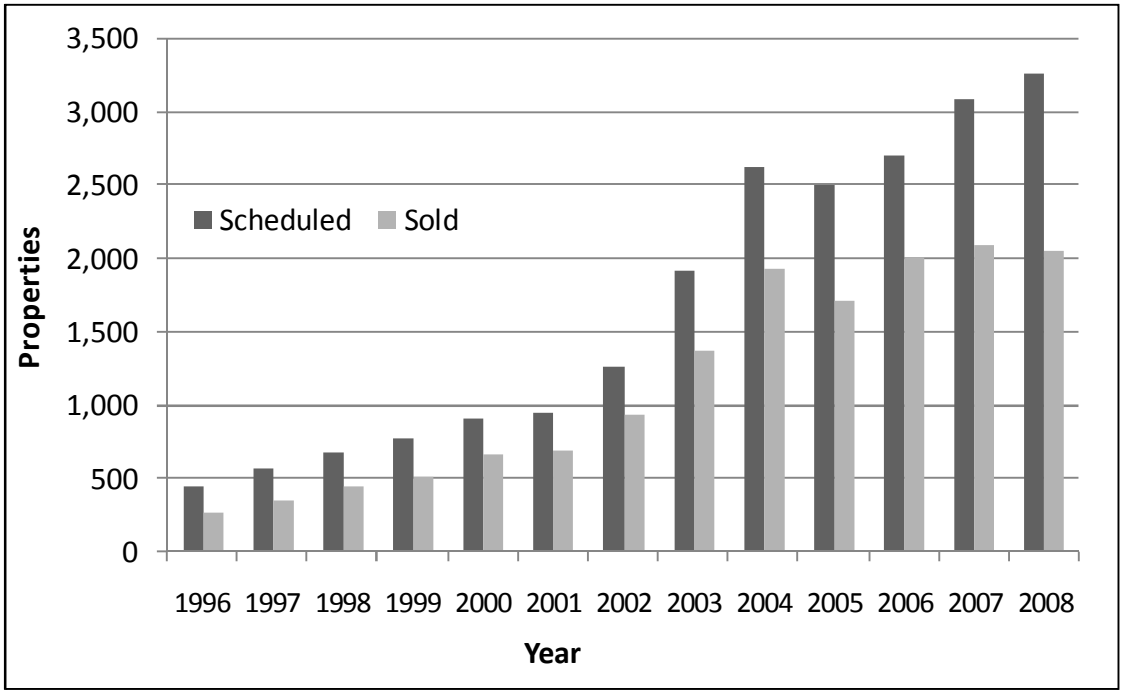
[3] In the data, the master commissioners do not indicate whether the property is residential or commercial.

Figure 2.F
Number of Properties Scheduled for Sale and Sold Through the Master Commissioner
Hardin County
2003 to 2008



Source: Hardin Circuit Court, Office of the Master Commissioner.

Figure 2.G
Number of Properties Scheduled for Sale and Sold Through the Master Commissioner
Jefferson County
1996 to 2008



Source: Jefferson Circuit Court, Office of the Master Commissioner.

The increasing number of cancellations in recent years is evident in some of these counties. In Jefferson County, 37 percent of sales were withdrawn in 2008, up from 32 percent in 2007 and 26 percent in 2006. In the first quarter of 2009, almost one-half of sales scheduled were withdrawn. In Hardin County, 34 percent of sales were withdrawn in 2008, up from 31 percent in 2007 and 27 percent in 2006. In the first quarter of 2009, more than 60 percent of scheduled sales were canceled in Hardin County. Increasing cancellations are often a sign of more last-minute loan modifications or payment plan arrangements or of lenders halting the foreclosure in anticipation of such an agreement.

Other Sources of Foreclosure Data

At the state level, foreclosure starts are now being counted by the Administrative Office of the Courts when foreclosure cases are entered into its case management system. Prior to April 2008, foreclosures were not entered separately from other contract disputes, and there was no way to identify foreclosure cases in the circuit courts. Beginning in April 2008, foreclosure cases that can be identified by court employees are entered using a new case type, which is still being fully implemented statewide.

Other public sources of foreclosure data are often reported. Private companies collect data on defaults and foreclosures, and some of them sell information to those looking to purchase properties. One widely known company of that type is RealtyTrac, which reports the foreclosure rate for the nation and for each state on a monthly basis.

Other public sources of foreclosure data may not cover the entire state and may underestimate the actual number of foreclosures within the state.

RealtyTrac reports the number of properties that were subject to a foreclosure filing and calculates the foreclosure rate as a percentage of housing units in the area. It appears that RealtyTrac collects county-level data, although the exact source of the data is not clear. Evaluation of online press releases and RealtyTrac reports indicated that coverage in Kentucky is limited to between 25 and 60 counties depending on the month considered. Because RealtyTrac omits several counties, it underestimates the actual number of foreclosures within the state.

For March 2009, RealtyTrac reported that 15 properties in Kentucky received a *lis pendens* filing—part of the initial stage of foreclosure—and used this figure as the number of foreclosure starts in the state for that month. For the same month, AOC counted 1,400 foreclosure case filings in the state. A *lis pendens*

and a case filing are different filings, but it is reasonable to assume that *lis pendens* filings would be made when cases are filed with the courts. This suggests that RealtyTrac may significantly underestimate *lis pendens* filings. Because of omitted geographic areas and the discrepancies outlined above, this study did not use RealtyTrac data for Kentucky. Studies and reports that depend on RealtyTrac data for Kentucky's foreclosure rate will almost certainly show Kentucky to be not nearly as affected by foreclosures as it is in reality. Because RealtyTrac focuses on urban and more populated areas, many other rural states also receive incomplete coverage from RealtyTrac.

Chapter 3

Causes of Recent Foreclosure Trends

Changes in real estate finance markets set the stage for much of what happened later. Three main factors that appear to have contributed to foreclosures are volatility in house prices, changing interest rates, and unemployment.

A number of factors appear to have contributed to the increase in foreclosures. It is difficult to pinpoint a primary cause while still in the midst of the situation, and it is likely that the causes for recent events in the housing industry and the current recession will be studied for decades. Thus far, however, foreclosures appear to have come in three waves resulting from three main underlying causes: house prices, interest rates, and unemployment (Brush; Goodman).

Changes in the way mortgages were originated and financed, and the types of mortgages offered to borrowers, led to dramatic growth in the housing market. Some of these changes may have allowed borrowers to obtain financing who might not have previously qualified for a mortgage loan, which may have increased the number of high-risk mortgages being issued. Growth in the housing market and greater access to credit also increased the number of real estate investors. The greater risks associated with many of these mortgage loans often went unnoticed until the housing market began to slow and house prices declined.

Borrowers who obtained adjustable-rate mortgages also faced higher interest rates and larger monthly payments that many could no longer afford. As housing prices decreased, the loan amount for some borrowers was greater than their house value. As borrowers defaulted on their payments, more houses were put on the market, which decreased home prices further. As demand for houses decreased and more foreclosed homes were put on the market, the home construction industry slowed. Eventually, the problems in the housing and real estate finance markets began to affect the national economy. The resulting job losses and reduced incomes contributed to additional defaults.

This chapter describes the changes in the real estate finance markets that set the stage for much of what happened later, then describes the three main factors that appear to have contributed to foreclosures: volatility in house prices, changing interest rates, and weakening employment. None of these factors alone caused the higher level of foreclosures seen recently, but they all appear to have affected the situation. In Kentucky, house prices have been more stable than in the nation overall, and Kentucky had fewer adjustable-rate mortgages than most states, but the impact from unemployment has been high.

Changes in the Real Estate Finance Markets

Subprime loans are made to borrowers who do not qualify for the best interest rate and loan terms. Subprime lending nearly doubled between 2004 and 2005.

One of the frequently cited factors affecting foreclosures was the growth in subprime mortgage loans. It is estimated that subprime lending volume nearly doubled between 2003 and 2005 (Tilton).

There is no industry definition of subprime loans. At a basic level, a subprime loan is a loan to a borrower who does not qualify for the best interest rate and loan terms. Subprime loan definitions often include loans to borrowers with credit scores below a certain threshold, loans originated with lenders designated as subprime lenders, and loans with interest rates above a certain level (HUD User; U.S. Dept of the Treasury. Office of the Comptroller).

Residential Mortgage-backed Securities

To understand how the growth in the subprime market occurred, it is necessary to understand how developments in residential mortgage-backed securities changed the incentives for lenders that originate mortgage loans.

The first common method of financing a mortgage loan is by lenders intending to keep the loan in their portfolios, known as originate-to-hold.

The mortgage finance market has undergone significant changes in recent years. Mortgage loans have traditionally been financed through two primary methods. The first method consisted of lenders such as savings and loans or commercial banks that originated mortgage loans using their own funds and held the loans in their portfolios until they were paid in full. This is referred to as originate-to-hold.

The second common method of financing a mortgage loan is by originating the loan and then selling it to another party, known as originate-to-distribute.

The second method for financing mortgage loans originally consisted of lenders that originated loans backed by the Federal Housing Administration or Department of Veterans Affairs and then had the option to sell these government-insured loans to investors. This practice is commonly referred to as originate-to-distribute. In the 1960s and 1970s, government-sponsored enterprises (GSEs) were created to streamline the selling of nongovernment-insured loans to investors. This was done in order to more widely implement the originate-to-distribute method and increase available funding for mortgage loans. These GSEs are the Federal Home Loan Mortgage Corporation, known as Freddie Mac and the Federal National Mortgage Association, known as Fannie Mae.

Mortgage loans can be pooled into financial securities that can be purchased to provide payments over a period of time. These securities are known as residential mortgage-backed securities.

Federal credit agencies buy mortgages from loan originators and then either hold the mortgages themselves or pool multiple mortgages into financial securities to be sold to investors. Investors purchase these securities, which pay investors a series of payments made over a period of time in the future. The pooled mortgage payments are used as collateral by the agency issuing the securities. These securities are often referred to as residential mortgage-backed securities and can be issued by Fannie Mae; Freddie Mac; the Government National Mortgage Association, known as Ginnie Mae; and private nongovernment agencies or banks. Because the GSEs—Fannie Mae and Freddie Mac—were created by the government and play a major role in mortgage markets, investors view securities issued by them as implicitly backed by the federal government.[1] Investors typically see government-backed securities as less risky than private securities (Fabozzi; Hayre).

Government-sponsored enterprises purchase conforming mortgages, which must meet guidelines on the payment-to-income ratio, the loan-to-value of the property ratio, and a maximum loan amount.

The GSEs—Fannie Mae and Freddie Mac—purchase conforming mortgages only, which must meet guidelines on the payment-to-income ratio, the loan-to-value of the property ratio, and a maximum loan amount. For example, if the monthly payment is large relative to the income earned by the borrower, which suggests that the borrower might have trouble making future payments, a GSE cannot purchase the loan.

Nonconforming mortgages are often bundled and sold into private-label, mortgage-backed securities.

Loans that do not meet these standards are nonconforming mortgages and are often bundled and sold into private-label mortgage-backed securities, which are not backed by the government. The first private-label, mortgage-backed securities were not issued until the late 1970s, and they did not have widespread use until the mid-1980s. Private-label, mortgage-backed securities grew slowly until the 1990s (Bruskin).

The value of mortgage-related securities issued in the U.S. bond markets went from almost $685 billion in 2000 to more than $3 trillion in 2003.

Between 2000 and 2003, the value of mortgage-related securities issued in the U.S. bond markets increased almost 350 percent, from almost $685 billion in 2000 to more than $3 trillion in 2003 (Securities). Much of the growth from 2000 to 2003 can be attributed to government agencies; private-label, mortgage-backed securities did experience significant growth from 2000 to 2006.

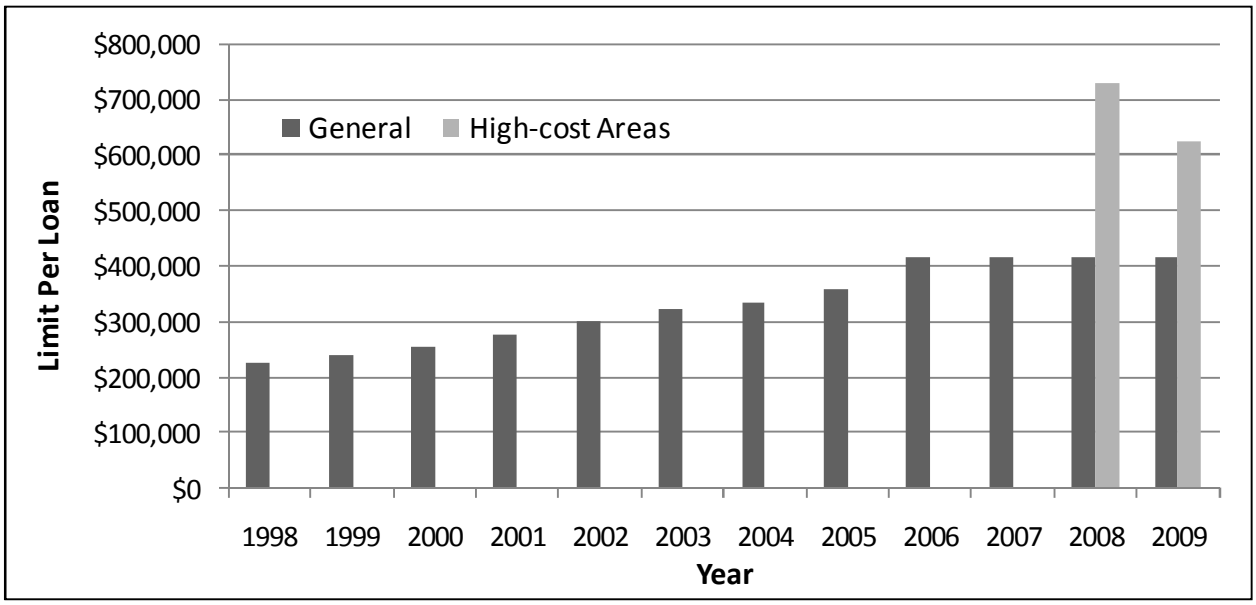
Conforming loan limits set by the GSEs have not changed for most areas, including Kentucky, since 2006. As housing prices increased, more loans exceeded the limits and could only be purchased by private investors.

Much of the growth in private-label, mortgage-backed securities may have been caused by loan limits on conforming mortgages. Figure 3.A shows conforming loan limits set by Fannie Mae and

[1] Since Ginnie Mae is a government agency created to finance government housing programs, bonds issued by Ginnie Mae are explicitly backed by the federal government.

Freddie Mac. Loans that exceed these limits are called jumbo loans and must be sold to the private market. Since 2006, the limits on conforming loans have not changed for most areas. As housing prices increased in certain areas of the country, more loans exceeded the limits imposed by the GSEs and, therefore, could only be purchased by investors in the private market. In 2008, higher conforming loan limits were established for certain areas of the country with high housing prices. The majority of mortgage loans in Kentucky did not exceed the loan limits by the GSEs but may not have met other underwriting standards.

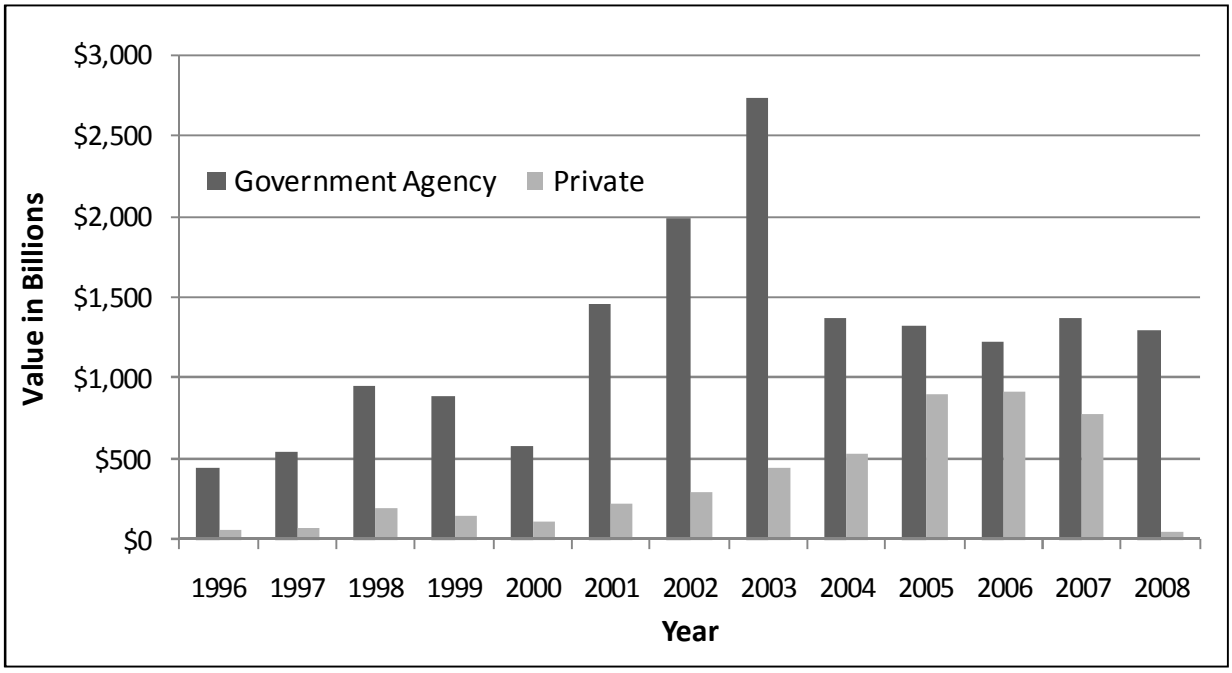
Figure 3.A
Conforming Loan Limits for Government-sponsored Enterprises, 1998 to 2009



Note: Limits are for one-unit houses. Changes in 2008 allowed increases in the maximum loan amount for certain high-cost housing areas.
Source: Fannie Mae. "Historical."

Figure 3.B illustrates the growth in private securities from 2000 through 2006, as well as a sharp drop from 2007 to 2008 after mortgage-backed securities were deemed a greater credit risk than previously thought.

Figure 3.B
Mortgage-related Bonds Issued in U.S. Bond Markets by Government Agencies and Private Issuers 1996 to 2008



Note: Government agencies include Fannie Mae, Freddie Mac, and Ginnie Mae.
Source: Securities.

Incentives Under Originate-to-distribute Loans

As more loans were sold into the private market, lenders may have been less careful in evaluating the risk of default for subprime borrowers. The incentives to issue a large number of mortgages with high risk likely contributed to the increased use of mortgage products that required little or no equity, offered low initial interest rates, and required little or no documentation of income.

One study found that lenders were less likely to carefully screen borrowers during the origination of the loan if the loan was eligible to be sold to investors (Keys). As a larger market for purchasing subprime loans developed, this may have led to less careful evaluation of risk for subprime loans. When a lender anticipates holding a loan until it is paid off, the lender assumes the risk that the borrower will not pay the loan. As a result, the lender carefully evaluates the risk that a borrower might default before issuing a mortgage. When a lender sells the loan to investors, the investors assume this risk.

Typically, risk affects the price that investors are willing to pay for an investment. Consider an investor that has the option of purchasing two different mortgage-backed securities. The first

security is backed by mortgages issued to borrowers who are likely to make their mortgage payments. The second security is backed by borrowers who are more likely to default on their mortgage loans. If investors are fully informed about the different levels of risk between these two investments, they would pay less for the riskier one.[2] If investors are not fully informed of the risk, however, they might pay too high a price for some of the riskier investments. This can give lenders an incentive to originate a large number of mortgages and sell them to investors regardless of the risk that the borrowers would not be able to make their payments.

Increased Use of Innovative Mortgage Products

The incentives to issue a large number of mortgages with high risk likely contributed to the increased use of mortgage products that required little or no equity, offered low initial interest rates, and required little or no documentation of income. Lenders made options available to borrowers who could not afford standard down payments and monthly payment terms.

Borrowers with less than a traditional 20 percent down payment can purchase private mortgage insurance or take out a second mortgage at the origination of the loan to use for the down payment.

For borrowers with less than a traditional 20 percent down payment, private mortgage insurance is available to protect the lender from loss if there is a default. Another option is a second mortgage at the origination of the loan, commonly called a simultaneous second lien, or a "piggyback" loan. The second mortgage provides the funds required to make part or all of the down payment on the property, which allows borrowers to purchase a home with minimal or no down payment.

Borrowers seeking lower monthly payments have a variety of options. For example, they can take out an interest-only mortgage, for which the payments only cover the interest and do not have a portion that goes toward the principal of the loan balance.

For those unable to afford the monthly payment of a traditional fixed 30-year loan, there are a variety of loan options that decrease the payment amount in the early years of the loan. Interest-only mortgage loans may begin with a term during which none of the payments go toward the principal of the loan before switching to a fully amortizing payment.[3] The initial payment only covers the interest on borrowing the amount of money used to purchase the house. After an introductory period, the payment amount may increase to a level that will pay off the balance of the loan in the remaining loan period, often leading to a substantial monthly payment increase. Similarly, negative amortization loans begin

[2] Ultimately, investors will demand a higher rate of return to compensate for the greater risk. This can be achieved through price differences or other terms associated with the investment.

[3] Amortization refers to paying off the balance of the loan in a set time period. Fully amortizing loans pay off the full balance in a set time period, while non-amortizing loans pay off none of the balance, and negative amortization loans cause the balance to grow larger.

with a period of payments that do not completely cover the entire interest portion of the loan, but a portion of the accrued monthly interest is added to the balance of the loan. With this mortgage product, the loan balance actually grows larger over time. Negative amortization loans are often structured as "payment option" loans or "pick a pay" loans, allowing the borrower to pay from multiple options of payments for a period of time, with the unpaid interest added to the balance of the loan.[4] Some loans come with a balloon payment, which does not fully amortize over the life of the loan and instead requires a lump-sum payment at the end of the term. Balloon loans are generally originated with a refinance or property sale in mind when the balloon payment comes due.

Loans that required little or no documentation of income or assets have been used to bypass underwriting standards and may have allowed some borrowers to borrow more than they could afford.

Another substantial change in mortgage lending was the increase in loans that required little or no documentation of income or assets. These loans, referred to as "low doc," "no doc," or "stated income" loans, were originally intended for borrowers whose income was difficult to document or verify, such as those who were self-employed or regularly paid through commissions. Increasingly, these loans have been used to bypass underwriting standards that require certain income-to-payment ratios, and this incomplete documentation may have allowed some borrowers to borrow more than they could afford (Fitch. "Drivers"). Little or no documentation of income and assets along with low down payment requirements have often been cited as the two main components of lower underwriting standards in recent years (Bernanke).

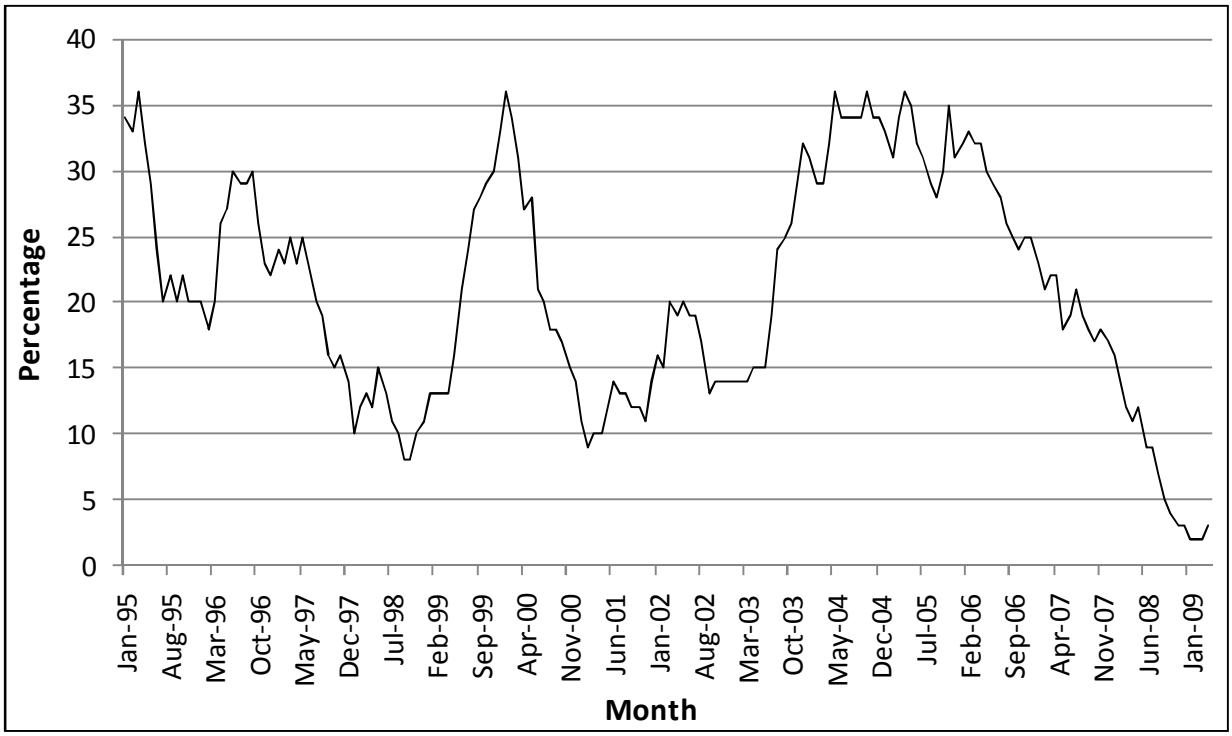
Many innovative loan products were combined with adjustable interest rates.

Many of these innovative loan products were combined with adjustable interest rates. Rates that adjust from the beginning of the loan are called standard or floating adjustable rate mortgages (ARMs). Hybrid loans, which have a brief period of fixed rates in the beginning, have increased in popularity in recent years (Freddie Mac. "Freddie"). Common terms include 2/28 or 3/27, in which the first number refers to the years with a fixed rate and the second number refers to the remaining years that have a floating interest rate. Some longer-term hybrid ARMs had fixed rate periods of 5 or 7 years.

[4] "Payment option" loans typically allow four payment choices. The first two choices are the payments that would fully amortize the loan in either 15 or 30 years. The third option is the interest payment only. The fourth option is a minimum payment that does not fully cover the interest and requires the unpaid interest to be added to the balance of the loan. These options are revoked when the balance of the loan reaches a preset level, such as 110 percent of the value of the property (U.S. Government).

Figure 3.C illustrates the percentage of all loans in the U.S. from 1995 to 2009 that had adjustable rates. The volume of adjustable rate loans was high in 2004 and 2005.

Figure 3.C
Monthly Percentage of Loans Issued With an Adjustable Rate
1995 to 2009



Note: Data cover all months from January 1995 to April 2009. Due to space limitations, labels for only some months are shown.
Source: Freddie Mac. "Historical."

One barrier to refinancing is a prepayment penalty associated with the initial loan. Prepayment penalties are often in effect for a set number of years at the beginning of the loan.

A borrower may have taken on a loan intending to refinance to more favorable terms after a period of time. One barrier to refinancing is a prepayment penalty associated with the initial loan. According to data from the U.S. Federal Reserve Bank of New York, about 84 percent of the Kentucky subprime loans covered in a survey conducted in February 2009 had a prepayment penalty at origination. Prepayment penalties that charge the borrower fees for paying off the loan early due to sale or refinance are often in effect for a set number of years at the beginning of the loan. For borrowers with little or no equity, and without the cash to pay the fees, these penalties can present a significant barrier to refinancing.

Some loan characteristics may be necessary in order to accurately price the risk of lending to someone without optimal credit ratings or a satisfactory borrowing history. The borrower may have accepted some loan characteristics as necessary conditions for home ownership.

It is important to note that some loan characteristics, such as high interest rates and prepayment penalties, may be necessary in order to accurately price the risk of lending to someone without optimal credit ratings or a satisfactory borrowing history. While these characteristics may be viewed unfavorably, if the borrower has evaluated the cost and decided that the higher-priced loan is preferable to not being able to borrow at all, then the lender and borrower have agreed on terms that are satisfactory to both in light of increased risk. These fees may be acceptable as necessary conditions for home ownership.

Loan terms can be problematic if the borrower is not aware of their existence during the origination of the loan. A recent study found that many consumers had trouble identifying loan terms using standard mortgage documents. Another study found that some loan products were likelier to have confusing or misleading loan terms.

Many of these characteristics are problematic only if the borrower was not aware of their existence or was misled about their existence during the origination of the loan. A 2007 study by the U.S. Federal Trade Commission's Bureau of Economics found that after viewing standard mortgage loan documents, approximately one-fifth of consumers surveyed could not identify the interest rate of the loan, the cash due at closing, or the monthly payment; one-third did not recognize that the loan included a balloon payment; and two-thirds did not understand the prepayment penalty. The study notes that current loan documents may not clearly convey costs, which could make it easier for consumers to be misled about a loan. A 2006 U.S. Government Accountability Office report found that alternative mortgage products such as interest-only and payment-option adjustable-rate mortgages were particularly likely to have confusing or misleading loan terms because of their complicated nature. The report explained that borrowers may not understand the risks of these loan products because "promotional materials by some lenders and brokers do not provide balanced information on [alternative mortgage products] benefits and risks" (U.S. Government. *Alternative* 2).

Home Prices and Interest Rates

The greater use of the mortgage products described above allowed more people to purchase homes, or in some cases more expensive homes. Some of these products created a segment of homeowners who were susceptible to changes in the housing prices and interest rates having a negative effect on them.

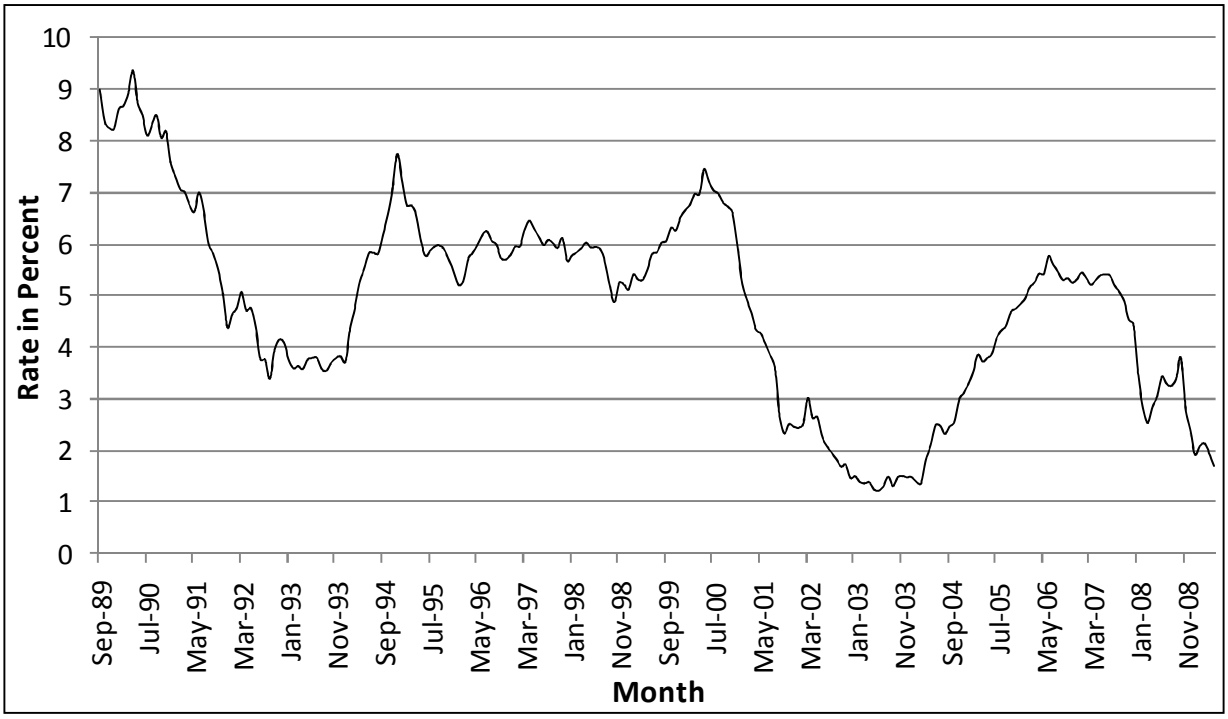
Changing Interest Rates

Adjustable-rate loans adjust based on an index, such as the London Interbank Offered Rate, plus a margin agreed in the original loan terms. Changes in the index cause changes in the payments of

adjustable rate mortgages. The U.S. Federal Reserve February 2009 survey reported that in Kentucky, the average margin for subprime adjustable rate mortgages was 6.28 points.[5]

Figure 3.D shows the 12-month London Interbank Offered Rate since 1989. Significant decreases in the index from 2000 to 2004 allowed many adjustable rate mortgages to have original interest rates that could not be sustained after rates started to rise.

Figure 3.D
12-month London Interbank Offered Rate, 1989 to 2009



Note: Data cover all months from September 1989 to May 2009. Due to space limitations, labels for only some months are shown.
Source: FedPrimeRate.com.

Lower interest rates in today's credit market help minimize increases in payments for borrowers with an adjustable rate mortgage. However, some borrowers with a below market introductory rate may still see their interest rate reset considerably higher.

Lower interest rates in today's credit market help minimize the increases in payments for borrowers with an adjustable rate mortgage. Without knowing what the initial interest rate on each loan was, it is not possible to know for sure what types of increases current borrowers are facing when their loans reset. However, many introductory rates for an ARM are below market rates, intentionally set low to make the loan product more attractive (Freddie Mac. "Freddie"). Borrowers with an especially low introductory interest rate may see their interest rate reset considerably higher, even with today's historically low indexes.

[5] The Federal Reserve survey did not cover all loans in the state.

Adjustable rate loans may be more likely to cause default because of uncertainty about future payment amounts.

Adjustable loans may be more likely to cause default because of the unknown payment amount after the adjustment. The borrower is exposed to uncertainty about future payments. Borrowers may also have qualified for the loan based on the initial payment amount, not the fully adjusted payment. This would mean that after the adjustment, the borrower is unable to afford the higher payment and may not have realized the full extent of the possible adjustment.

In 2006, 12 percent of loans in Kentucky were adjustable rate loans.

The Federal Housing Finance Board reported that in 2006, 12 percent of the loans in its survey from Kentucky were adjustable rate loans, compared with a median of 15 percent for all states. The highest percentage of loans with an adjustable rate in their survey was in California, with 46 percent. The lowest occurrence of adjustable rate loans was in Alaska, where only 3 percent of the loans adjusted.

The Mortgage Bankers Association National Delinquency Survey for the fourth quarter 2008 indicated whether most loans were prime, subprime, Federal Housing Administration, or Veterans Affairs loans, as well as whether the loan had a fixed or adjustable rate. The number and percentage of each type of loan are shown in Table 3.1. Approximately 11 percent of Kentucky loans were subprime. The survey did not provide the rate structure for a small number of loans.

Table 3.1
Types of Loans in Kentucky, Fourth Quarter 2008

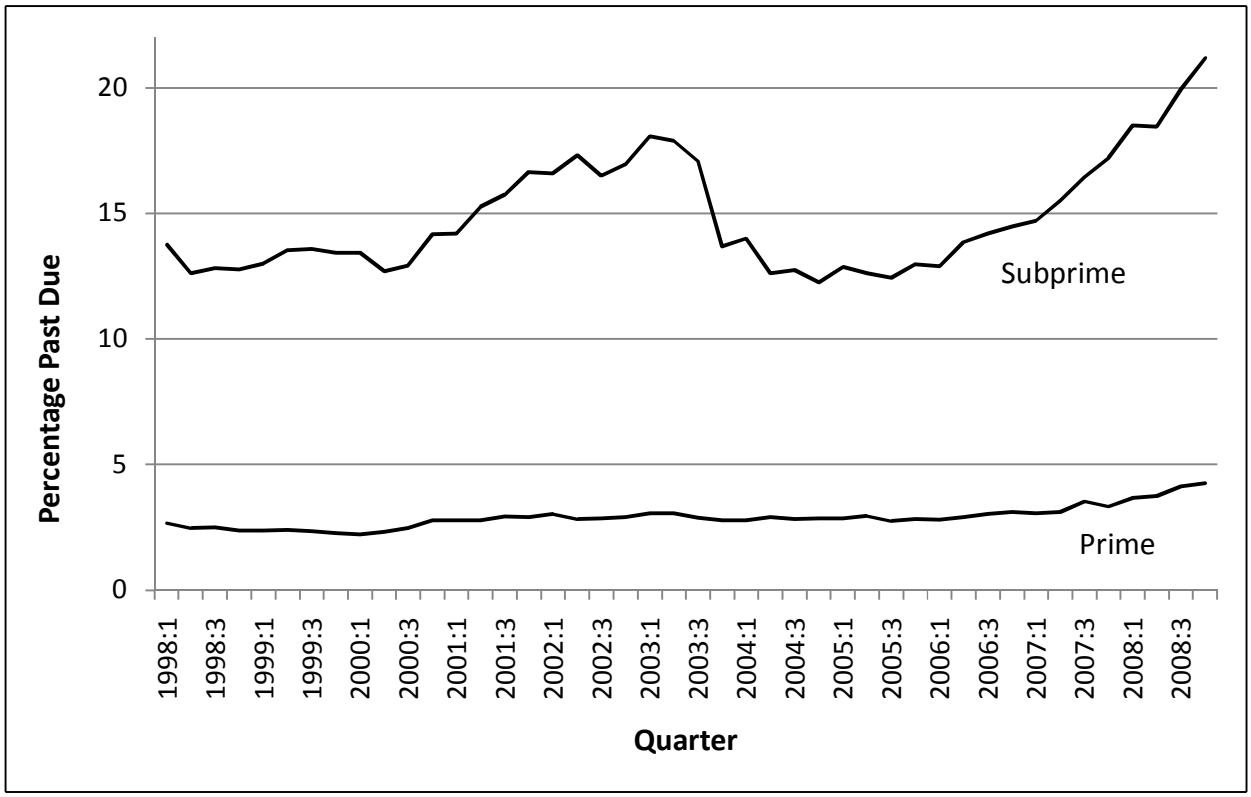
Type of Loan			Number	Percent of Total
Prime			310,651	70.5%
	Fixed Rate	89.5%		
	Adjustable Rate	7.6%		
Subprime			48,011	10.9%
	Fixed Rate	66.0%		
	Adjustable Rate	34.0%		
FHA			63,617	14.4%
	Fixed Rate	76.4%		
	Adjustable Rate	2.5%		
VA			18,225	4.1%
Total			440,504	100.0%

Note: FHA is Federal Housing Administration; VA is Veterans Affairs.
Total does not add to 100 percent due to rounding.
Source: Mortgage Bankers Association National Delinquency Survey.

Data from the National Delinquency Survey show that subprime loans that were past due began to rise shortly after interest rates began to rise.

Data from the National Delinquency Survey, shown in Figure 3.E, illustrate the percentage of prime and subprime loans in Kentucky that were past due from 1997 through the beginning of 2009.[6] Because there is a delay between when the borrower stops paying and when foreclosure proceedings begin, the percentage of loans that are past due by quarter is a timelier indicator of borrower difficulty. The data show that the percentage of subprime loans that were past due decreased sharply from 2003 to 2004, as mortgage rates stayed low and more available credit made refinancing easier. Interest rates began to rise in 2005, and by 2006 the percentage of subprime loans that were past due began to rise as well. The percentage of prime loans that were past due had remained relatively low but began increasing during the past year.

Figure 3.E
Percentage of Prime and Subprime Loans Past Due in Kentucky
1998 to 2008



Note: Seasonally adjusted. Data cover the period from the first quarter of 1998 to the fourth quarter of 2008. Due to space limitations, labels for only some quarters are shown.
Source: Mortgage Bankers Association National Delinquency Survey.

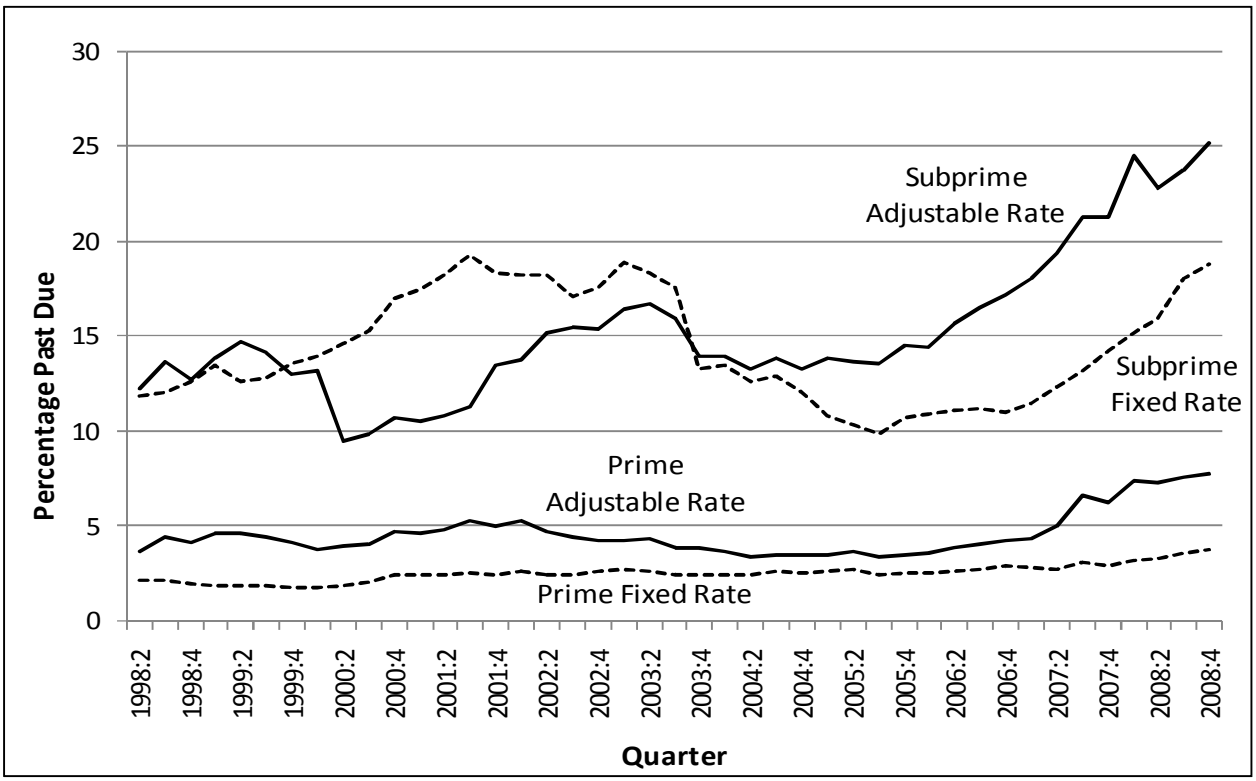
[6] The Mortgage Bankers Association does not define subprime but asks that lenders report loans as being subprime if they are considered by that lender to be subprime. Therefore, lenders may use different criteria among themselves, but they should have consistent definitions over time.

Figure 3.F shows the percentage of adjustable rate prime, fixed rate prime, adjustable rate subprime, and fixed rate subprime loans that were past due for Kentucky. The percentage of loans that were past due increased for both adjustable and fixed rate subprime loans. The percentage past due also increased for adjustable and fixed rate prime loans, but the increases were significantly less. Even considering Kentucky's relatively low exposure to adjustable rate loans, the impact of adjustable rates can be seen. The increase in past due adjustable rate loans occurred earlier than the increase in past due fixed rate loans.

Almost 90 percent of prime loans in Kentucky have fixed rates.

During the fourth quarter of 2008, almost 90 percent of Kentucky's prime loans had fixed rates and less than 10 percent had adjustable rates according to the National Delinquency Survey. About two- thirds of Kentucky's subprime loans had fixed rates; the other third had adjustable rates. The percentage of subprime adjustable rate loans reached a peak in late 2005 and 2006, when more than 45 percent of subprime loans in Kentucky had adjustable rates.

Figure 3.F
Percentage of Prime and Subprime Loans Past Due in Kentucky by Type of Rate
1998 to 2008



Note: Seasonally adjusted. Data cover the period from the first quarter of 1998 to the fourth quarter of 2008. Due to space limitations, labels for only some quarters are shown.
Source: Mortgage Bankers Association National Delinquency Survey.

Decline in Housing Prices

Increased defaults and foreclosures led to an overall tightening in the credit markets by 2007, which contributed to a decreased demand for housing and a decline in house prices in some areas of the U.S.

Increased defaults and foreclosures in subprime and adjustable rate loans led to an overall tightening in the credit markets by 2007 (Bair; Bernanke). Less available credit, rising interest rates, and rising mortgage payments led to further decreases in the demand for housing. These factors also led to an increase in homes put on the market as borrowers attempted to escape rising housing costs. This led to more widespread impacts on house prices, causing significant declines in some areas and flat prices in others.

House price indexes for some metropolitan areas around the country started to decline as early as 2005.

As early as 2005, there were indications of a weakening housing market. House price indexes for some metropolitan areas started to decline in late 2005, indicating a growing decrease in demand for housing in some parts of the country (Standard). This decrease in demand may have been caused by rising interest rates, which were historically low from 2003 to 2005 before increasing in mid-2005 (Freddie Mac. Weekly). These higher interest rates affected new fixed rates loans but also introduced uncertainty and increased payments for existing adjustable rate loans.

The Federal Housing Finance Agency calculates two main house price indexes. These indexes measure repeat mortgage transactions on the same property over time. According to the All-Transactions House Price Index, which measures sales and refinances, Kentucky has seen an increase in house prices in the past year.

The Federal Housing Finance Agency calculates two main house price indexes that measure single-family house prices for repeat mortgage transactions handled by Fannie Mae or Freddie Mac only. Transactions that exceed the limit for purchase by Fannie Mae or Freddie Mac are excluded, as are Federal Housing Administration and Veterans Affairs loans and properties not classified as single-family housing, such as condominiums. Since they cover repeat mortgage transactions, price changes are tracked for the same property over time through sales or refinancing.

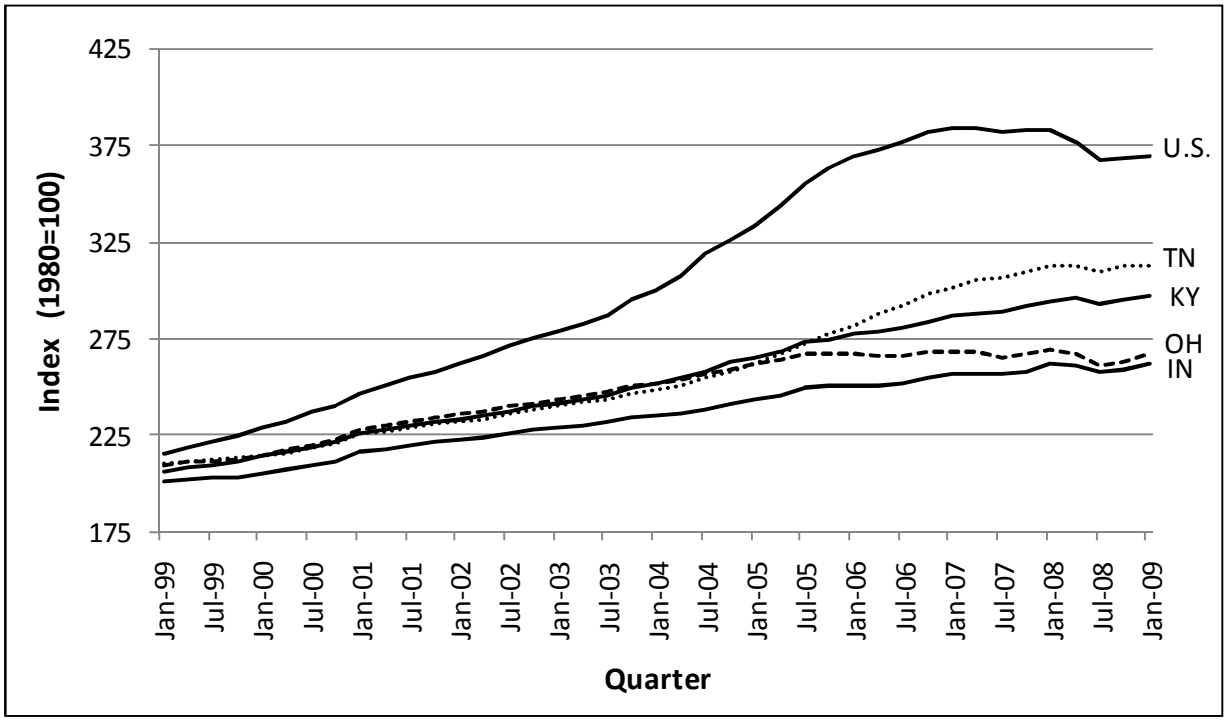
One of the indexes is the All-Transactions House Price Index, which includes sale prices for new purchases and appraisals for refinances. Table 3.2 and Figure 3.G show the index for Kentucky, the U.S., and some surrounding states. House prices in Kentucky have increased in the past year according to this index.

Table 3.2
All-Transactions House Price Index
Percent Change for U.S., Kentucky, and Selected States

	1-year	2-year	5-year	10-year
U.S.	-3.35%	-3.69%	23.35%	71.42%
Kentucky	0.82%	3.45%	17.68%	44.09%
Indiana	-0.11%	2.02%	11.19%	30.35%
Ohio	-0.73%	-0.29%	6.15%	27.93%
Tennessee	0.14%	3.80%	26.06%	48.59%

Note: Current through the first quarter of 2009; the 1-year change is the change in the index from the first quarter of 2008 to the first quarter of 2009.
Source: Staff calculations based on data from the Federal Housing Finance Agency.

Figure 3.G
All-Transactions House Price Index for the U.S., Kentucky, and Selected States 1999 to 2009



Note: Data cover the period from the first quarter of 1999 to the first quarter of 2009. Due to space limitations, labels for only some quarters are shown.
Source: Federal Housing Finance Agency.

Kentucky did not experience the dramatic appreciation of house prices in recent years and is not experiencing the major price declines that are contributing to many foreclosures in other states.

For the metropolitan statistical areas (MSA) in Kentucky, house prices decreased in Elizabethtown, Cincinnati-Middletown, and Evansville and increased in the remaining MSAs. Prices increased in areas not in an MSA.

Within the state, the All-Transactions House Price Index is calculated for the metropolitan statistical areas (MSA). A separate index is calculated for counties that are not located within an MSA. Table 3.3 shows the index for all MSAs that include Kentucky counties. According to the index, 1-year house prices decreased in the Elizabethtown, Cincinnati-Middletown, and Evansville MSAs. The Owensboro MSA had the greatest 1-year price increase (1.5 percent), but prices increased in the remaining MSAs and in areas not in an MSA as well.

Table 3.3
All-Transactions House Price Index
Percent Change for Metropolitan Statistical Areas in Kentucky

Metropolitan Statistical Area	1-year	2-year	5-year	10-year
Not in an MSA	1.4%	5.4%	22.7%	47.2%
Bowling Green	0.8%	3.4%	15.8%	33.7%
Cincinnati-Middletown	-0.8%	-0.4%	9.4%	33.5%
Clarksville	1.0%	4.8%	28.2%	48.7%
Elizabethtown	-0.9%	2.1%	22.0%	49.5%
Evansville	-0.8%	0.8%	9.7%	29.7%
Huntington-Ashland	0.7%	4.4%	23.7%	51.1%
Lexington-Fayette	0.8%	3.3%	17.9%	49.4%
Louisville-Jefferson County	0.1%	2.5%	15.3%	42.7%
Owensboro	1.5%	5.6%	10.7%	29.4%

Note: Current through the first quarter of 2009; the 1-year change is the change in the index from the first quarter of 2008 to the first quarter of 2009.
Source: Staff calculations based on data from the Federal Housing Finance Agency.

The Purchase-Only House Price Index only counts actual property sales. This index shows a decrease in house prices in Kentucky over the past year but not as large of a decrease as surrounding states or the U.S. overall.

The All-Transactions House Price Index includes all sales and refinanced mortgages that are purchased by Fannie Mae or Freddie Mac. The second index, the Purchase-Only House Price Index, excludes refinance appraisals and only counts actual property sales. This index also illustrates how Kentucky home prices have fared better than prices in some surrounding states that have experienced sharper declines. The Purchase-Only index may be a better indicator of house prices in a slower real estate market because it only counts house prices that result in an actual sale. The Purchase-Only Index is calculated only for states and for the largest MSAs, none of which are in Kentucky. Table 3.4 shows the index for Kentucky, the U.S., and selected surrounding states.

Table 3.4
Purchase-Only House Price Index, Seasonally Adjusted
Percent Change for the U.S., Kentucky, and Selected States

	1-year	2-year	5-year	10-year
U.S.	-7.1%	-10.2%	9.8%	54.8%
Kentucky	-0.5%	-0.1%	11.1%	36.6%
Indiana	-3.0%	-4.0%	4.0%	19.5%
Ohio	-5.1%	-8.7%	-4.3%	15.1%
Tennessee	-4.1%	-3.4%	17.6%	38.4%

Note: Current through the first quarter of 2009; the 1-year change is the change in the index from the first quarter of 2008 to the first quarter of 2009.
Source: Staff calculations based on data from the Federal Housing Finance Agency.

In the first quarter of 2009, Kentucky's 1-year percentage change in the Purchase-Only index ranked fifth highest in the nation despite a 0.5 percent decline from the first quarter of 2008 to the first quarter of 2009. The highest price appreciation was in Alaska, with a 4.8 percent increase in prices in the last year. The lowest price appreciation was in Nevada, where prices declined 31.1 percent in the last year.

From 2002 to 2007, national house prices increased roughly twice as much as national median household incomes. In Kentucky, house prices increased about three times as much as Kentucky household incomes.

Looking at a different time period shows how the increase in house prices outpaced the increase in incomes during years when national house prices were increasing rapidly. Table 3.5 shows how household income and housing prices changed from 2002 to 2007. National house prices increased roughly twice as fast as national median household incomes. Housing prices in Kentucky did not increase as much as in the rest of the nation but did increase more than three times as much as Kentucky household income. Increasing house prices increase the equity and wealth of those who already own a home. However, individuals looking to purchase a house may find homes less affordable. More expensive homes require larger down payments and larger loans.

Table 3.5
Growth in Median Household Incomes and House Price Index
for the U.S., Kentucky, and Selected States
2002 to 2007

	U.S.	Kentucky	Indiana	Ohio	Tennessee
5-year growth in median household income	18.45%	7.32%	15.61%	15.03%	11.25%
5-year growth in All-Transactions House Price Index	39.82%	22.53%	13.99%	10.81%	30.49%

Note: Growth in All-Transactions House Price Index is measured between the last quarters of the year.
Source: Staff calculations based on data from the Federal Housing Finance Agency and U.S. Census Bureau. Median.

Declining Home Equity

House prices that are falling or not rising as much as expected can impact the borrower's home equity. Borrowers who took out an adjustable rate mortgage likely did so with the intention of refinancing before the rate reset. A subprime borrower may intend to spend 2 or 3 years making on-time payments in the hopes of improving his or her credit scores and moving to a prime loan before payments increase. The recent moderation or decrease in house prices and the lack of easily available credit in the mortgage market have combined to make it more difficult for borrowers to refinance out of unaffordable mortgage payments. If housing prices have decreased, selling the property may return less than the amount due. Even if housing prices have increased slightly, they may not have gone up enough to cover transaction costs from the sale.

Declining home values and large mortgage loans decrease home equity. Borrowers may owe more on their homes than they are worth. These borrowers may default on their loans.

Borrowers with little or no equity in their homes have less to lose when faced with default. If home prices have declined, or if the homeowner has borrowed more than the value of the house, he or she may be "upside down" or "underwater" on the loan. These terms describe borrowers who owe more on their homes than they are worth. A default and foreclosure will damage the borrower's credit, but the borrower may prefer to default on the loan to escape continued high payments on a house believed not to be, and may never be, worth as much as the loan amount. The mortgage industry refers to this as "ruthless default" or voluntary foreclosure. There is little evidence that a homeowner who can afford payments and still chooses to default is common. It is likely an inability to make monthly payments, sell the house, or refinance the loan that leads a borrower to abandon further attempts to salvage the loan and keep the property.

Homebuyers who make a down payment start out with some equity in their home, but data suggest that down payments have been low in recent years. The National Association of Realtors reported in 2006 and 2007 that the median down payment for first time homebuyers was 2 percent, while 45 percent reported that they put no money down.

Typically, as housing prices increase and a borrower makes monthly payments and pays down the loan balance, equity in a house grows. Homebuyers who make down payments start out with some equity, but data suggest that down payments have been low in recent years. In its annual Profile of Home Buyers and Sellers, the National Association of Realtors reported in both 2006 and 2007 that the median down payment for first-time homebuyers was 2 percent; 45 percent reported that they put no money down (National Association of Realtors. "NAR"; National Association of Realtors. "Survey"). In U.S. Federal Reserve data for Kentucky in February 2009, more than 16 percent of the subprime loans in the survey had a second lien at the origination of the mortgage. This likely indicates that a second mortgage loan was being used in

place of or to supplement a down payment. Additionally, because some of these loan products do not generate equity, after a number of years borrowers may find that their home equity is minimal.

Home equity can be reduced through cash-out refinances, home equity loans, or home equity lines of credit.

Some homeowners tap into their home equity for cash. This can be done though cash-out refinance or through a home equity loan. The U.S. Census Bureau's 2007 American Housing Survey reported that of the 15.1 million owner-occupied households that reported a refinanced primary mortgage, 2.2 million cited the reason for refinancing was to receive cash.[7] The median amount of cash received in the refinance was $31,274. The number of households with a home equity line of credit was 9.8 million; 5.4 million reported an outstanding loan associated with that line of credit, with a median loan balance of $35,934.

Cash-out refinances, home equity loans, and home equity lines of credit are often used to fund home improvements or repairs, but there is growing evidence that home equity is being used for other purposes. When asked how much of their cash from a refinance was used for home additions, improvements, or repairs, the median response was 15.9 percent. Of the 5.4 million households with a home equity line of credit, fewer than half reported that the amount was used for home additions, improvements, or repairs (U.S. Census Bureau. American). In data compiled by the U.S. Federal Reserve in February 2009, almost 53 percent of the owner-occupied subprime mortgages were cash-out refinances, indicating that the homeowner may have already been in financial trouble and needed extra cash when the loan was originated.

Weak Labor Market

Recently, changes in employment have become a significant cause of default on mortgage loans.

Changes in employment have become a significant cause of default on mortgage loans. As overall weakness in the housing market impacted the financial industry and the broader economy, unemployment began to rise. Some refer to this as the third wave of foreclosures, with the first being caused by the decline in home prices and the second by the increasing payments on adjustable rate loans. Kentucky had relatively little exposure to the first two waves but has had a substantial increase in unemployment. These job losses may explain a large portion of the foreclosures in Kentucky.

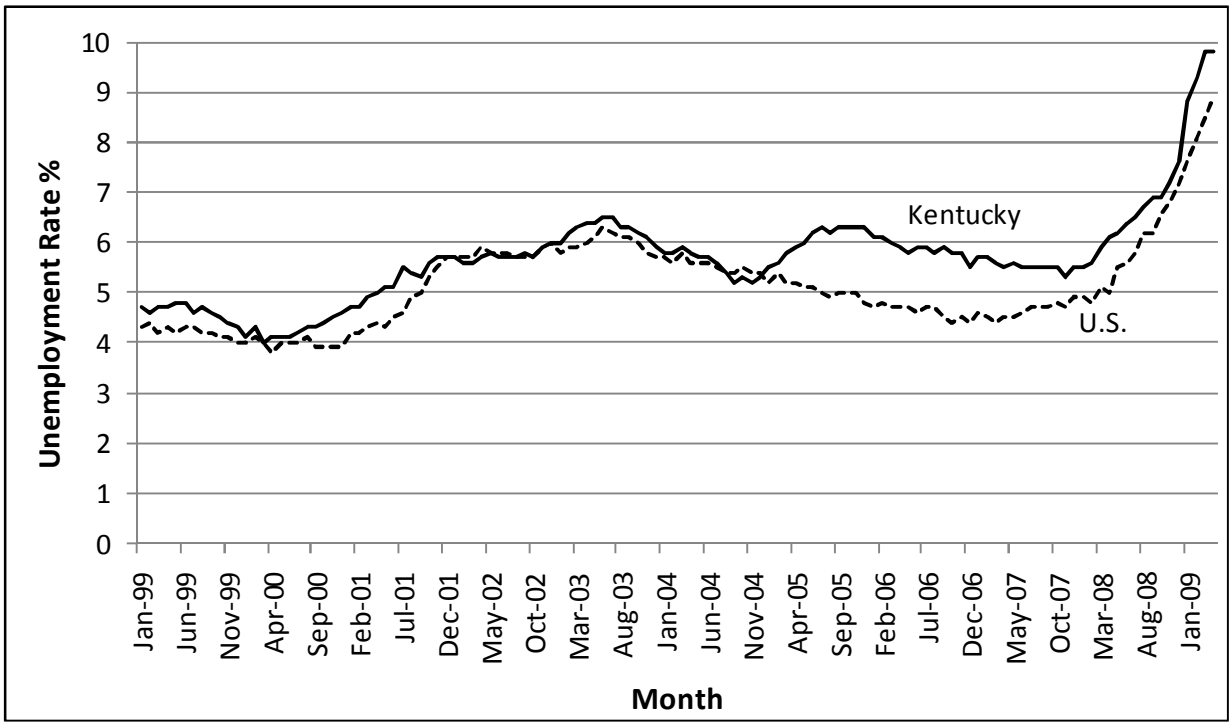
Kentucky's unemployment rate as of April 2009 was 9.8 percent, higher than the U.S. rate of 8.9 percent.

Kentucky's unemployment rate as of April 2009 was 9.8 percent, higher than the U.S. rate of 8.9 percent. Kentucky's unemployment

[7] The most popular response was to get a lower interest rate.

rate has historically been higher than the national rate. This rate also does not include individuals who have had hours or wages reduced. Figure 3.H shows the unemployment rate for Kentucky and the U.S. for the past 10 years. The unemployment rate began increasing rapidly in late 2007. Kentucky's employment peaked in June 2007 at 1.9 million jobs and has decreased by almost 50,000 jobs since then. This decrease represents a decline of about 2.5 percent since the peak (U.S. Dept. of Labor. Bureau. Local).

Figure 3.H
Monthly Unemployment Rate for Kentucky and the U.S., 1999 to 2009



Note: Data cover all months from January 1999 to April 2009. Due to space limitations, labels for only some months are shown.
Source: U.S. Dept of Labor. Bureau. Labor; U.S. Dept of Labor. Bureau. Local.

Increased unemployment is likely the cause of increased delinquencies in fixed rate mortgages since 2007.

Changes in employment are likely the cause for increased delinquencies in fixed rate mortgages since 2007. According to the Mortgage Bankers Association National Delinquency Survey, more than 63 percent of the loans in Kentucky are fixed rate prime mortgages, meaning even a small increase in the foreclosure rate for these loans can indicate a much larger number of foreclosures.

Chapter 4

Effects of Foreclosure

Those affected by foreclosures include borrowers; mortgage lenders, servicers, and investors; neighborhoods; and governments. Effects vary depending on the nature of the loan, how the foreclosure proceeds, and the condition of the property during and after foreclosure.

Impact on Borrowers

Borrowers involved in a foreclosure must find a new place to live, have more difficulty obtaining credit, and lose equity in their home.

Borrowers who are involved in foreclosure incur direct costs associated with the foreclosure. They lose their home. They may lose equity they have in their home and find it more difficult to obtain credit, because foreclosure lowers their credit score. Financial problems contribute to foreclosure, so it is difficult to accurately determine the extent that foreclosure adds to these problems.

Borrowers not involved in foreclosures may be affected because credit may be more difficult or more expensive to obtain.

Borrowers who are not involved in a foreclosure can incur costs that result from others' foreclosures: they might have more difficulty accessing credit and may face stricter underwriting standards as lenders evaluate the risk of default more closely (Harvard). Lenders may also charge borrowers not in foreclosure higher interest rates to cover any costs incurred by foreclosures.

Impact on Mortgage Lenders, Servicers, and Investors

Foreclosure costs to lenders vary depending on the type of loan and contractual agreements regarding the servicing of each loan.

The costs of foreclosures to mortgage lenders, servicers, and investors vary depending on the type of loan and contractual arrangements between lending institutions. The majority of loans are sold by originators on the secondary market to third parties who assume the risk of default. Because of this, foreclosure may have minimal impact on the originators of the loans.

Loan servicers that handle payments from borrowers may share some of the default risk and may be contractually obligated to continue payments to investors.

Loans that meet eligibility requirements for purchase by government-sponsored enterprises are conforming loans. GSEs often package and sell loans to investors as mortgage-backed securities and then contract with third parties to service the loans.[1]

[1] Loan servicers receive payments from the borrower and pass them along to investors.

In this arrangement, the GSEs, the loan servicer, and any investors that purchase the securities may assume the risk of borrower default.

Depending on the contract, these third-party servicers may share some of the default risk. In many cases, if a borrower defaults on the loan, the servicer is contractually responsible for initiating the foreclosure proceedings and paying the associated costs. The total costs to the servicer would depend on the length of the foreclosure process and the proceeds from the foreclosure sale. The servicer must continue to remit payments to investors until the property is sold at auction. The servicer must also assume responsibility for taxes and property maintenance. In most cases, properties are purchased by the servicer because the servicer has the largest equity in the property and, therefore, the most to lose if the property is sold below the current loan value. These properties are then offered for sale on the real estate market.

Nonconforming loans are either held by the originator or sold on the secondary market. Because of the greater risk of default with securities that are backed by nonconforming loans, investors expect a higher rate of return from these securities. This is generally passed on to the borrowers in the form of higher interest rates. With these loans, there are a number of possible arrangements between loan originators, servicers, lenders, investors, and borrowers. The distribution of costs among these groups will depend on these contractual arrangements. In most cases, servicers will contractually assume the risk of default.

With both conforming and nonconforming loans, proceeds from a foreclosure sale can help offset these losses, though the foreclosure process itself can contribute to additional costs. To initiate foreclosure proceedings, servicers or lenders must file suit in circuit court. Most foreclosure notices are not answered by borrowers in default, so a default judgment is issued. A small percentage of borrowers do answer, and additional legal costs are incurred to prepare a response. Additional principal and interest payments are lost if litigation lengthens the time between default and foreclosure sale.

Private mortgage insurance protects the mortgage lender from some of the loss associated with a loan default and foreclosure.

Historically, loans are insured against mortgage losses through private mortgage insurance, and some of the losses are eventually recouped (Hall). These insurance policies only insure a portion of the mortgage. Fannie Mae requires the purchase of private mortgage insurance to cover the first 12 percent of losses for homes with 80 percent to 85 percent loan-to-value ratio. For higher

loan-to-value ratios, the coverage requirement is higher (Underwriting). With nonconforming loans, private mortgage insurance can be optional, though interest rates tend to be higher without it. In both cases, the cost to borrowers varies with the amount of insurance. In the past, premiums have ranged from 0.32 percent to 0.78 percent of the total mortgage amount (Colquitt).

Foreclosure costs average $25,000 to $30,000. Some lenders may attempt to minimize losses by avoiding foreclosure through loan modifications or other agreements.

Local sources informed staff that the average cost of each foreclosure is $25,000 to $30,000 (Hall). Lenders can take certain actions in an attempt to offset these losses. Sources suggest that lately, lenders have shown a greater willingness to work with borrowers and to offer loan modifications and options such as short sales (VanShuren). This provides some evidence that the lenders are now being affected more than in the past and have a higher exposure to risk.

Loss mitigation arrangements are more common with conforming loans because of President Obama's Making Home Affordable program, which provides borrowers who meet certain criteria the opportunity to refinance their loans or qualify for a range of modifications that may reduce their monthly payments. Servicers who successfully modify a loan receive incentive compensation (Fannie Mae. Announcement).

Impact on Neighborhoods

Neighborhoods are affected by foreclosures when property values decline from abandoned property, distressed sale prices, and possibly increased crime.

Possibly the most obvious indirect cost to third parties is the effect on neighborhood property values. When foreclosure proceedings are initiated, the homeowner has less incentive to maintain the home and is less able to afford home repairs. If the foreclosed home is abandoned, the resulting vacancy can depress surrounding property values, especially in low-income neighborhoods (Immergluck. "The External"). This happens not only due to the failure to maintain these homes but also because of the increase in crime that often accompanies abandoned property. Frequently, vandals strip these properties of pipes and copper wiring, which can be sold at recycling centers. Squatters may occupy abandoned homes and sometimes engage in criminal activities. Research has shown that in some areas, a 1 percent increase in foreclosures is accompanied by a 2.3 percent increase in violent crime (Immergluck. "The Impact").

Any increase in neighborhood crime might depress property values. In addition, foreclosed and abandoned properties typically

sell for substantially less than other properties. These lower prices are used by real estate agents and appraisers when they estimate the value of nearby homes and can lower the market value of surrounding properties.

Studies have concluded that an additional foreclosure will result in neighboring properties losing between 0.2 percent and 1.5 percent of their value (Immergluck. "The External"; Been). The studies were limited to specific dense urban areas, and the effects were concentrated in low-income neighborhoods with fewer owner-occupied dwellings. Because of this, the impact for Kentucky, which has a relatively small proportion of these types of properties, may differ.

The Center for Responsible Lending estimates that in Kentucky in 2009, more than 500,000 homes will be affected by foreclosures resulting in property value losses of more than $600 million.

The Center for Responsible Lending, a nonprofit research and policy organization, used similar findings to estimate that foreclosures will directly or indirectly reduce the values of 520,000 Kentucky homes in 2009, with each home experiencing an average loss in value of about $1,160. Using this estimate, the total decrease in home values resulting from foreclosures would be $605.2 million in 2009 for Kentucky. Further, this report suggested that the total cost of property devaluation resulting from foreclosure will be more than $2.2 billion by 2012.

Kentucky property valuation administrators (PVAs) are responsible for assessing the value of property for tax purposes. Foreclosures have the most impact when there are multiple foreclosures in a small area. Individual foreclosures tend to have little effect on the total valuation of property for large areas. Foreclosure sale prices from master commissioner sales represent distressed values and are not representative of typical home prices. As a result, PVAs do not use the prices from foreclosure auction sales when assessing property values (Lindauer).

One area that has been heavily impacted is West Louisville, where 22 neighborhoods experienced a net decline in total property values from their last assessment to 2009. The total drop in property value from these neighborhoods was almost $240 million. This figure does not include other individual properties that lost value but that were located in a neighborhood experiencing a net increase in value (Lindauer).

The affected neighborhoods do have high concentrations of foreclosed, vacant, and abandoned properties, all of which contributed to decreased home values. This is thought to be partly due to the high frequency of investor-owned properties. According

to the Jefferson County PVA, 68 percent of foreclosures in the affected neighborhoods were investor-owned properties, and a disproportionate number of these properties became abandoned. Despite the lowered property values in some neighborhoods, total taxable property assessments in Jefferson County increased from 2008 to 2009 (Lindauer).

Property values can decline for reasons other than foreclosure. Assessments by the property value assessments can also lag actual property values.

Assessed property values can decline for reasons other than general neighborhood decline resulting from high foreclosure activity. For example, property value assessments may be lowered if the property is damaged or destroyed, such as by fire or if all or part of the home is demolished. Therefore, any decreases in property values cannot fully be attributed to foreclosures. Changes in property value assessment also lag changes in actual property value because PVAs are only required to physically inspect real property every 4 years. In years in which property values are changing quickly, the assessment may become outdated before the property is assessed again.

Impact on Government

Costs to Government

State and local governments incur costs from foreclosures because of upkeep of abandoned property and the impact on real property taxes.

State and local governments incur costs from foreclosures. Local government agencies often pay for upkeep for vacant and abandoned properties. State and local property tax revenue can be affected when property tax bills become delinquent and when property values are stagnant or declining. Increased foreclosures or declining property values may make an area less desirable for new residents.

Property Tax Revenue. Lower property values represent a decline in the tax base, but they do not always result in less revenue because some real property tax rates reset each year to adjust for growth in the value of real property.

House Bill 44, enacted in 1979, limits to 4 percent each year the state real property tax revenue growth from existing property. If the assessments of existing real property increase more than 4 percent, the tax rate must be reduced to ensure that revenue growth does not exceed 4 percent. If the value of existing real property increases less than 4 percent, the tax rate remains the same and revenue growth is less than 4 percent. To the extent that foreclosures contribute to assessments growing by less than 4 percent, foreclosures will result in slower revenue growth for the state.

Kentucky's local governments face similar restrictions on the growth of revenue from their property taxes. According to KRS 132.010, the compensating tax rate is the rate that generates at least as much property tax revenue as the previous year. Local governments generally select a rate between the compensating rate and the rate that would generate an increase in revenue of 4 percent.[2] If the value of property declines, the compensating tax rate could be increased to ensure that the same level of revenue as the previous year was collected. Lower property values might result in decreasing revenue, or slower revenue growth, for local governments if officials set rates lower than the compensating rate.

Some special taxing districts, such as fire protection districts, have a cap on the tax rate they are allowed to charge. If these districts were to experience a net decrease in property assessments, and they had already reached the cap allowed, then revenue collected by that district would decline.

A Joint Economic Committee report estimated that foreclosures in Kentucky would lead to a loss of about $3.4 million in property taxes over a 2-year period.

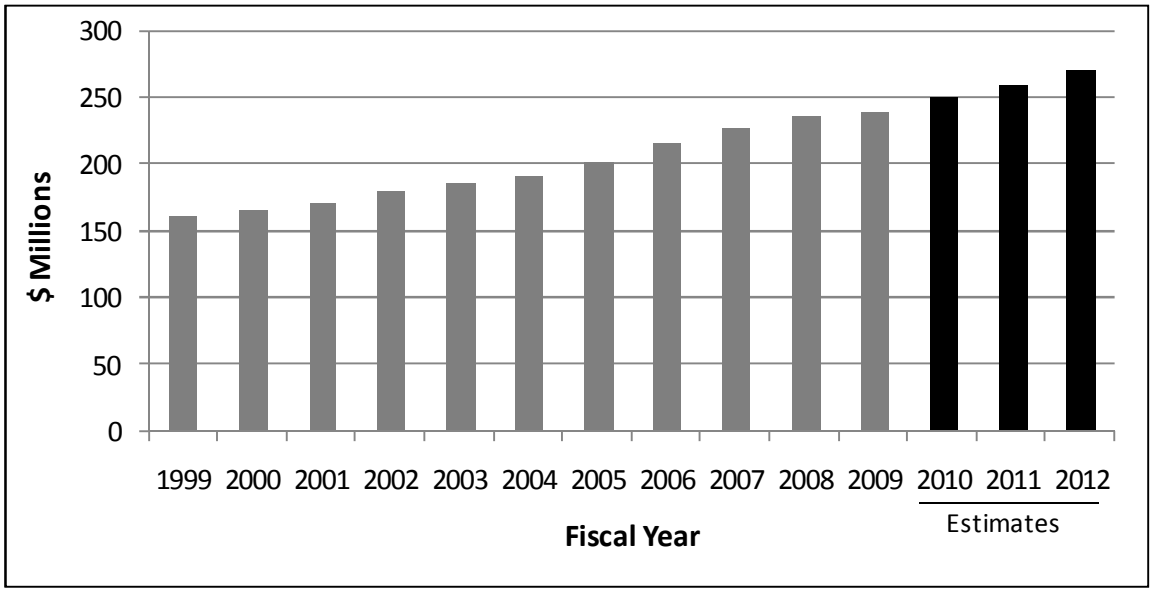
There have been some estimates of the lost tax revenue resulting from foreclosures. In 2007, the U.S. Congressional Joint Economic Committee published a report estimating that from the third quarter of 2007 through the fourth quarter of 2009, subprime foreclosures in Kentucky would lead to property tax revenue of approximately $3.4 million dollars less than it would have been otherwise. The Jefferson County PVA estimated that decreased property values in the 22 neighborhoods that experienced a total decline in value resulted in almost $3 million in lost taxes for the city, the state, and school districts (Lindauer). It is not clear, however, that these estimates incorporated changes in the tax rates that could offset reductions in the value of real property.

Real property tax revenue collections by the state are forecasted to increase in coming years but at a lower rate.

Overall real state property tax revenue collections are forecasted to continue to increase but at a lower rate. Lower real property tax collections are due to a forecasted unchanged real property tax rate, increased delinquencies, and less new property added to the tax base. Property tax collections for FY 1999 to FY 2008, as well as official property tax revenue forecasts for FY 2009 through FY 2012, are shown in Figure 4.A.

[2] Local taxing districts may select a property tax rate that yields real property tax revenue growth of more than 4 percent, but the rate would be subject to recall by voters.

Figure 4.A
State Real Property Tax Revenue Collections and Estimates in Kentucky
Fiscal Year 1999 to Fiscal Year 2012



Note: FY 2010 to FY 2012 figures are the official revenue forecasts and the planning estimates adopted by the Consensus Forecasting Group in May 2009.
Source: Commonwealth. Office of State; Commonwealth. Consensus.

Property tax revenue is also affected by unpaid or delinquent property tax bills. Unpaid or delinquent property tax bills caused by a foreclosure usually result in a delay in revenue, but not a loss. Delinquent property tax bills become first liens on a property, ahead of even the mortgage lien. When a borrower with an insurance and tax escrow account defaults on a loan, the bank or servicer often will continue to pay the property tax bills. Loans that have been purchased by a GSE contractually require the loan servicer to continue paying property taxes even if the borrower is delinquent on payments (Hall). When the property is sold at a foreclosure sale, any taxes due are taken from the proceeds of the sale. The only instance in which a delinquent property tax bill from a foreclosure would not be paid in full is when the property sells for less than the amount of the tax lien. Therefore, property tax bills may be delinquent for a long time but are eventually recovered from the proceeds of the sale.

Cost of Vacant Properties. Another cost to government from foreclosures is maintenance of vacant and abandoned properties. Estimating direct costs to governments for maintenance of a foreclosed property requires knowledge of both the government services involved in the foreclosure for that area and the extent that the government may get involved in the upkeep of the property. A

2005 study of the cost of a foreclosure to the city of Chicago estimated that the direct municipal cost of each foreclosure ranged from $27 to more than $34,000. The cost depends on whether the property was vacant and, if so, for how long; attracted criminal activity or damaging fire; was demolished by the city; had unpaid property taxes; or had property code violations. The overall cost to government also depends on whether collection of these costs was attempted with the owners (Apgar).

The Louisville Metro Department of Housing and Family Services is the agency responsible for abandoned and vacant property and its budget includes $3.7 million for this purpose (Dunlap). According to data from the Jefferson County PVA, as of May 2009, there were about 5,800 vacant and abandoned properties in Jefferson County. Of that number, about 700 were known foreclosure properties (Lindauer).

Revenue to Government

Costs from the actual sale of the property, including advertising, appraisals, and the salary of the master commissioners, are covered through fees collected from the proceeds of the sale. Fees collected in excess of actual expenses incurred are remitted back to the Administrative Office of the Courts at the end of the year. Collection of these fees has increased in recent years, as can be seen in Table 4.1.

Table 4.1
Revenue Collected by
the Administrative Office of the Courts
From Master Commissioner Excess Fees
Fiscal Year 2004 to Fiscal Year 2009

Fiscal Year	Revenue
2005	$6,532,983
2006	$6,638,956
2007	$9,915,611
2008	$11,838,959
2009	$13,426,241

Source: Commonwealth's Financial Analysis System.

KRS 31A.010(4) requires that these excess funds be used to hire additional deputy clerks or office personnel salaries. House Bill 408 of the 2008 Regular Session directed that the Administrative Office of the Courts spend $7.8 million in FY 2009 and $8.2 million in FY 2010 to pay for deputy clerks' salary increases .

Chapter 5

Government Responses to Increases in Foreclosures

Federal, state, and local governments have all responded to increasing foreclosures. Federal programs include a loan modification and refinance program, as well as a program aimed at dealing with the effect of foreclosed homes on neighborhoods. Kentucky has implemented a referral program for homeowners needing a certified housing counselor. Other states have also enacted laws related to foreclosures. A foreclosure conciliation conference program is being implemented in Jefferson County. It is not yet clear how effective these programs will be.

Federal Making Home Affordable Program

The federal Making Home Affordable program began in March 2009. Its key components are the Home Affordable Modification Program and the Home Affordable Refinance Program.

The American Recovery and Reinvestment Act of 2009 authorized the U.S. Department of the Treasury to develop a plan for homeowner affordability and stability. Making Home Affordable, the department's detailed plan outlining and implementing its guidelines, began in March 2009. The plan has two key components: the Home Affordable Modification Program and the Home Affordable Refinance Program.

Home Affordable Modification Program

The modification program is meant to help at-risk homeowners avoid foreclosure by reducing their monthly mortgage payments or by helping them catch up on defaulted payments. The U.S. Department of the Treasury has created specific guidelines that Fannie Mae and Freddie Mac will use for loans they own or guarantee. Incentives will encourage use of the guidelines across the mortgage market.

The modification plan is meant to help at-risk homeowners avoid foreclosure by reducing their monthly mortgage payments or helping them catch up on defaulted payments. The federal government has stated that it also expects the plan to help stabilize home prices for homeowners in neighborhoods hardest hit by foreclosures. The Department of the Treasury has created specific guidelines to be used for mortgage modifications made under the program. Fannie Mae and Freddie Mac will use these guidelines for loans that they own or guarantee. The Department of the Treasury and the Department of Housing and Urban Development (HUD) will work with regulators and other federal and state agencies to implement these guidelines across the entire mortgage market (U.S. Dept. of the Treasury. "Making Home Affordable: Summary").

Participating homeowners must be in imminent risk of default because of financial hardship. Financial incentives to participate in the program are provided to financial institutions, loan servicers, and borrowers.

Participating homeowners do not need to have missed payments but must be in imminent risk of default or in default because of demonstrated financial hardship (U.S. Dept. of the Treasury. "Making Home Affordable: Summary"). Their mortgage payments

must exceed 31 percent of their monthly income. Financial incentives are provided to financial institutions and to loan servicers that participate in the program. In some cases, financial incentives are also available to borrowers who meet the terms of their agreements (U.S. Dept. of the Treasury. "Home").

Fannie Mae and Freddie Mac have made the Home Affordable Modification Program mandatory. Participation will become mandatory for any financial institutions that accept funding from Treasury's Financial Stability Plan.

Both Fannie Mae and Freddie Mac have made the Home Affordable Modification Program mandatory (Fannie Mae. Home). Participation by private lenders in this program is voluntary at its outset, but participation will be mandatory for any institution that accepts future funding from Treasury's Financial Stability Plan, which was the plan that initiated the "stress tests" on banks. Those banks have access to a Treasury-provided capital buffer to help absorb losses and serve as a bridge to receiving increased private capital. The plan also provides capital to unstable lending institutions (U.S. Dept. of the Treasury. Fact).

The borrower must first complete a 3-month trial period of a loan modification before being considered for a long-term agreement. Any foreclosure process will be suspended during the trial period and, if the borrower fails the trial, while the borrower is being considered for other foreclosure prevention options.

Before a modification agreement can be made between a lender and a borrower, the borrower must complete a 3-month trial period. If the borrower is able to fulfill the modified payment plan for the trial period, the borrower may be considered for an official agreement (U.S. Dept. of the Treasury. "Home"). If a foreclosure action is in process, it will be suspended during the 3-month trial period. Foreclosure actions may not be initiated or restarted until the borrower has failed the trial period plan and the borrower has been considered and found ineligible for other available foreclosure prevention options (Fannie Mae. Home).

The U.S. Department of the Treasury's trial guidelines list possible mortgage modifications, such as applying defaulted amounts to the principal, reducing the interest rate, extending the loan term, and granting partial principal forbearance.

The U.S. Department of the Treasury's trial guidelines list the following as possible mortgage modifications:

- capitalizing arrearage, which means adding accrued interest, past due taxes and insurance premiums, delinquency charges, and escrow advances to the outstanding principal balance of the mortgage;
- reducing the interest rate (subject to a floor of 2 percent per year);
- extending the term of the loan or the amortization up to 40 years; and
- forbearing principal, which means refraining from enforcing payment of some of the principal debt until either the loan's maturity date, the sale of the property, or the payoff of the balance, at which time a balloon payment of the amount under forbearance would be due (U.S. Dept. of the Treasury. "Home" 7).

For borrowers who do not qualify for loan modifications, Treasury is providing incentives to loan servicers and borrowers to pursue short sales or deeds-in-lieu of foreclosure rather than foreclosures.

Foreclosure Alternatives. If a borrower is eligible for the modification program but does not qualify for a modification or was unable to sustain payments even under a modified loan, the program provides financial incentives to borrowers, servicers, and investors to encourage short sales and deeds-in-lieu of foreclosure. Lenders have often preferred to pursue foreclosure because of the complexity and time involved in short sales and deeds in lieu. The U.S. Department of the Treasury hopes to streamline these processes by standardizing the processes and documentation ("Making Home Affordable: Update").

Additional financial incentives are given to lenders that modify loans for borrowers in neighborhoods with the most severe and potentially persistent home price declines.

Home Price Decline Protection Incentives. In this recent addition to the Home Affordable Modification Program, additional financial incentives are given to lenders that modify loans for borrowers in neighborhoods where the drop in home prices has been most severe and lenders fear these declines may persist (U.S. Dept. of the Treasury. "Making Home Affordable: Update").

Home Affordable Refinance Program

The purpose of the refinance program is to provide creditworthy borrowers who have shown a commitment to paying their mortgages the opportunity to get into a mortgage with payments that are more stable for the life of the loan.

The refinance program is for homeowners with solid payment histories whose homes have lost so much value that under traditional terms they cannot refinance.

The program is aimed at homeowners with solid payment histories on existing mortgages owned or securitized by Fannie Mae or Freddie Mac but whose homes have lost value, reducing their loan amount to less than 80 percent of the property's appraised value. Under traditional standards, loans to such homeowners are considered too risky to refinance, so homeowners are unable to refinance their mortgages to take advantage of lower interest rates. They also miss the chance to refinance higher-risk loan terms such as an adjustable-rate mortgage, interest-only payments, or balloon payments into a more stable mortgage, such as a 30-year fixed-rate loan (U.S. Dept. of the Treasury. "Making Home Affordable: Summary").

Eligible loans include those for which the first mortgage does not exceed 105 percent of the current market value of the home. Any Fannie Mae-approved lender, which includes most major banks and mortgage brokers, can provide this program. It expires in June 2010.

Eligible loans include those for which the first mortgage does not exceed 105 percent of the current market value of the property. The current value of the property is determined after the borrower applies to refinance through the program. Any Fannie Mae-approved lender, which includes nearly all major banks and mortgage brokers, is authorized to provide this refinance program. The program expires on June 10, 2010 (U.S. Dept. of the Treasury. "Making Home Affordable: Borrower").

Federal Moratoriums on Foreclosures

In November 2008, Fannie Mae and Freddie Mac suspended foreclosures. A number of banks followed suit.

Fannie Mae and Freddie Mac were taken into conservatorship by the U.S. government in September 2008. In November 2008, Fannie Mae and Freddie Mac suspended foreclosure sales and evictions from occupied properties through January 2009—later extended through March 2009. A number of banks also began moratoriums on foreclosures around November 2008. Many banks renewed their moratoriums through March 2009 at the urging of Congress (Bogoslaw). In February 2009, the U.S. Department of the Treasury's Office of Thrift Supervision also called on its institutions to voluntarily stop owner-occupied foreclosures. The extension on the moratoriums was to give the department time to implement its Making Home Affordable plan guidelines. All the federally sponsored moratoriums ended by March 31, 2009. Several state-sponsored moratoriums are still in effect.

Neighborhood Stabilization Program

Round 1

The Neighborhood Stabilization Program (NSP) authorizes the U.S. Department of Housing and Urban Development (HUD) to distribute emergency funding to states and large local jurisdictions hardest hit by foreclosures.

The Neighborhood Stabilization Program (NSP) is a federal program administered by HUD designed to help states and localities stabilize neighborhoods affected by large numbers of foreclosures. The Housing and Economic Recovery Act of 2008 included the establishment and emergency funding of the program. NSP funds were distributed in March 2009 to states and some large local jurisdictions hit hardest by foreclosures. The distributions were based on a formula created by HUD that is based on greatest need. This first round of NSP grants is called NSP1.

The neighborhoods to be selected for the funds are those in which so many foreclosures and abandonments have occurred that the neighborhood is in danger of slipping into blight. The intent of the program is to stabilize property values.

Officials at the Kentucky Governor's Department for Local Government said that the primary purpose of NSP is to help local governments invest in neighborhoods that are at the "tipping point" because of the economic downturn in the housing market. The tipping point refers to the point at which the number of foreclosures and abandonments has caused the value of remaining homes in a neighborhood to decline. This may lower the taxes generated by the neighborhood. It also means that the neighborhood is in danger of declining into blight because many homeowners will owe more on their mortgages than their homes are worth on the market. This means they will be unable to refinance into more affordable or stable loans or will be unable to sell their homes when they need to, which will increase the prospect of more foreclosures and abandonments in the neighborhood. The administrators of NSP funds may buy the

lender-owned properties at a discount and resell them. The intent of the program is that the lenders' liquidity will improve, property values will stabilize, and the neighborhoods will generate more property taxes.

Funds must be used for households whose income does not exceed 120 percent of area median income. At least 25 percent of the funds must be used to purchase and redevelop residential properties that house those whose incomes do not exceed 50 percent of area median income.

Income requirements apply in determining the neighborhoods in which the funds can be used. Funds appropriated by NSP1 must be used for households whose income does not exceed 120 percent of area median income. In addition, at least 25 percent of the funds will be used to purchase and redevelop abandoned or foreclosed residential properties that will be used to house individuals or families whose incomes do not exceed 50 percent of area median income (P.L. 110-289, Title III Sec. 2301 (f)).

HUD allocated the funds based on number and percentage of foreclosures, subprime mortgages, and defaults. Most NSP Round 1 funds went directly to states, which could then distribute them to local entities.

In determining the amounts to be allocated, HUD followed Congressional direction that NSP grants be targeted to areas based on the number and percentage of foreclosures, subprime mortgages, and mortgage defaults and delinquencies (Commonwealth. Office of the Governor. Dept. for Local Government. "Neighborhood Stabilization Program--1"). Most NSP1 funds went to states, which then had the option of spending the funds directly or distributing them to local grantees such as local governments, nonprofits, housing authorities, and redevelopment organizations (Commonwealth. Office of the Governor. Dept. for Local Government. Draft).

Kentucky's NSP1 total statewide allotment was $37.4 million.

Funding for NSP1 was allocated based on greatest need, although each of the 50 states and Puerto Rico received a minimum award of $19.6 million (U.S. Dept. of Housing. Neighborhood. "Explanation"). Kentucky's NSP1 total statewide allotment was $37.4 million.

The determination of need was based on the number and percentage of foreclosures, the number and percentage of subprime mortgages, and the number of neighborhoods most likely to face a significant rise in the rate of foreclosures.

The determination of need was based on the number and percentage of home foreclosures; the number and percentage of homes financed by a subprime mortgage related loan; and the number of neighborhoods most likely to face a significant rise in the rate of home foreclosures, based on such factors as the number and percentage of homes in default or delinquency (P.L. 110-289, Title III, Div. B, sec. 2301(c)(2)).

In Kentucky, the Governor's Department for Local Government allocated the funds to local grantees.

In Kentucky, the Governor's Department for Local Government allocated the funds to the local grantees shown in Table 5.1. According to an official at the department, the difference between the funds received from HUD and the funds allocated so far is a standby project that was not finalized at the time the original awards were made and state long-term planning and administrative costs.

Table 5.1
State Neighborhood Stabilization Program Round 1 Funds Allocated by the Governor's Department for Local Government

Agency/Jurisdiction	Amount	Area To Be Served
Bardstown, City of	$580,000	City of Bardstown
Beattyville Housing Development Corp.	$561,352	City of Beattyville
Community Housing, Inc.	$783,500	Cities of Winchester and Mt. Sterling
Community Ventures Corp.	$2,750,000	Fayette, Scott, Madison, Jessamine, and Franklin Counties
Covington, City of	$5,000,000	City of Covington
Federation of Appalachian Housing Enterprise	$523,500	Harlan, Perry, Letcher, Madison, and/or Bath Counties
Green River Housing Corp.	$997,791	Daviess, Henderson, and Ohio Counties
Henderson Housing Authority	$749,700	City of Henderson
Hope Center	$1,721,268	Lexington/Fayette County
Housing Authority of Bowling Green	$2,032,551	City of Bowling Green
The Housing Partnership	$5,151,250	Louisville/Jefferson County
Lexington-Fayette Urban County Govt.	$1,883,047	Lexington/Fayette County
Louisville Metro	$3,500,000	Louisville/Jefferson County
Ludlow, City of	$835,455	City of Ludlow
Newport Millennium	$1,767,336	City of Newport
Pennyrile Housing	$1,371,000	City of Hopkinsville/ Christian County
Purchase Housing	$1,372,500	McCracken, Marshall, Calloway, and Graves Counties
REACH	$720,000	Lexington/Fayette County
Richmond, City of	$1,268,933	City of Richmond
Welcome House	$418,800	Covington/Kenton County
Total (includes local administrative funds)	$33,987,983	

Source: Commonwealth. Office of the Governor. Dept. for Local Government. "Neighborhood Stabilization Program—1" and Neighborhood Stabilization Program Funding Awards.

The Louisville/Jefferson County Metro Government received a separate grant of $6.97 million.

Louisville/Jefferson County Metro Government NSP Round 1. The HUD formula identified Louisville/Jefferson County Metro Government as the only county in Kentucky assigned a "most distressed" score of 100 out of 100 points. The government received a local grant, separate from the state grant, of $6.97 million in NSP1 funds, which is being focused on five neighborhoods (Louisville. Division. "Neighborhood"; Louisville. Division. "The NSP").

Round 2

Another $1.93 billion has been authorized for NSP Round 2. States, local governments, and nonprofits may compete for grants. The application deadline is July 17, 2009.

A second round of NSP funds in the amount of $1.93 billion has been authorized under the American Recovery and Reinvestment Act of 2009. Known as NSP2, it is a competitive grant, rather than one based on a formula. Bids must be for a minimum of $5 million. States, local governments, nonprofit organizations, and consortia of nonprofits may apply for funds. For-profit entities may not apply; however, any eligible applicant may apply with a for-profit entity as its partner. The application deadline was July 17, 2009 (U.S. Dept. of Housing. "Notice"; U.S. Dept. of Housing. "Neighborhood Stabilization Program 2").

HUD will award the competitive NSP grants based on one of two need indices.

Allowable activities will be relatively unchanged from those in NSP1. Applicants must propose to carry out NSP2 activities in neighborhoods that have a high HUD-created index score based on either the average foreclosure needs or the average foreclosures with vacancy risk (U.S. Dept of Housing. "Neighborhood Stabilization Program 2").

Kentucky Homeownership Protection Center

In 2008, the General Assembly authorized creation of the Kentucky Homeownership Protection Center to help homeowners facing default find free, reliable mortgage counseling.

In 2008, the General Assembly authorized the Kentucky Housing Corporation to create the Kentucky Homeownership Protection Center, which it has done. The center's purpose is to be a central point of contact for homeowners facing default. The center refers those homeowners to counseling agencies that will work with the homeowner free of charge to explore his or her options. This includes contacting the mortgage holder and attempting to negotiate a loss mitigation workout, if appropriate (KRS 198A.400).

The center sets specific requirements for participating foreclosure counseling agencies.

The center sets requirements for participating counseling agencies. A center official reported that to be accepted into the program, counseling agencies must be incorporated in Kentucky and be in good standing. They must be a 501(c)(3) nonprofit organization and must be certified by HUD. They must submit proof of at least 1 year's experience providing education or counseling in homeownership. They must be certified by a national organization, such as NeighborWorks America, which requires 56 hours training on foreclosure intervention counseling.

Jefferson Residential Foreclosure Conciliation Program

The Jefferson Circuit Court has begun a Residential Foreclosure Conciliation Program. The court refers foreclosure cases for a conciliation conference between the servicer and the homeowner. If the homeowner qualifies and follows the steps, the mortgage holder is required to participate in a conference or the court will not authorize a foreclosure sale.

A Residential Foreclosure Conciliation Program was created by order of the Jefferson Circuit Court on March 30, 2009. Under this program, the court intervenes in all foreclosure cases on owner-occupied property, early in the process, by referring them for a conciliation conference between the servicer and homeowner. The order cites the large increase in the number of foreclosure cases that have been or are likely to be filed, requiring the expenditure of substantial court resources. For all cases in which the homeowner qualifies and chooses to take the necessary steps for a conciliation conference, the mortgage holder is required to participate in the conference before the court will authorize a foreclosure sale (Commonwealth. Jefferson. 30th). Setting up the conference does not stop the foreclosure process (Commonwealth. Jefferson. Notice).

The program works as follows. When a foreclosure complaint is first filed in court by the mortgage holder against the homeowner, and the court has served the foreclosure notice and summons to the homeowner, the court also issues a notice advising the homeowner of the conciliation program. The eventual goal is to have every homeowner who receives such a notice be visited in person by an outreach worker to answer questions, under the oversight of Making Connections Louisville, a nonprofit group.

The court's notice to the homeowner outlines the steps the homeowner must take to participate in the conciliation program.

The notice outlines the steps the homeowner must take to participate in the program. First, the homeowner completes a financial packet with the aid of a free housing counselor. Then the packet goes to the lender for its review. Finally, the homeowner attends a conciliation conference with someone from the mortgage holder with decision-making authority to reach a workout agreement. If the homeowner is unable to afford legal counsel, a pro bono attorney will be present at the conference (Commonwealth. Jefferson. Master; Commonwealth. Jefferson. Notice).

A workout agreement is not mandatory, but if the mortgage holder does not attend, a foreclosure sale will not be held.

The conciliation conference is scheduled by the court and is held before the master commissioner. A workout agreement is not mandatory, but if the mortgage holder does not attend the conference, a foreclosure sale will not be held (Commonwealth. Jefferson. 30th).

The conciliation program has been in a pilot stage since March 30, 2009, with four circuit court divisions participating. All divisions were expected to begin participating on July 1, 2009.

Since its inception on March 30, 2009, the Residential Foreclosure Conciliation Program has been in a pilot stage, with only four of the circuit court's divisions participating (Commonwealth. Jefferson. Master). An attorney with the program confirmed that the circuit court expected all its divisions to participate beginning July 1, 2009.

Results of Government Initiatives

Recent studies indicate that for many borrowers, loan modifications and foreclosure moratoriums are not successful in stopping foreclosure. One government report shows that redefaults are common.

Government initiatives to slow the rate of foreclosures are still being evaluated. Recent reports on the results of loan modifications and evidence from past foreclosure moratoriums indicate that for many borrowers, these actions are not successful in stopping a foreclosure and may impose additional costs on future borrowers.

Loan Modifications

Even before recent standardization through federal programs, lenders were modifying loans as the number of borrowers in default increased. There is evidence that for many borrowers, these loan modifications were not successful.

A quarterly report by the U.S. Department of the Treasury's Office of the Comptroller of the Currency and Office of Thrift Supervision offers details on the number of loan modifications that are unsuccessful as indicated by the borrower defaulting on the loan again within a short period of time. This report collects data from the 9 national banks and 4 thrifts that have the largest mortgage servicing portfolios. The report covers about 66 percent of all outstanding mortgages.

As shown in Table 5.2, for loans modified in the third quarter of 2008, almost one-third had again defaulted just months later. Re-default rates grew as more time passed since the modification. For loans modified in the first quarter of 2008, more than 40 percent of borrowers had re-defaulted after 9 months.

Table 5.2
Percentage of Modified Loans in the U.S. 60 or More Days Delinquent

	Borrower Defaults on Loan		
Modification Date	**3 Months After Modification**	**6 Months After Modification**	**9 Months After Modification**
First Quarter 2008	22.2%	35.2%	43.8%
Second Quarter 2008	26.8%	41.8%	n/a
Third Quarter 2008	31.3%	n/a	n/a

Source: Reproduced from U.S. Dept. of the Treasury. Office of the Comptroller 20.

Loan modifications can result in monthly payments that increase, decrease, or remain unchanged.

A loan is modified by a servicer when the terms of the loan are changed. Effects of modifications are that the payment amount can increase, decrease, or remain unchanged. For example, the payment can increase when past principal and interest are added to the balance of the loan; the payment can decrease if the interest rate is reduced, the loan term is extended, or a portion of the loan balance is forgiven or transferred to a balloon payment. The payment can remain unchanged if an interest rate is locked to prevent future increases.

A 2008 report showed that for all loans modified that year, less than half resulted in a lower monthly payment, and almost one-third resulted in a higher payment. Modifications that decreased the monthly payment had lower default rates.

As shown in Table 5.3, for all loans modified in 2008, less than half resulted in a lower payment, and almost a third resulted in a higher payment. The remaining modifications resulted in a payment that did not change. Modifications that decreased the payment amount had lower redefault rates after 3 months than modifications that increased or did not change the payment amount.

Table 5.3
Percentage of Modified Loans in the U.S. 60 or More Days Delinquent by Change in Payment, Fourth Quarter 2008

Payment Change	**Percentage of All Modifications**	**Redefault Rate 3 Months After Modification**
Decreased by more than 10%	29.3%	13.8%
Decreased by 10% or less	12.5%	18.5%
Unchanged	26.6%	41.9%
Increased	31.6%	29.2%
Total	100.0%	

Source: Reproduced from U.S. Dept. of the Treasury. Office of the Comptroller 26, 28.

Another analysis reported that if a loan modification increases the principal balance by more than 5 percent, redefaults are 60 percent to 70 percent after 12 months. If the modification decreases the balance, redefaults are 30 percent to 40 percent

Fitch Ratings provides evidence on redefaults for loan modifications that involve a change in the principal. Principal can increase when past due loan payments and accumulated penalties and interest are added to the loan balance instead of being due immediately. Principal can decrease when a portion of the loan is forgiven. For loans for which the modification results in an increase in the principal balance of more than 5 percent, redefaults after 12 months are approximately 60 percent to 70 percent. For loans for which the result is a decrease in the principal balance, the re-default rate is 30 percent to 40 percent after 12 months (Fitch. "U.S.").

As unemployment increasingly becomes the most common reason for default, loan modifications become more difficult.

As unemployment increases and becomes a more common reason for default, loan modifications can become more difficult. Federal programs that require payment amounts below a certain percentage of income become impossible to implement if the borrower is unemployed.

Foreclosure Moratoriums

Foreclosure moratoriums may impose additional costs on lenders that will affect future borrowers.

The implementation of a foreclosure moratorium may allow the borrower more time to catch up on payments or to negotiate a modification. However, these moratoriums may impose additional costs on lenders that affect future borrowers.

One study found that foreclosure moratoriums during the Great Depression decreased foreclosures; but later, borrowers faced a decreased amount of available real estate credit and increased interest rates.

One study found that the moratorium 27 states placed on foreclosures during the Great Depression did decrease foreclosures; but, borrowers later faced a decreased amount of available real estate credit and increased interest rates. However, the benefits to society may have outweighed the costs to future borrowers, and lenders may have benefited since the moratorium may have "halt[ed] a downward spiral in property values" (Wheelock 580).

State Laws Enacted on Relevant Home Foreclosure Issues

Twenty-five states enacted 36 laws in 2008 or 2009 that deal with relevant foreclosure issues.

Twenty-five states enacted 36 laws in 2008 or 2009 that are relevant to the issues examined in this report (National Conference. "Foreclosures"; National Conference. "2008"). Staff classified each law into one or more of six categories as shown in Table 5.4. Appendix A contains brief summaries of the laws.

Eighteen state laws enacted in 2008 and 2009 deal with requirements that mortgage holders notify borrowers of pending foreclosure action, the borrower's right to seek loan modification counseling, and notice of where such counseling can be obtained. Of these laws, four require the mortgage holder to engage in at least a minimal loan modification negotiation with the borrower, one has such a requirement for subprime loans only, and two provide for the state to give monetary assistance for foreclosure counseling.

Ten laws deal with restrictions on private foreclosure consultants; that is, those providing such services for a fee. Such consultants have generally not been approved by either a state housing agency or HUD. Of the remaining laws listed, six deal with state financial assistance to certain borrowers in danger of foreclosure, three are relevant to the collection of foreclosure data, two deal with moratoriums on foreclosures, and one deals with the maintenance of foreclosed property to stabilize neighborhoods.

Table 5.4
State Laws on Relevant Home Foreclosure Issues Enacted in 2008 and 2009

State	Bill Number	Year Enacted	Action					
			Foreclosure Alternatives & Notification	Private Foreclosure Consultant	Financial Assistance	Data Collection	Moratorium	Neighborhood Stabilization
Alaska	S.B. 231	2008			●			
Arkansas	S.B. 396	2009	●					
California	A.B. 180	2008		●				
	S.B. 1137	2008	●					●
	S. B. 7	2009					●	
Colorado	H.B. 1402	2008	●					
	H.B. 1197	2009				●		
Connecticut	H.B. 5577	2008			●		●	
	H.B. 5578	2008	●					
	H.B. 5623	2008			●			
Delaware	S.B. 252	2008		●				
Hawaii	H.B. 2326	2008		●				
	S.B. 2454	2008	●					
Idaho	S.B. 1431	2008		●				
Illinois	H.B. 4195	2008	●					
	S.B. 1879	2008	●					
Iowa	H.F. 2653	2008		●				
	S.F. 364	2009	●					
Kentucky	H.B. 552	2008	●					
Louisiana	S.B. 5990	2008	●					
Maine	L.D. 2189	2008		●				
Maryland	H.B. 640	2009				●		
Michigan	H.B. 4658	2008	●					
Minnesota	H.F. 3420	2008	●					
	S.F. 3073	2008			●			
Nebraska	L.B. 123	2008		●				
New Jersey	A.B. 2780	2008	●					
New York	S.B. 8143	2008	●	●				
North Carolina	H.B. 2463	2008	●					
Oregon	H.B. 3630	2008	●	●				
Pennsylvania	S.B. 486	2008			●			
Virginia	S.B. 797	2008	●					
West Virginia	H.B. 3082	2009				●		
Washington	S.B. 6431	2008		●				
	S.B. 6711	2008			●			
	S.B. 5810	2009	●					
Total			18	10	6	3	2	1

Source: Compiled by Program Review staff based on National Conference. "Foreclosures"; National Conference. "2008."

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Appendix A

Relevant State Laws on Housing Foreclosure Enacted in 2008 and 2009

Program Review staff selected state laws enacted in 2008 and 2009 that were relevant to the issues in this report and divided them into six categories:

- foreclosure alternatives and notifications
- private foreclosure consultants
- financial assistance
- data collection
- moratoriums on foreclosures
- neighborhood stabilization

The following table contains the name of the state, the bill number, year enacted, and summary for each law. In creating the explanations, staff examined the summaries of all laws and the text of some laws for clarity. A law that covers more than one of the six categories will appear within each relevant section of the table.

Foreclosure Alternatives and Notifications (18 laws)

Enacted 2009

Arkansas S.B. 396 creates the Arkansas Housing Trust Fund; monies in the fund can be used for foreclosure counseling.

Iowa S.F. 364 mandates that the mortgage holder must mail the homeowner a notice of the availability of counseling and mediation when a foreclosure action begins.

Washington S.B. 5810 requires the mortgage holder, before filing a notice of default, to contact the borrower, assess the borrower's financial situation, and explore alternatives to foreclosure.

Enacted 2008

California S.B. 1137 requires the mortgage holder to

- contact the borrower 30 days before filing a notice of default with the court,
- contact the borrower to explore options for avoiding foreclosure, and
- provide the borrower a HUD telephone number to find a HUD-certified counseling agency.

Colorado H.B. 1402

- requires for residential foreclosures that a commercial lender give the borrower written notice, at least 30 days after the borrower's default and at least 30 days before filing its notice of election and demand, containing contact information for the Colorado foreclosure hotline and the lender's loss mitigation representative;
- creates the Foreclosure Prevention Grant Fund to be administered by the Division of Housing's Department of Local Affairs to provide outreach and notice of foreclosure prevention assistance to persons in danger of foreclosure and communities with high foreclosure rates; and
- appropriates $100,000 from the general fund to the Foreclosure Prevention Grant Fund and from the Foreclosure Prevention Grant Fund to the Department of Local Affairs.

Connecticut H.B. 5578 requires a lender to provide, on written request, a reinstatement payment statement in writing to the borrower.

Hawaii S.B. 2454 amends mortgage foreclosure law to ensure that consumers and others receive important information regarding a foreclosure in a timely manner.

Illinois H.B. 4195 requires that a notice be sent to a mortgagor prior to a judicial sale, even if the mortgagor was previously defaulted, that will notify the homeowner of the right to remain in possession for 30 days after the entry of the order of possession.

Illinois S.B. 1879 requires that for all residential foreclosure actions filed, the plaintiff must attach a homeowner notice to the summons that contains specified information.

Kentucky H.B. 552 authorizes the Kentucky Housing Corporation to establish the Kentucky Homeownership Protection Center. The purpose of the center is to provide a centralized location for information on public services to assist a homeowner who is in default or in danger of default on a home loan.

Louisiana. S.B. 5990 authorizes the Louisiana Housing Finance Agency to establish a program to provide free mortgage foreclosure counseling and education to homeowners who have defaulted or are in danger of defaulting on their home mortgages. The agency is authorized to enter into agreements with other entities to carry out the program, establish a central toll-free telephone line, award grants for training of counselors, and establish standards for certification of such counselors.

Michigan H.B. 4658 extends the uses of the Michigan Housing and Community Development Fund to foreclosure prevention and assistance.

Minnesota H.F. 3420 establishes that

- when the written notice is provided and before the notice of pendency is filed, a party foreclosing on a mortgage must give to the homeowner the information that foreclosure prevention counseling services provided by an authorized foreclosure prevention counseling agency are available; and
- the party entitled to foreclose must provide to the appropriate authorized foreclosure prevention agency the mortgagor's name, address, and most recent known telephone number.

New Jersey A.B. 2780, which remains in effect until Jan. 1, 2011, contains the following provisions:

- The "Save New Jersey Homes Act of 2008" requires creditors to provide a 3-year period of extension to borrowers who are obligated to repay introductory rate mortgage loans on residential properties under certain circumstances. An introductory rate mortgage provides for an introductory interest rate that resets after a period of time. The bill provides a period of extension, during which the introductory rate does not reset, to "eligible borrowers" whose mortgage interest rates are about to reset. The bill also provides a period of extension during which foreclosure proceedings are suspended. By providing a period of extension for existing mortgages, the intent of the bill is to allow time for creditors and borrowers to renegotiate more reasonable terms.
- Prior to the date on which the interest rate will reset on an introductory rate mortgage, a mortgage holder must provide to an eligible borrower a series of written notices alerting the borrower to the impending interest rate reset and providing information about any refinancing or renegotiation of the loan offered by the mortgage holder and the borrower's right to obtain a 3-year period of extension under the terms of the bill.
- The mortgage holder must provide an eligible borrower with a 3-year period of extension, during which the interest rate on the introductory rate mortgage will not increase above the original introductory rate, on the condition that the eligible borrower provides a certificate of extension. The certificate of extension must state that the borrower 1) is unable to pay the monthly payments that will apply after the date that the interest rate resets; 2) agrees to continue monthly payments calculated at the introductory interest rate, during the period of extension; 3) agrees to pay the mortgage holder, at the time of transfer of the property, any interest deferred on account of the period of extension; and 4) agrees to accept the mortgage holder's placement of a subordinate lien on the property to secure the repayment of the interest deferred on account of the period of extension.

(continued)

(New Jersey A.B. 2780 continued)

- A mortgage holder who grants a period of extension to an eligible borrower facing foreclosure has the right to record a subordinate lien on the eligible foreclosed borrower's property to secure the borrower's repayment of the amount of interest deferred by the period of extension and any arrearages owed on the mortgage. The subordinate lien has the same priority as the lien of the introductory rate mortgage.
- An eligible borrower who fails to make the appropriate payments during the period of extension forfeits all rights concerning the deferment of interest payments and suspension of foreclosure.
- A mortgage holder who issues to an eligible foreclosed borrower a notice of intention to foreclose an introductory rate mortgage must send to the borrower a series of written notices, separate and distinct from all other correspondence and written in plain language. The notices must include a list of alternatives to foreclosure that an eligible foreclosed borrower may pursue, including any refinancing of the loan and any renegotiation of loan terms offered by the mortgage holder. They also must include an explanation of the eligible foreclosed borrower's right to obtain a period of extension for 3 years and an explanation of the procedure that an eligible foreclosed borrower must follow to obtain a period of extension.
- A mortgage holder must provide an eligible foreclosed borrower with a 3-year period of extension, during which the interest rate on the introductory rate mortgage shall not increase above the original introductory rate, and during which foreclosure proceedings are suspended. The creditor must grant this relief on the condition that the eligible foreclosed borrower provides a certification of extension. The certification of extension must state that the borrower agrees 1) to continue monthly payments, with interest calculated at the introductory rate, during the period of extension; 2) to pay the creditor, at the time of transfer of the property, any interest deferred on account of the period of extension and any arrearages on the mortgage; and 3) to accept the creditor's placement of a subordinate lien on the property to secure the repayment of the interest deferred on account of the period of extension and any arrearages owed on the mortgage.
- A creditor who grants a period of extension to an eligible foreclosed borrower shall have the right to record a subordinate lien on the foreclosed borrower's property to secure the borrower's repayment of the amount of interest deferred by the period of extension and any arrearages owed on the mortgage. The subordinate lien has the same priority as the lien of the introductory rate mortgage.

New York S.B. 8143 requires that

- lenders and mortgage loan servicers give borrowers with high-cost home loans or higher-priced home loans notice before certain actions are taken;
- lenders send a preforeclosure notice to borrowers at least 90 days before foreclosure proceedings may be initiated;
- lenders list in the notice the government-approved housing counselors serving the borrower's area; and
- a mandatory settlement conference be established for foreclosure proceedings involving homeowners with certain subprime loans.

North Carolina H.B. 2463 requires mortgage servicers to send a notice to the borrower at least 45 days before foreclosure is initiated with the following information:

- an itemization of all past due amounts causing the loan to be in default;
- an itemization of any other charges that must be paid in order to bring the loan current;
- a statement that the borrower may have options available other than foreclosure and that the borrower may discuss such options with the mortgage lender, the servicer, or a counselor approved by HUD;
- the address, telephone number, and other contact information for the mortgage lender, the servicer, or the agent who is authorized to attempt to work with the borrower to avoid foreclosure;
- the name, address, telephone number, and other contact information for one or more
- HUD-approved counseling agencies operating to assist borrowers in North Carolina to avoid foreclosure; and
- the address, telephone number, and other contact information for the consumer complaint section of the office of the Commissioner of Banks.

Oregon H.B. 3630 requires the following:

- A notice of home loss danger is to be sent to borrowers for which notice of foreclosure is filed. The notice is to contain telephone numbers for borrower access to loan information and consultant services.
- The Department of Consumer and Business Services is to adopt rules specifying a statewide telephone contact number and Web site address where borrowers receiving notice of home loss danger may find possible sources of information and assistance.

Virginia S.B. 797 requires high-risk mortgage lenders or servicers to provide written notice of the intention to send a notice to accelerate the loan balance 10 business days prior to sending the notice of acceleration. If the borrower indicates the desire to avoid foreclosure, the high-risk mortgage lender or servicer must give the borrower 30 calendar days' forbearance.

Private Foreclosure Consultants (10 laws)

Enacted 2008

California A.B. 180 regulates private foreclosure consultants.

Delaware S.B. 252 regulates foreclosure consultants and foreclosure reconveyances in order to protect homeowners from foreclosure rescue schemes that deplete the homeowner's equity.

Hawaii H.B. 2326 requires mortgage foreclosure rescuers to provide specific information and disclosures to distressed property owners and imposes specific prohibitions on mortgage foreclosure rescuers.

Idaho S.B. 1431 mandates that all contracts entered into while a residential home is in the foreclosure process must be in writing and that consumers have a 5-day right of rescission. A warning for consumers about foreclosure rescue scams is to be included in foreclosure notification papers and in any written contract.

Iowa H.F. 2653 regulates mortgage foreclosure consultant contracts and mortgage foreclosure reconveyance transactions.

Maine L.D. 2189

- includes measures designed to protect homeowners from equity stripping during foreclosures;
- requires foreclosure purchasers to ensure that title is transferred back to the homeowner or that the foreclosure purchaser pays the homeowner at least 82 percent of the fair market value of the property within 150 days of when the homeowner is evicted or voluntarily gives back possession of the home;
- requires foreclosure purchasers to verify that a foreclosed homeowner has a reasonable ability to make the payments needed to take back title to the home; and
- requires that the foreclosed homeowner receive counseling on the advisability of the transaction.

Nebraska L.B. 123 places requirements on foreclosure consulting contracts.

Oregon H.B. 3630 imposes duties and restrictions on foreclosure consultants and equity purchasers. Provision of foreclosure consulting services to homeowners is to be pursuant to written contract. Conveyance of homeowner equity in a residence in foreclosure is to be pursuant to written contract.

Washington S.B. 6431 requires a distressed property purchaser and a foreclosed homeowner to enter into a distressed property reconveyance in the form of a written contract. Contract requirements are established.

New York S.B. 8143 regulates independent foreclosure property consultants. Upfront fees are prohibited. A written contract is required.

Financial Assistance (6 laws)

Enacted 2008

Alaska S.B. 231 authorizes the Alaska Housing Finance Corporation to provide financial assistance to prevent homelessness, including prevention of foreclosures.

Connecticut H.B. 5577 creates three mortgage assistance programs and establishes a 10-member mortgage assistance program committee. The programs must be funded by state bonding and loan repayments under the programs. The committee must develop written standards that establish 1) the standards for qualifying mortgagors for the emergency mortgage assistance programs; 2) the scope and nature of the emergency assistance available; and 3) the terms and conditions under which the Department of Economic and Community Development will provide and be repaid for the assistance provided under the programs. For all loans, a fiduciary duty is established from all lenders and mortgage brokers to borrowers. Financing of insurance and refinancing that do not benefit the borrower are prohibited.

Connecticut H.B. 5623 authorizes that recipients of Temporary Family Assistance or State Supplemental benefits who are foreclosure defendants be eligible for Department of Social Service emergency housing benefits when a foreclosure judgment is entered, rather than when the property owner's right to redeem has expired.

Minnesota S.F. 3073 increases the maximum amount of financial assistance an individual or family may receive to prevent a mortgage foreclosure to110 percent of the greater of state or applicable metropolitan statistical area median monthly owner cost multiplied by six.

Pennsylvania S.B. 486 requires, through the Homeowner's Emergency Mortgage Assistance Program, notice requirements for foreclosure proceedings, mortgage assistance payments, and an ongoing study of foreclosure activity and trends in Pennsylvania, using data and information accumulated from notices and applications for assistance.

Washington S.B. 6711 establishes the smart homeownership choices program in the Department of Financial Institutions to assist low-income and moderate-income households facing foreclosure. An appropriation is made from the general fund solely for deposit in the smart homeownership choices program account. The department is required to enter into an interagency agreement with the state housing finance commission to implement and administer the program. The commission is required to assist homeowners who are delinquent on their mortgage payments to bring their mortgage payments current in order to refinance into a different loan product.

Data Collection (3 laws)

Enacted 2009

Colorado H.B. 1197 directs the Division of Housing to collect and compile home foreclosure data from each county to issue a report, at least quarterly, summarizing the information. The foreclosure report is to be available to the public. The information in the report is the official foreclosure data for the state.

Maryland H.B. 640 authorizes counties or municipal corporations to enact local laws requiring that notice be given to a county or municipal official when a foreclosure complaint is filed on residential property in the county or municipality.

West Virginia H.B. 3082 provides for

- the gathering and reporting of information pertaining to sales of residential real estate pursuant to deeds of trust,
- the compilation and filing of data by trustees with the county clerks,
- the periodic forwarding of gathered information—the minimum information is identified—to the Commissioner of Banking,
- fees to be paid for receipt and processing of the filed information, and
- reporting of foreclosure statistics by the Commissioner of Banking.

Moratoriums (2 laws)

Enacted 2009

California S. B. 7 imposes a 90-day moratorium on giving a notice of sale for loans between Jan.1, 2003 and Jan. 1, 2008, that are for the first mortgage on the borrower's principal residence and for which a notice of default has been filed. The law remains in effect until Jan. 1, 2011.

Enacted 2008

Connecticut H.B. 5577 authorizes the banking commissioner to impose a case-by-case foreclosure moratorium of up to 6 months.

Neighborhood Stabilization (1 law)

Enacted 2008

California S.B. 1137 requires that until Jan. 1, 2013, the owner of vacant residential property purchased at a foreclosure sale or acquired through foreclosure maintain the property.

Sources: Compiled by Program Review staff from summaries provided by the National Conference of State Legislatures (National Conference. "Foreclosures"; National Conference. "2008"; and staff examination of some state laws.