

What's Causing The Rise in Home Foreclosures in New Hampshire and How High Will They Climb?



New Hampshire Bankers Association

August 2007

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Table of Contents

I.	Executive Summary	3
II.	Introduction.....	5
III.	Historical Perspective on Foreclosure Rates in New Hampshire.....	6
IV.	The Mortgage Credit Cycle and the Rise of Subprime Lending	7
V.	Mortgage Credit Quality in New Hampshire.....	10
VI.	Why are Foreclosures So High?.....	13
VII.	The Role of New Hampshire Banks	17
VIII.	The Impact on Borrowers and the NH Housing Market.....	22
IX.	How High Will Foreclosure Rates Go in New Hampshire?	27
X.	Policy Responses.....	29
XI.	Conclusions	31

I. Executive Summary

Mortgage delinquencies and foreclosures have been rising in New Hampshire, generating significant media attention and public concern about the health of NH's housing market, the integrity and soundness of its financial institutions and markets, and the broader impacts that rising foreclosures may have on the overall New Hampshire economy. For some, the current situation in housing and mortgage credit markets evokes memories of the housing recession of the early 1990s that crippled NH's banking industry.

The pain of families affected by foreclosures, the impact on home values across the state, the potential impact on the New Hampshire economy, and suspicions of questionable or improper practices by some mortgage lenders have created an environment ripe for public policy initiatives to mitigate the problem of rising defaults and foreclosures in the state.

This report is an effort to help inform policy debates by providing an objective analysis of the current problems facing housing and mortgage credit markets in New Hampshire. The report examines characteristics of mortgage lending in New Hampshire, trends in mortgage defaults, places the current situation into historical context, examines the role of New Hampshire institutions in mounting mortgage credit problems, highlights factors that are contributing to rising foreclosures, presents an estimate of the near-term outlook for mortgage defaults in the state, and offers some cautions for policymakers considering actions to mitigate problems in the mortgage credit market.

Key Findings of the Report Include:

- ◆ Despite a dramatic rise in foreclosures, mortgage defaults remain below the levels experienced in the early 1990s in New Hampshire and we estimate that foreclosure rates will remain below the levels of the early 1990s.
- ◆ The current mortgage credit crisis repeats a pattern characteristic of previous mortgage credit and housing market cycles but is exacerbated by the widespread use of non-traditional mortgage products.
- ◆ Subprime mortgages have increased ten-fold (from 1,700 to 22,000) in New Hampshire this decade, accounting for 34 percent of new mortgages between 2003 and 2007. In total, however, subprime mortgages represent only about 13 percent of all mortgages in New Hampshire.

- ◆ High delinquency and foreclosure rates are primarily a problem among subprime mortgages. About 19 percent of adjustable rate subprime mortgages in New Hampshire are delinquent and 6 percent are in some stage of foreclosure (although not all will be foreclosed), while just 2 percent of fixed rate prime mortgages (the dominant mortgage in the state) are delinquent and just two tenths of one percent (.002) of fixed rate prime mortgages are in foreclosure.
- ◆ Despite rapid increases in delinquency and foreclosure rates, New Hampshire remains at about the national average of all states in terms of mortgage delinquencies.
- ◆ Subprime mortgages account for almost 70 percent of the foreclosures in the state despite representing just 13 percent of all mortgages.
- ◆ Unlike prior housing market downturns, the current high default and foreclosure rates are occurring in spite of an economy with job growth and rising incomes.
- ◆ “Risk layering” or the inclusion of more than one risk factor in subprime mortgages (such as no down payment, low or no documentation of income, interest only or negative amortization loans, and the use of second or “piggyback loans” to cover down payment and closing costs) increasingly characterized subprime loans issued during 2005 and 2006 and has contributed to the rapid defaults of 2005 and 2006 subprime mortgages.
- ◆ New Hampshire banks have not been making subprime loans, their loan delinquency rates are well below the average for all mortgage lenders in the state and in total they have not contributed to the recent rise in foreclosure rates, initiating only about 3 percent of foreclosures in the state in the past year.
- ◆ A large number of adjustable rate subprime mortgages are undergoing rate changes or “resets” for the first time in 2007 and the number of resets will peak between the end of 2007 and mid 2008. As many as 20 percent of homeowners facing rate resets will experience monthly mortgage payment increases that they will not be able to make.
- ◆ Home price appreciation and foreclosure trends move in opposite directions in NH. When price appreciation slows or declines, foreclosures increase. Home price appreciation, interest rates, the willingness of lenders to modify troubled mortgage loan agreements, and the availability of mortgage credit will determine how high foreclosures rise in New Hampshire over the next two years.
- ◆ Problems in the mortgage credit market will likely decrease the effective demand for home purchases in New Hampshire by between 10 and 15 percent through 2008.
- ◆ Despite current problems, traditional subprime mortgages (absent the risk layering characteristic of many recent mortgages) play an important role in increasing homeownership opportunities for families that would not otherwise qualify for mortgages in the prime market.

- ◆ Policy makers need to be especially cautious that their desire to mitigate the problems resulting from high foreclosure rates does not unwittingly contribute to the difficulties facing subprime mortgage holders and the larger housing market in New Hampshire.

II. Introduction

In 2006 the New Hampshire housing market reversed its long, steep, upward trend and in the process revealed substantial problems in mortgage credit markets that have led to dramatic increases in loan defaults and foreclosures in the state. Media reports of declines in home sales, home prices, and dramatically rising delinquency rates and foreclosures have created an environment that calls for action by regulators and policymakers who want to respond to the very real pain experienced by affected families and to lawmakers who are concerned about the impacts of mortgage and housing market woes on the larger New Hampshire economy.

At the same time, the policy environment is rife with speculation about causes, effects and future implications of problems in the mortgage and housing markets, but short on empirical information on which policymakers can evaluate what, if any, action is warranted from public officials to address the situation. Mortgage foreclosures are surging, as is the political pressure to do something about them. Public opinion of business and financial businesses in particular, is trending lower and this situation presents opportunities for agenda-driven analyses with little empirical support to advance “solutions” to the current crisis.

Understanding the origins of current mortgage credit problems and the substantial increase in home foreclosures in New Hampshire are crucial to the process of mitigating the short and long-run costs of the crisis. Research that offers blanket attacks on financial markets and institutions, or which suggests that all recent problems are simply the result of “predatory” lending does not aid in the pursuit of sound policy. Policymakers can right some problems in the housing and mortgage markets but doing so will be difficult in the heightened political atmosphere of a presidential election and with the emotions of families losing their homes to foreclosure pervading the political process.

This report seeks to inform the policy debates surrounding problems in the mortgage credit market and the rising number of mortgage loan defaults and home foreclosures that have occurred in the state. We begin by placing the current situation into historical context and by examining trends in the

characteristics of mortgage loan originations in recent years. We document trends in mortgage delinquencies and defaults by loan type and discuss the reasons why defaults and foreclosures are so high among some types of mortgage loans. We clarify the role played by New Hampshire banks, highlight the impact on borrowers and the New Hampshire housing market, and offer one possible scenario of the near term outlook for foreclosures in the state. Finally, we offer some cautions and suggestions to policymakers interested in addressing the complex issues of mortgage credit markets in New Hampshire.

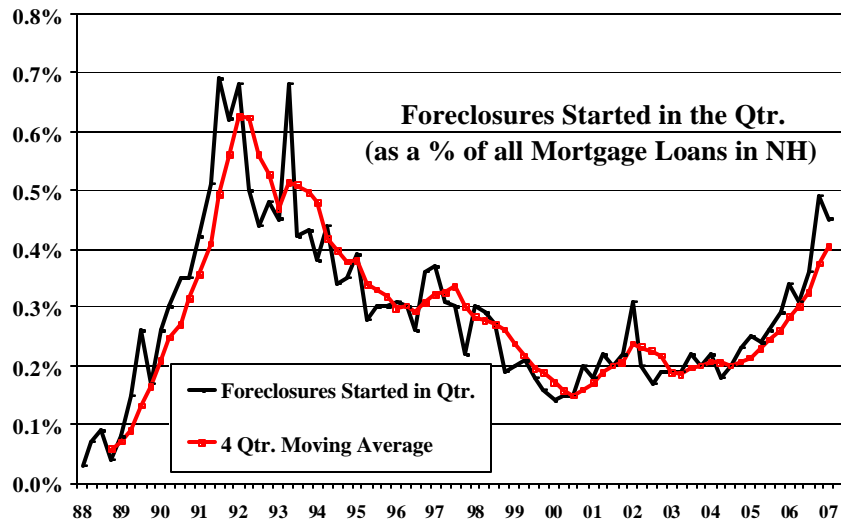
III. Historical Perspective on Foreclosure Rates in New Hampshire

A rise in mortgage delinquencies when home price inflation slows or turns to deflation is not a new phenomenon. Nearly two decades ago, New Hampshire and the rest of New England experienced a recession in the housing market that saw a large drop in home values in New Hampshire, accompanied by a dramatic rise in mortgage loan defaults and foreclosures that crippled the banking industry in the state. More recently, defaults and foreclosures increased (especially among subprime borrowers), during the brief recession that affected New Hampshire in 2002 and 2003.

In comparison to the mortgage credit market of the early 1990s, the current housing market slump and concomitant rise in delinquencies, defaults and foreclosures are significant but still well below levels experienced during the severe recession of the 1990s (Figure 1). The current rise in foreclosure rates differs from the housing market recession of the 1990s in several important ways:

- ◆ The health of New Hampshire banks is not at risk from the current housing slump or mortgage credit problems in the state. NH banks have not offered loan products that increase the risk of default to borrowers with limited or impaired credit. Delinquencies and foreclosures among the mortgage loans of NH banks are small in comparison to the well-publicized problems of the many out-of-state subprime mortgage lenders with limited ties to the New Hampshire economy.
- ◆ The current rise in defaults and foreclosures is occurring at the same time the New Hampshire economy is adding jobs and income is growing.
- ◆ Although delinquency rates have increased among most categories of loans, the significant problems that have produced rapid increases in foreclosure rates are limited to a subset of mortgage loans, notably adjustable rate, subprime mortgages, and especially among that category of loan issued in 2005 and throughout 2006.

Figure 1
 Foreclosure Rates Have Risen Sharply (In the Absence of a Recession) But are Still Below Historical Highs During the Recession of the Early 1990s



IV. The Mortgage Credit Cycle and the Rise of Subprime Lending

The current rise in foreclosures and the crisis in mortgage credit is rooted in three related factors:

- ◆ Low interest rates that made credit more widely available and borrowing less costly.
- ◆ Increased housing demand, in part fueled by low interest rates.
- ◆ A rise in “speculation” in the housing market as home price appreciation increased and buyers felt assured of gains on home purchases.

These factors are characteristic of a pattern or “cycle” in mortgage lending that has occurred repeatedly. When housing markets are strong and mortgage demand grows, the increased demand for loans allows existing mortgage lenders to expand their business and new lenders to enter the market. New entrants into the mortgage market (mortgage lenders who had previously done little or no business in New Hampshire) eventually create overcapacity in the mortgage lending market when the demand for mortgage loans eventually slows or falls. As the lending market cools (e.g., when interest rates rise, home price increases abate, or the economy slows), competition among lenders for the reduced pool of borrowers heats up and lenders may lower credit standards (i.e., make riskier loans) in order to maintain market share. The riskier loans are more likely to become delinquent and default. In some cases, the rise in delinquencies and defaults contributes to a downward spiral in the housing market that further

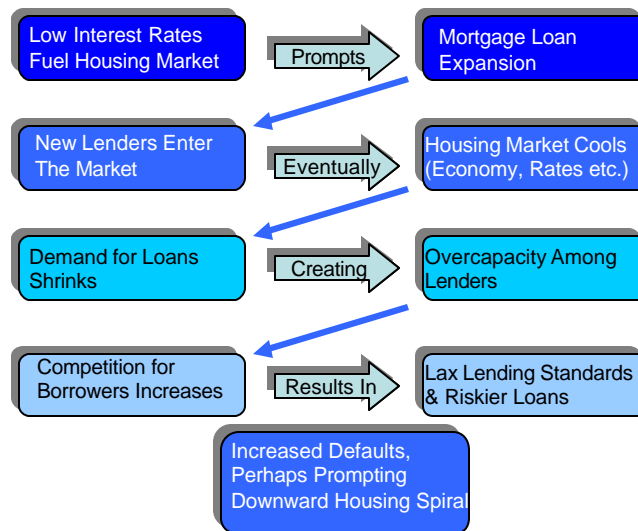
reduces demand and adds downward pressure to home values that pushes additional borrowers into default.

Figure 2 depicts a typical mortgage credit cycle. Lending behavior in the mortgage market over the past few years has generally followed this pattern.

Between 2004 and

2006, in an effort to maintain or increase loan volume, lenders introduced alternative mortgage loans that made it easier for borrowers to obtain a loan and many relaxed standards for loan approval, perhaps with a tacit belief that rising home values would soon reduce the risk of default or with the expectation the loans would soon be sold, packaged for sale with other loans, or otherwise soon leave the original lender's portfolio.

Figure 2
The Current Situation Is Typical of Mortgage Credit Cycles (But With Some Unique Features)



The Rise of Subprime Mortgage Lending

The subprime mortgage market provides loans to borrowers with limited or impaired credit who do not meet the credit standards for borrowers in the prime market. These loans are generally more expensive for borrowers and have interest rates higher than prevailing prime mortgage rates to compensate lenders for the added risks associated with lending to borrowers with weaker credit histories. There are many variations of subprime loan products but some of the more common include:

- ◆ Loans made for the full (or close to the full) purchase price of the home, allowing borrowers to purchase with no equity in the home.
- ◆ Loans with less rigorous documentation such as stated income or “low documentation” loans, where borrowers state their income and asset information instead of providing documented

proof. Historically, these loans were primarily offered to self-employed borrowers who had difficulty documenting their income, but have increasingly been offered to wage earners.

- ◆ Loans that expose borrowers to sudden payment increases, such as:
 - Loans with low initial interest rates that increase, often dramatically, after the initial fixed period is over (2/28 loans where interest rates remain artificially low for the first 2 years of the loan and then are subject to significant rate increases for the remainder of the loan is one popular example.)
 - Interest only (IO) or “negative amortization” loans, which have lower initial monthly payments as no principal is repaid for an initial period.
- ◆ Longer-term (40-year and longer) loans, which have lower monthly payments but which build homeowner equity more slowly. This is especially problematic for recent borrowers when home values are declining.

Many subprime mortgages in this credit cycle contained more than one of features listed above. Subprime lending has grown dramatically in the U.S. and in New Hampshire in this mortgage credit cycle, rising from just 1,700 mortgages in New Hampshire at the start of 1999, to about 22,000 at the beginning of 2007, and accounting for 34% of mortgage loan growth in the state between 2003 and 2006 (Figure 3). The increase in subprime mortgages combined with slow or negative home price appreciation is the primary contributor to the rise in foreclosures in New Hampshire. Despite the recent rise in subprime loans, they currently comprise only 13% of all mortgages in New Hampshire (Figure 4).

Figure 3

Subprime Loans Have Grown Dramatically and Accounted for 34% of Mortgage Loan Growth in NH Between 2003 and 2006

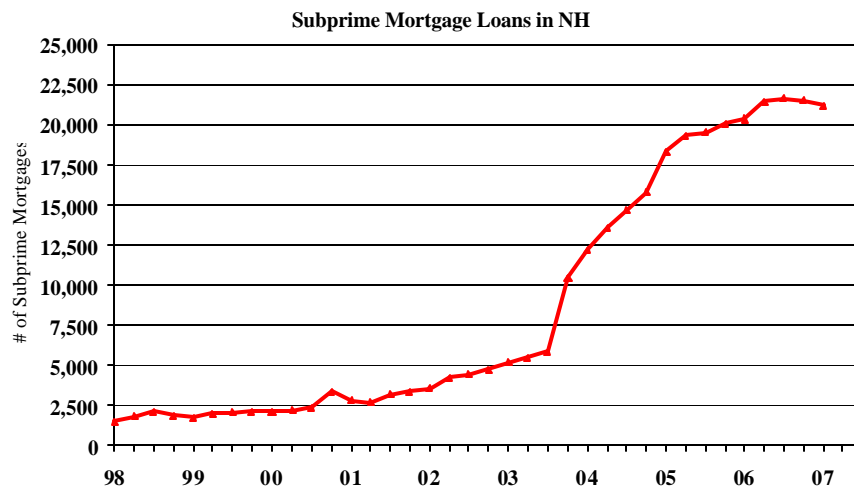
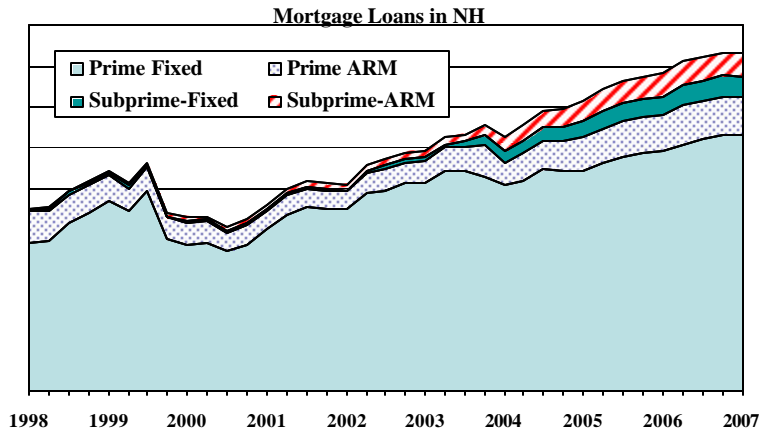


Figure 4

Fixed, Prime Rate Loans Remain the Dominant Mortgage in NH.
 Subprimes are 13% of all NH's Mortgages Despite Representing
 34% of Mortgage Growth From 2003-2006

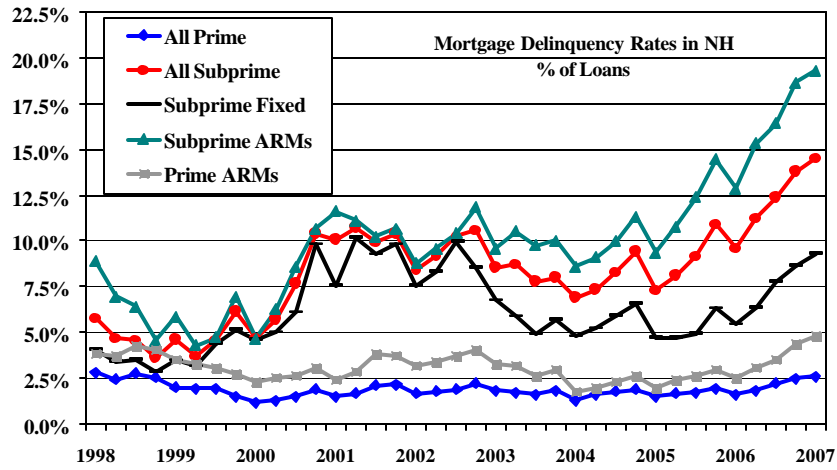


V. Mortgage Credit Quality in New Hampshire

Mortgage credit quality has been eroding in New Hampshire for two years. The poor performance of subprime loans is due to the recent slowdown in home price appreciation and the characteristics of many adjustable rate subprime mortgages (ARMs) which have produced large monthly payment increases for borrowers with loan features that allow for low initial monthly loan payments for a limited period of time (typically two years but some as little as six months). This is highlighted in Figure 5 which shows delinquency rates of subprime adjustable rate mortgages in New Hampshire of approximately 19%, compared to delinquency rates among prime fixed rate loans of approximately 2%.

Serious loan defaults and foreclosures are also largely a problem concentrated in the subprime mortgage market. Figure 6 shows the percentage of prime and subprime mortgages that were in foreclosure during each quarter since 1998. Figure 7 shows that subprime loans made up almost 70% of

Figure 5
Mortgage Delinquencies Have Been Rising for 2 Years but Problems Have Been Concentrated Among Subprime, Especially Adjustable Rate Subprime Loans



mortgage loans in foreclosure at the beginning of 2007, having risen sharply as a percentage of NH foreclosures since 2005. The chart also shows that, to this point, the mortgage credit crisis has had only a small impact on the prime mortgage loan market.

Figure 6
A Rise in Subprime Loan Defaults is Not Unusual, But the Speed With Which Defaults are Occurring (Shortly After Loan Origination) and in the Absence of an Economic Recession Make the Current Situation Different

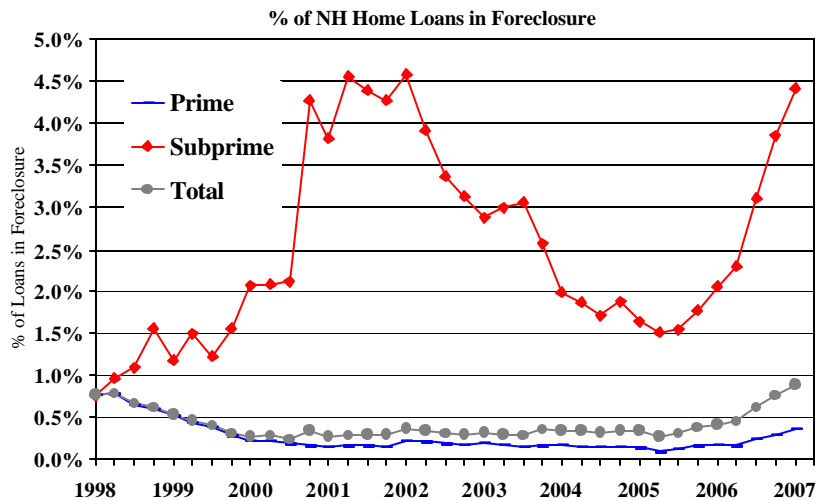
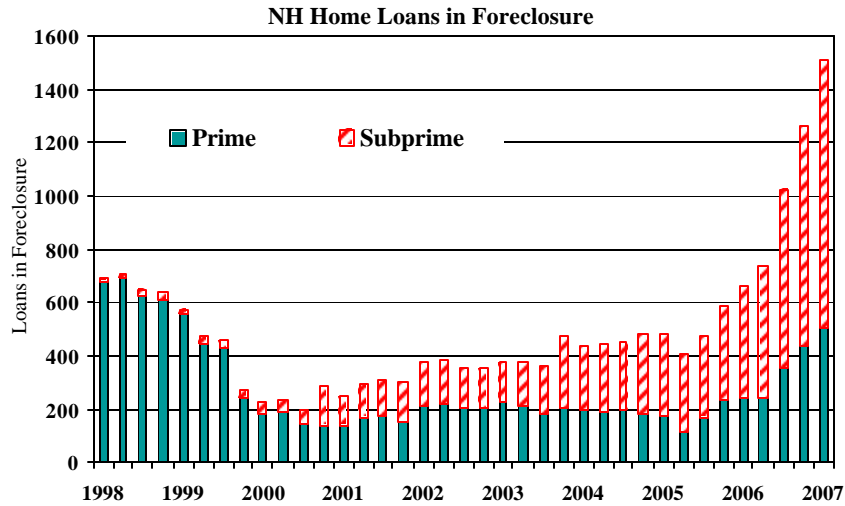


Figure 7

Prime Loan Foreclosures Have Risen but are Lower Now than in the Late 1990's. Subprimes are Almost 70% of all Foreclosures

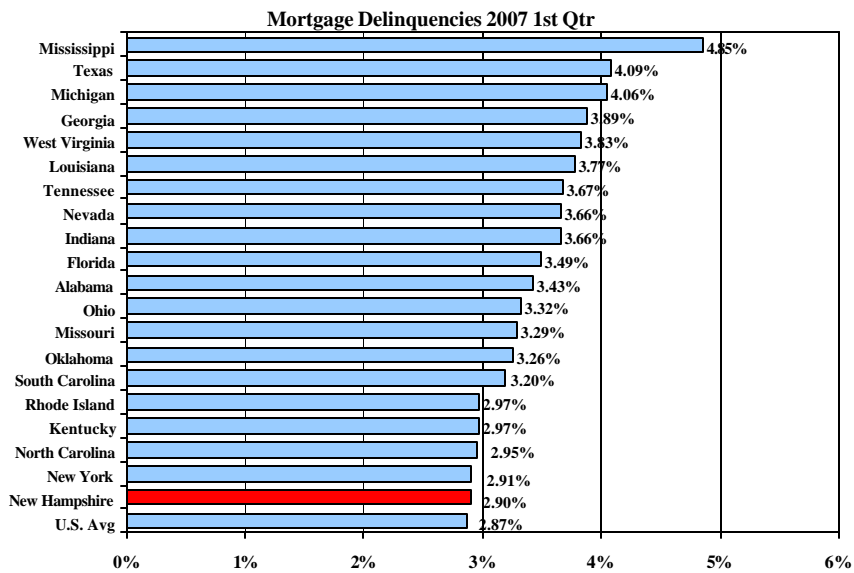


NH Compared to Other States

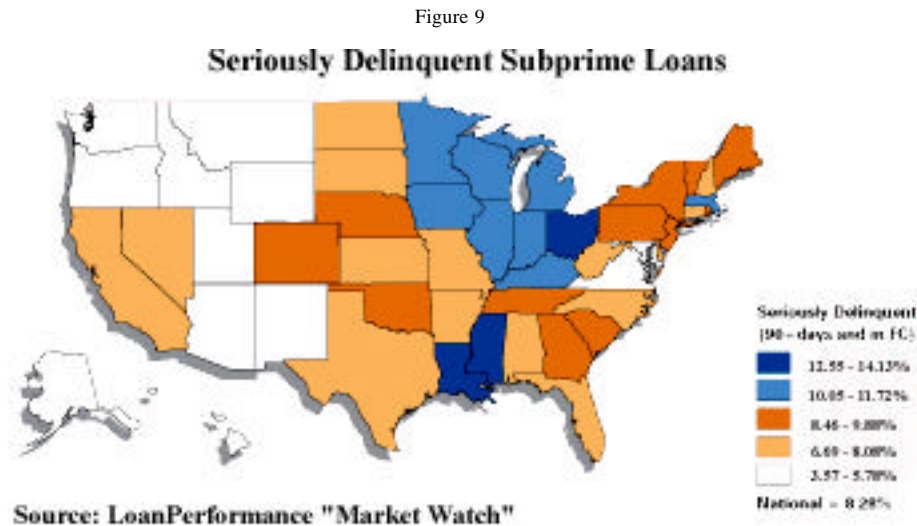
Although mortgage credit quality in the subprime market has deteriorated rapidly in the state, New Hampshire compares relatively well across most types of mortgage loans on measures such as loan

Figure 8

Mortgage Delinquencies in NH are at About the U.S. Average and Well Below States With the Highest Delinquency Rates



delinquency rates. Figure 8 shows that New Hampshire is at about the national average on the percentage of mortgage loans that were delinquent during the first quarter of 2007. Figure 9 is from First American Corp.'s *LoanPerformance* subsidiary and provides an indication of regional patterns in delinquencies among the most troubled category of mortgage loans, subprime adjustable rate mortgages. Again, these data show that New Hampshire is in the middle range of states on measures of seriously delinquent (90+ days late or in foreclosure) and with lower delinquency rates than most of its neighbors.



VI. Why are Foreclosures So High?

A rise in subprime delinquencies has occurred during previous housing market slumps in New Hampshire. However, the speed and level at which delinquencies have climbed is not entirely attributable to the cooling housing market. Typically there is some lag between a slowdown in home price growth and a sharp rise in serious delinquencies. The rapid increase in defaults in 2006 in response to slowing home price appreciation is attributable to:

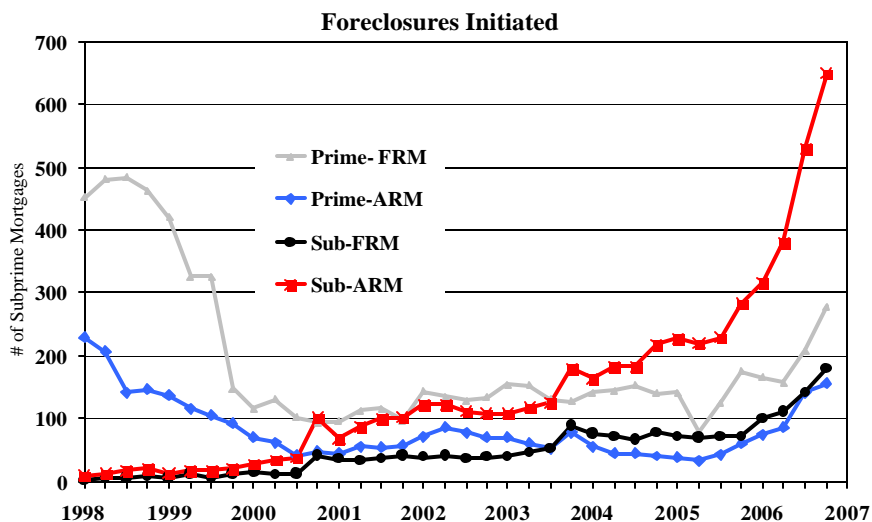
- ◆ An increase in the percentage of subprime mortgages among new mortgages.
- ◆ The prevalence of adjustable rate mortgages with very low initial interest rates that adjust upward (or “reset”) resulting in dramatic increases in monthly mortgage payments.
- ◆ The increased use of non-traditional mortgage products such as stated income or “low documentation” loans, interest only or “negative amortization loans,” no down payment loans, and the use of second or “piggyback loans” to cover down payment and closing costs.

These products were not as widely available during previous mortgage credit cycles.

- ◆ Subprime loans that increasingly contained more than one of the non-traditional features listed above resulting in...
- ◆ Higher leverage (levels of debt) among more recent subprime borrowers.

For example, as 2005 progressed and especially during 2006, many mortgage applicants were able to get loans with low initial monthly payments, without documenting their income or assets, and without putting money down. This type of "risk layering" has especially contributed to high default rates among later 2005 and 2006 subprime mortgage loans. Another factor contributing to higher default rates among later subprime mortgages was an increase in loans to less experienced first-time home buyers. These buyers are less likely to have previously managed large debts and may not have as clear an understanding as existing home owners of the full costs of home ownership. A hot housing market, low interest rates, and no-money-down mortgages encouraged many renters to purchase homes. The rise in home prices during most of this decade prevented many subprime mortgages with higher risk factors from defaulting because homeowners experiencing financial stress were able to refinance their loans or to sell their homes to avoid foreclosure. More recently these options have not been readily available to financially stressed borrowers. As the housing and credit markets shifted and made selling or refinancing more difficult, the result has been an increase in default rates. Anecdotal evidence also suggests that

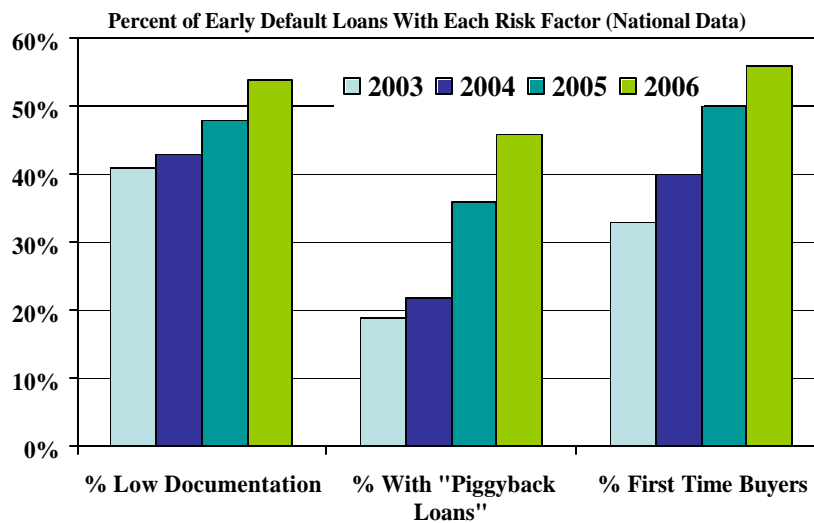
Figure 10
The Dramatic Rise in Foreclosures is Largely Attributable to Adjustable Rate Subprime Mortgages



many of the home purchase loans in recent years have been made to housing market speculators not intending to reside in the home. If these borrowers were highly leveraged, facing payment increases and a declining housing market, they may have less incentive to work to retain recently purchased homes and more likely to default.

Figure 11 uses national data from bond rating agencies and shows how “early payment default” subprime mortgages (mortgages that defaulted within one year) increasingly contained factors that are associated with higher default rates as the mortgage credit cycle progressed. Especially prominent was the increase in “piggyback” loans where borrowers take a “silent” or additional mortgage in order to finance the down payment and closing costs of a home purchase.

Figure 11
 Subprime Loans Became Riskier as the Mortgage Credit Cycle Progressed and the Housing Market Peaked

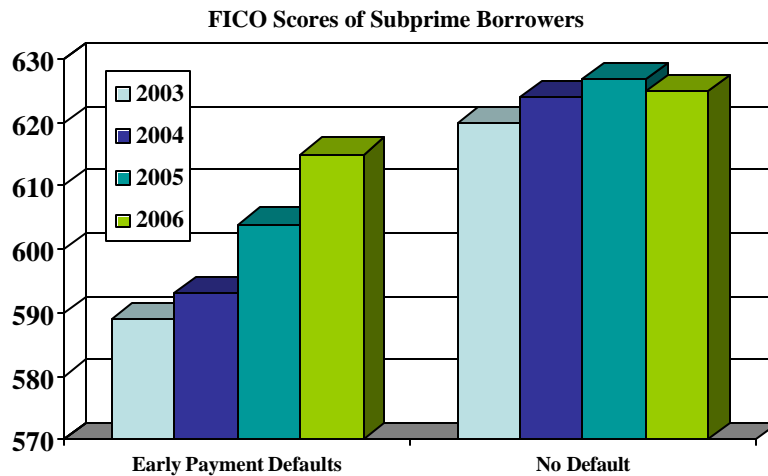


Source: Fitch Ratings

It does not appear that defaults are the result of an increase in loans to less creditworthy borrowers, rather, it appears that the characteristics of loans and the ability of borrowers to obtain higher leverage (borrow more with less equity) that is more associated with increased mortgage defaults. FICO credit scores have actually been rising nationally over the past several years among borrowers who are defaulting on mortgage loans within a year of origination according to the Fitch investment rating services (Figure 12). Rather than contradicting the value of FICO scores as a predictor of default, however, this finding highlights the important role of high borrower leverage as a contributor to high mortgage defaults in this credit cycle. Borrowers with higher FICO scores can borrow more and have higher leverage,

and this is evidenced by the high percentage of loans in 2005 and 2006 with high loan-to-value ratios, no documentation loans, low or no down payment loans and they are more likely to be able to secure a second “piggyback” loan to complete a home purchase.

Figure 12
 “FICO” Credit Scores Are Still A Good Predictor of Loan Risk but Scores Have Increased Along With Defaults. The Likely Reason – Higher Scores Allowed 2005 and 2006 Borrowers to Obtain Higher Leverage (Levels of Debt)



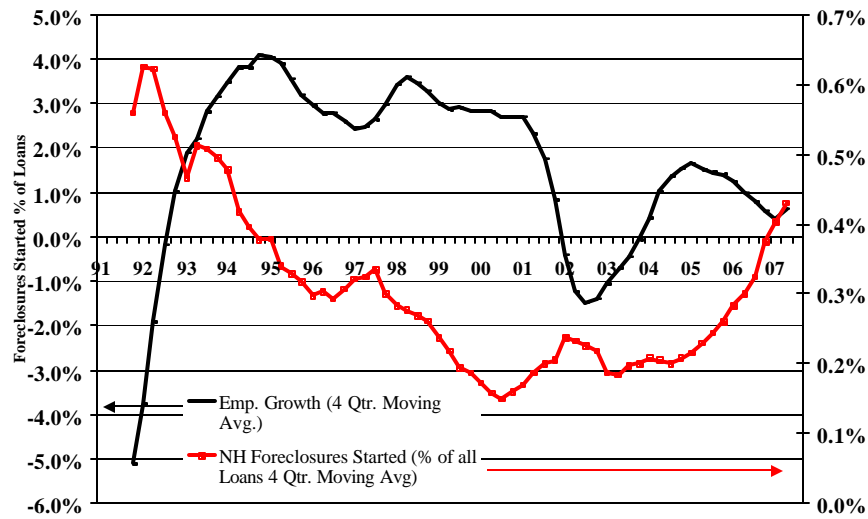
Source: Fitch Ratings

The Effect of the Strength of the New Hampshire Economy

Mortgage defaults and foreclosures typically rise when the economy falters and defaults decline when economic growth is more robust. The impact of New Hampshire’s economy is clearly evident in past mortgage credit cycles. Figure 13 shows that the extremely high foreclosure rates of the early 1990s were accompanied by large job losses. Foreclosure rates dropped to very low levels when job growth during much of the middle 1990s was above 2% per year. Foreclosure rates rose again as the economy slowed and New Hampshire experienced a brief recession at the beginning of this decade. Since that time, however, the relationship between job growth and mortgage defaults has not held, as job growth has been accompanied by rising foreclosure rates, again indicating that lending practices and the characteristics of loans and borrowers have played a dominant role in the current trend of rising foreclosures.

Figure 13

Foreclosures Typically Decline When Jobs Are Growing but Foreclosures Increased Despite Jobs Growth During This Mortgage Credit Cycle



VII. The Role of New Hampshire Banks

The housing recession of the early 1990s resulted in a banking crisis in New Hampshire that rippled throughout the state’s economy. That crisis resulted from several factors including easy credit, overbuilding in the real estate market, and a weak economy. Problems in the current housing market began with low interest rates but the rapid increase in non-traditional mortgage products and relaxed lending standards that qualified more buyers for home mortgages, or that qualified homebuyers for more expensive homes than they otherwise could afford, are primary contributors to current problems in mortgage credit quality.

There are several reasons for wanting to understand the role that New Hampshire banks may have played in creating the current mortgage credit and housing environment, including:

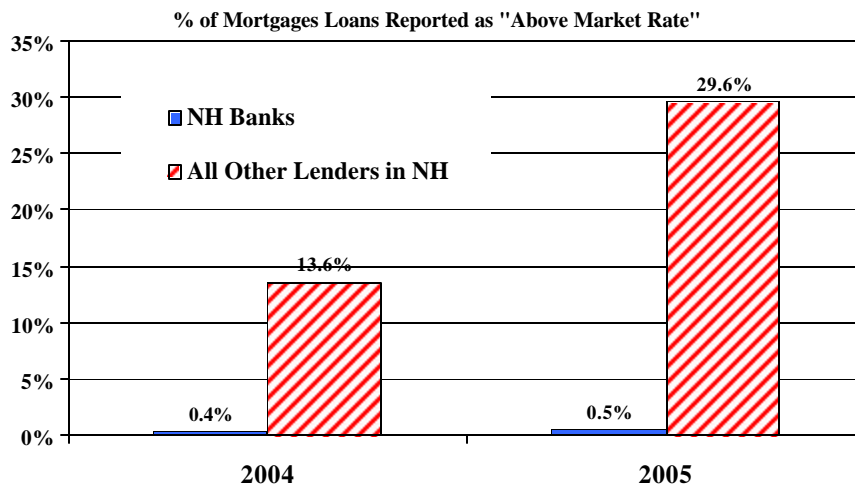
- ◆ Public confidence in the financial health of NH banks is important for well functioning credit markets that facilitate economic growth. Thus it is important to know the degree to which NH banks have exposure to the current mortgage credit crisis.
- ◆ Citizens, businesses, and other organizations in New Hampshire should be able to understand and evaluate the business practices of financial institutions with whom they choose to do business. Given the choice, many individuals and organizations prefer to do business with financial institutions that have a reputation for prudent business practices. For

many individuals and businesses, it is also important to consider the overall impact that an organization has on a community and the well-being of individuals when deciding with whom to do business.

- ◆ Policymakers and regulators need to know the types of financial organizations and what practices are contributing to the crisis in mortgage and housing markets if they decide to intervene in the functioning of those markets.

To assess the degree to which New Hampshire banks engage in subprime lending, we examined “Home Mortgage Disclosure Act” (HMDA) data that mortgage lenders are required to file annually by federal regulators. Beginning in 2004, the Federal Financial Institutions Examination Council (FFIEC) required lenders to report a measure of the interest rates they charge for each mortgage loan they originate. First mortgage purchase loans with interest rates below 3 percentage points or less above a comparable Treasury issue (when the loan is fully “indexed” or its interest rate is expressed in terms of the rate that includes relevant loan costs and which applies after any initial low or “teaser rates” expire) are not required to report any interest rate information, but loans that are 3 percentage points above the comparable Treasury rate are required to report the spread between the Treasury note and the mortgage. The FFIEC intends this reporting structure to help identify subprime lenders and many analysts

Figure 14
Above “Market Rate” Interest Loans are a Proxy for “Subprime” Loans –
Federal Filings Show NH Banks are Not Engaging in Subprime Lending



Source: Required “Home Mortgage Disclosure Act” filings available at <http://www.ffiec.gov/hmda/default.htm>

use the HMDA data as a surrogate measure to identify subprime lending patterns. Subprime loans can contain a variety of loan provisions but most analysts and researchers identify subprime loans on the basis of the cost of loans (interest rate) to borrowers.

The Consumer Federation of America delineates the loans into three broad categories: prime and near-prime (below 3 percentage points of the Treasury threshold), subprime (loans above 3 percentage points above the threshold), and high-cost (loans 5 percentage points or higher than the threshold). The subprime loans are categorized as any reported over-threshold interest rate, i.e. 3 percentage points or higher than the Treasury threshold. HMDA filings for 2006 were not publicly available as of July 2007 but our analysis of filings by all New Hampshire state and nationally chartered banks reveal that New Hampshire banks engaged in virtually no subprime lending during 2004 and 2005 (Figure 14), and we expect that 2006 filings will show a similar pattern.

A review of Federal Deposit Insurance Corporation (FDIC) quarterly reports filed by New Hampshire commercial and savings banks shows that the dollar value of delinquent residential mortgages are less than 1% of the value of mortgages held by New Hampshire banks. It is clear from these data that NH banks have not engaged in subprime lending and that delinquencies of mortgages held by NH banks are low compared to NH mortgages held by other institutions.

To determine the significance of New Hampshire banks in the rise in foreclosures in New Hampshire, we examined data from private companies that provide loan performance data to financial institutions and foreclosure information to investors. The list of the financial institutions with the largest share of foreclosures in New Hampshire over the prior 12 months is presented in Table 1. That data, however, does not allow us to distinguish which financial organization made the original loan from the organization that is foreclosing, who may only be the “servicer” of the mortgage rather than the actual holder of the loan. This is especially true for foreclosures listing “Mortgage Electronic Registration Systems” (MERS) as the foreclosing organization.¹ MERS is a company that provides a registration and tracking system for mortgage loans. With mortgage loans more frequently being sold, transferred, and

¹ Today, mortgages are sold, packaged or securitized and otherwise transferred many times during the life of the loan. MERS provides a service to lenders by providing a central registration for mortgages, issuing unique loan numbers (much like social security numbers) that allow for better tracking and more rapid settlement when loans change ownership. In some case, MERS is the legal holder of mortgage loans, in other cases a servicer, and in some cases it simply supplies registration and tracking services. MERS is often listed first in foreclosure documents and only a cursory review of these documents is likely to assume that MERS is the holder of the loan. Our closer examination of foreclosure notices enabled us to distribute many of the MERS foreclosures to the actual holder of the loans.

securitized,² it is more difficult than ever to track the path of ownership of a loan for legal purposes. In some cases, MERS is the legal holder of mortgage loans, in other cases a servicer, and in some cases it simply supplies registration and tracking services.

To better glean the role of original lenders from the current holders of mortgage loans, servicers, or registration systems, and to determine how many of the foreclosures were initiated by NH banks, we examined 455 foreclosure notices filed in New Hampshire between May and July of 2007. The results of this detailed analysis of foreclosures by lender are also presented in Table 1. Our analysis of foreclosure notices indicates that using either data from third parties or our own analysis of foreclosure filings shows that no New Hampshire banks are among the list or organizations with the largest share of foreclosure over the past year or during the most recent 3 month period examined.

Table 1
Percentage of NH Foreclosures by Mortgage Holder

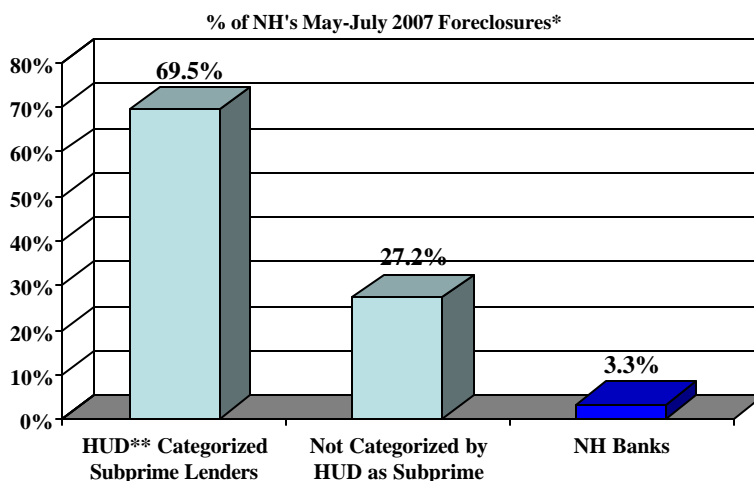
<u>From Third Party Analyses June 06-07</u>		<u>From PolEcon's Analysis May-July 2007</u>	
MERS	24.7%	Wells Fargo	6.8%
Wells Fargo	12.1%	Deutsche Bank	5.5%
Deutsche Bank	10.8%	U.S. Bank National Assoc.	5.3%
Option One	9.9%	MERS	5.3%
Fannie Mae	6.9%	Option One	5.1%
Washington Mutual	5.5%	Countrywide	4.8%
U.S. Bank National Assoc.	5.0%	Fannie Mae	4.4%
J.P. Morgan Chase	3.3%	HSBC	3.7%
Ameriquest	1.8%	NH Housing Finance Authority	3.7%
Wachovia	1.6%	America's Wholesale Lender	3.3%
Citi Financial	1.6%	Washington Mutual	2.9%
New Century	1.5%	JP Morgan Chase	2.6%
Argent	1.0%	Tie: Ameriquest & Citi Financial	2.0%

²“Securitization” refers to the bundling or packaging of mortgage loans into securities which can be sold to investors. Securitization has long been important to creating liquidity in the mortgage credit market. Government chartered organizations such as “Fannie Mae” and “Freddie Mac” have been buying and securitizing loans for decades as a way to increase liquidity in mortgage markets. More recently, securitization has included more complex securities which include loans to borrowers that would not meet Fannie Mae and Freddie Mac mortgage guidelines.

Consistent with other data presented in this report, the lists in Table 1 are largely populated with subprime lenders. There are two noteworthy exceptions. First, the New Hampshire Housing Finance authority (NHHFA) originated 3.7 percent of the foreclosures in the state during the period examined. This is neither unexpected nor troubling. The NHHFA is charged with increasing homeownership opportunities for borrowers who might not otherwise qualify for mortgages. Before the explosion of subprime lenders and mortgage products, organizations such as the NHHFA provided one of the few opportunities for first-time homebuyers with limited credit to obtain a mortgage. As subprime lenders and products fall by the wayside, organizations such as the NHHFA will continue to play an important role in providing opportunities for homeownership for first-time buyers. At the same time, because of their charge and the population they serve generally has less access to credit, they are likely to experience greater default rates. This is especially true during the current decline in the housing market where default rates among all types of loans have risen. The second is exception is Fannie Mae, the Federal National Mortgage Association (FNMA).

Figure 15 shows the limited impact that NH banks are having on foreclosure rates in the state. The chart reiterates that the recent rise in foreclosures in New Hampshire is largely attributable to subprime loans and shows that NH banks account for just over 3 percent of recent foreclosures. HMDA data indicates that New Hampshire banks have not been issuing subprime loans and Figure 15

Figure 15
 70% of the NH Foreclosures Initiated Between May and July of 2007
 Were by Subprime Lenders – While Only 3% Were by NH Banks



*Based on PolEcon's review of 455 foreclosure notices filed in NH in May-July of 2007
 **U.S. Dept. of Housing and Urban Development

confirms that as a result of the more conservative and traditional lending practices of New Hampshire banks, they have had almost no impact on the recent increase in foreclosure rates in New Hampshire.

However, the more prudent mortgage lending practices of New Hampshire

banks have come at the expense of market share in the mortgage lending market. HMDA data suggests that New Hampshire banks have been originating a smaller share of the state's new mortgage loans as more aggressive subprime and non-bank lenders have been more willing to offer non-traditional mortgages to meet the needs of harder to qualify borrowers.

New Hampshire Banks Sacrificed Market Share for Loan Quality

- NH Banks are most successful when the communities and regions in which they operate thrive economically
- Riskier lending practices that may increase foreclosures in a community do not promote thriving communities
- The cost of "defaults" are more significant for NH banks
 - For regulatory reasons
 - For business reasons
 - Lending mistakes (in the form of social costs) stay in the communities in which they are located even if the loan is packaged and sent elsewhere

VIII. The Impact on Borrowers and the NH Housing Market

The impact of foreclosure on homeowners is devastating and need not be discussed here. Rather, we consider the impact that the most common type of subprime loan (adjustable rate loans with low initial interest rates and monthly payments that adjust or "reset" after some period of time - typically 2 years but often shorter) may have on New Hampshire households as initial interest rates adjust or "reset" in the near future. Understanding these impacts is key to forecasting the future of many of the subprime loans originated in New Hampshire in recent years and the likely impacts on New Hampshire's mortgage and housing markets.

Almost 20% of Subprime Borrowers With Adjustable Rate Loans Will Face Rate Adjustments that Increase Mortgage Payments Beyond Their Means

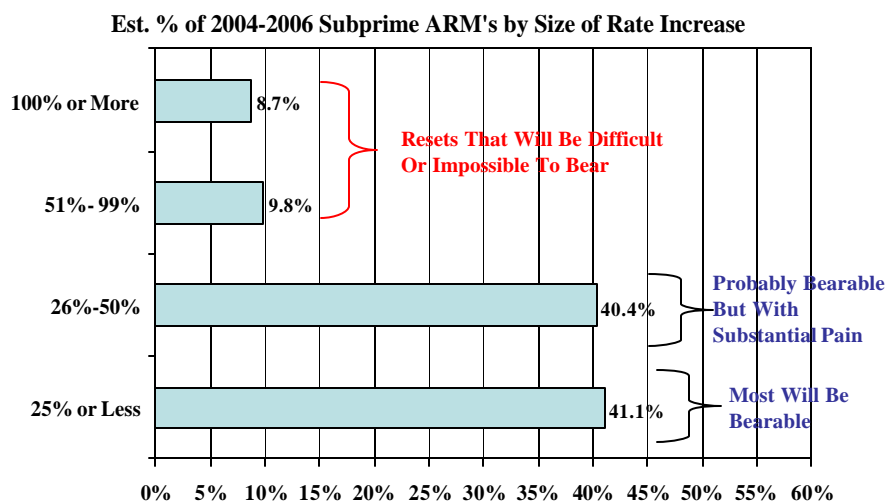
Most adjustable rate subprime loans issued in 2003 and 2004 have already experienced their first rate "reset" that resulted in a significant increase in their monthly mortgage payments. The impact of these

rate resets is clear from the data in this report, dramatic increases in delinquencies, defaults and foreclosures among this category of mortgage loan. The peak year for subprime ARMs in New Hampshire was 2005 and many of those loans are “resetting” this year, resulting in a large increase in foreclosures. Slightly fewer loans will face resets in 2008, but the number of loan defaults is likely to increase over 2007 levels for the following reasons:

- ◆ Loans from 2006 appear to contain more risk factors associated with default.
- ◆ Interest rate trends may result in larger rate hikes from reset than experienced by loans that reset in 2006.
- ◆ Many more borrowers with loans originated in 2006 will have negative equity in their homes because of price declines making refinancing impossible.
- ◆ Tightened lending standards and lack of mortgage credit will eliminate refinancing options for many facing high rate resets.
- ◆ As the housing market slump has deepened, fewer 2006 borrowers will be able to sell their homes to escape the impact of high rate resets.

Using data from a national study of subprime mortgages conducted by First American CoreLogic Inc.³ and applied to New Hampshire borrowers, Figure 16 highlights the percentage of subprime ARM loans originated in New Hampshire between 2004 and 2006 by the percentage of rate increase that they

Figure 16
Rate Resets Will Peak Late in 2007 or Early 2008 and Defaults are Likely in 15-20% of The Loans

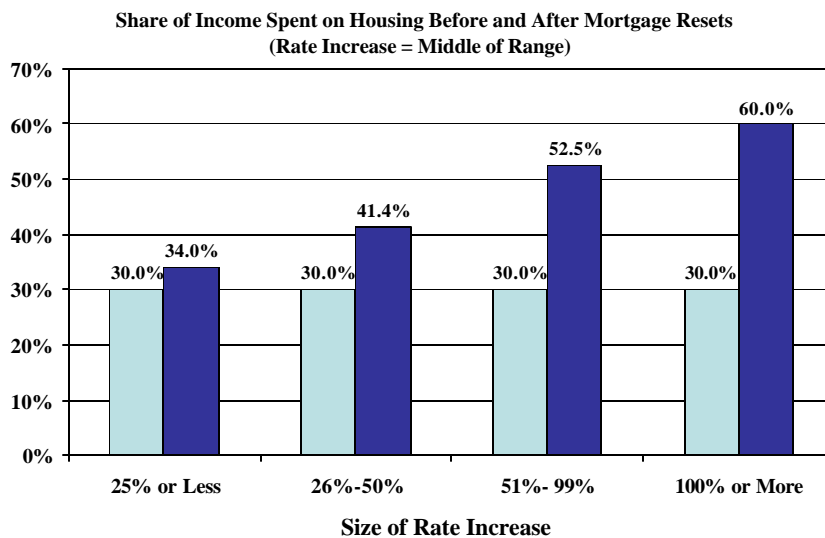


³Cagan, Christopher, “Mortgage Payment Reset: The Issue and the Impact,” First American CoreLogic Inc., 2007.

are likely to experience. The chart shows that almost 19% of subprime ARMs have recently or will soon experience mortgage rate increases of 50% or more. These increases will produce high levels of default among borrowers in this category, especially if interest rates climb higher. Rate increases of between 26 and 50% will be experienced by another 40% of subprime ARM borrowers but a majority of these loans are likely to survive but with significant financial stress to borrowers.

To highlight the impact on households we apply each level of potential rate increase to a typical household that devotes 30% of its budget to housing payments to see how rate resets can financially overwhelm borrowers (Figure 17). Using the midpoint or median of the range for each potential rate increase, for example the range increase of 26-50% uses a rate increase of 38% for illustrative purposes, the chart shows how much a of a household budget would be devoted to housing payments both before (assuming 30%) and after rate reset. From the chart, we can see how the median rate increase for resets below 50% could be managed with some difficulty, but that increases above 50% will be very difficult for the estimated 19% of households facing resets of that magnitude. Although not all of these loans will default and fewer will ultimately be foreclosed, a large percentage of them are already among the rising number of foreclosures in New Hampshire and as the number of resets peak within the next 12 months, many more loans will default.

Figure 17
The Effect of Mortgage “Resets” on Household Budgets



Source: PolEcon Calculations

Impacts on the Housing Market

Rising foreclosures have widespread and significant impacts on the housing market that affect all current and prospective homeowners. Some of these impacts include:

- ◆ Increase in the supply of homes on the market.
- ◆ Reduction in supply of mortgage credit.
- ◆ Reduction in effective demand for homes on the market.
- ◆ A decline in home values.

Demand side effects center on the reduction in effective housing demand due to the decline in mortgage credit availability. One widely used calculation assumes 25% of subprime borrowers would not qualify for loans according to new mortgage guidelines issued by federal regulators. Combining that number with estimated subprime originations at 30% of total originations suggests lowered effective mortgage demand of 7.5%. However, the effect on the housing market is actually worse than this. First-time buyers have disproportionately been subprime borrowers in recent years. A ripple effect occurs in the housing market when first-time buyers enable move-up buyers. Thus the effect on housing activity is likely to be more like 10-15%.

Housing activity has declined sharply over the past 18 months and most forecasts suggest further declines. At least some portion of the anticipated effect of tightened mortgage credit has already occurred. The “Inter-Agency Guidance on Non-Traditional Mortgage Products” was initially issued last summer⁴, early enough to affect the housing market since late 2006. Many subprime lenders have disappeared and many more have announced plans to eliminate some of the more problematic mortgage products popular among subprime borrowers. The likely additional effect on housing activity attributable to further credit tightening could represent about one-half of the total effects from credit tightening. The overall effect is likely to reduce effective demand in NH by 3,000-4,800 homes, adding more than two months to the supply of unsold inventory of housing units in the state. These effects will contribute to further price reductions that will reduce homeowner equity and increase pressures on more recent subprime loans but they are not severe enough to produce the kind of housing market decline experienced during the early 1990s.

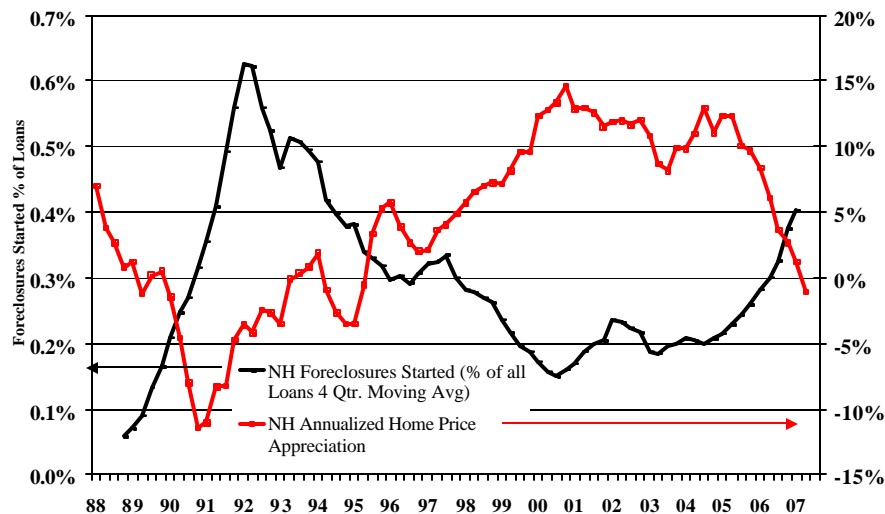
⁴ Issued jointly by the Office of the Comptroller of the Currency, Federal Reserve, Federal Deposit Insurance Corp., Office of Thrift Supervision, and National Credit Union Administration.

Feedback Effects – The “Downward Spiral” in Housing

The effects of stricter lending standards and mortgage credit tightening include an increase in the inventory of homes for sale and a decline in effective housing demand. Both of these imply further downward pressure on home price appreciation and feedback effects on the mortgage delinquencies and foreclosures in New Hampshire.

Figure 18 highlights the historical relationship between foreclosures and home price appreciation in New Hampshire. The chart shows that foreclosure rates and home price appreciation move in opposite directions. Higher home price appreciation is accompanied by lower rates of foreclosure initiation and lower appreciation is associated with higher foreclosure rates (with a short lag). The relationship is recursive; foreclosures are both prompted by declines in price appreciation as well as a contributor to price declines.

Figure 18
Home Price Appreciation Reduces the Probability of Foreclosure.
Declines in Appreciation Will Increase Foreclosure Rates



In the current environment these “feedback effects” are likely to be strong for several reasons:

- ◆ The current housing market contains a higher percentage of mortgages that are subprime with an expectation of appreciation that would enable refinancing prior to “resets” or changes in mortgage terms.
- ◆ A high percentage of homeowners (and likely most subprime borrowers) with mortgages issued from late 2004 through 2007 will have negative equity in their home, reducing refinancing opportunities.

- ◆ Tightening lending standards will make refinancing difficult for homeowners looking to avoid difficult rate resets or other changes in loan terms and will reduce the number of qualified buyers for homeowners looking to avoid mortgage defaults by selling their properties.
- ◆ Foreclosures typically sell at heavily discounted prices and the addition of a large number of foreclosed properties selling at 25% price reductions will add further downward pressure on prices.

In combination, these effects will place significant downward pressure on housing demand, credit availability, and home prices. Ultimately, how strong these effects are, and the magnitude of the “downward-spiral” in the housing market they create, will determine how many homeowners eventually fall into default or foreclosure in New Hampshire.

IX. How High Will Foreclosure Rates Go in New Hampshire?

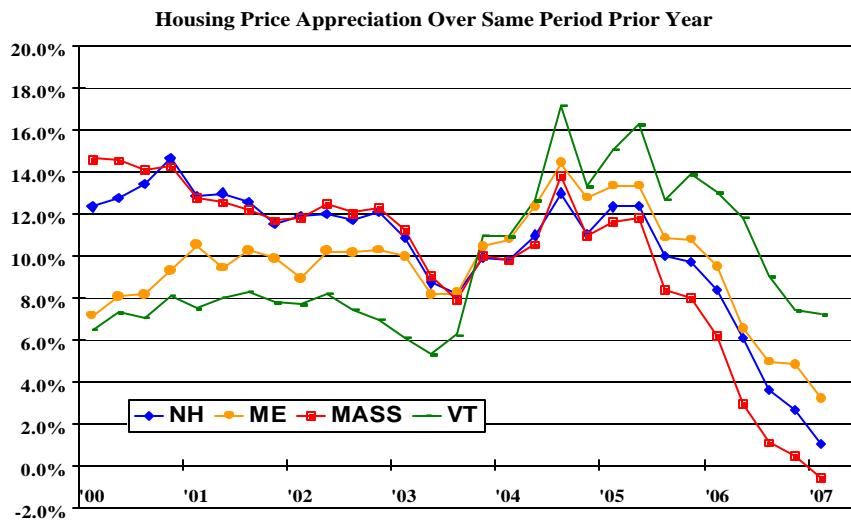
Absent a major change in the economic outlook (the nation or New Hampshire do not enter a recession), home price appreciation trends will be the major determinant of how high foreclosures go in New Hampshire, with other factors such as interest rates (which will affect rate resets and which will either deter or encourage home buyers to enter the market), tightening of lending standards, and credit availability also playing important roles. We estimate that for every 10 percent decline in the value of homes in New Hampshire, there is an 80 percent increase in home foreclosures. The willingness of lenders to offer workout options for homeowners seriously delinquent on their mortgages will also play an important role in determining the level of foreclosure over the next two years.

These factors are difficult to forecast and the range of estimates of the full effect of subprime mortgages and a declining housing market on foreclosures in New Hampshire is wide. Our analysis shows that the vast majority of loans in distress, or already in foreclosure, are held by institutions with limited presence in New Hampshire. In many cases original loans have been sold, securitized or repackaged many times. Because of the broader economic and social costs to communities, New Hampshire banks and other institutions that depend upon the local and regional economy’s health to thrive have a strong incentive to minimize the economic disruptions caused by foreclosure. It is not clear that these same incentives apply to many of the organizations holding the majority of distressed loans,

most of whom may have little presence in New Hampshire. In theory, there are strong financial incentives for mortgage holders to facilitate loan workouts but this may not apply if mortgage holders are eager to exit their positions in a troubled mortgage market.

The availability of workouts for delinquent loans in New Hampshire may also be affected by the loss rates experienced by the mortgage lenders (or current holders of the loans) when they foreclose on properties. Data from LoanPerformance Inc. indicates that in New Hampshire, the severity of losses⁵ for mortgage holders on foreclosed properties is among the lowest in the country. With an average loss of 29% of loan balance on foreclosed properties, New Hampshire ranks 46th among states in severity of losses for mortgage holders on foreclosed properties, well below the national average of 41% and less than half of the average severity of loss among the top states. For mortgage holders looking to reduce seriously delinquent loans, and or exit the market, foreclosure in New Hampshire may thus be a more attractive option than it is in a state where mortgage holders may experience higher losses on foreclosed properties.

Figure 19
Home Price Trends Will Play A Big Role In Determining How Many Loans Eventually Fall Into Foreclosure. A 10% Decrease in Values Will Increase NH Foreclosures by 80%.

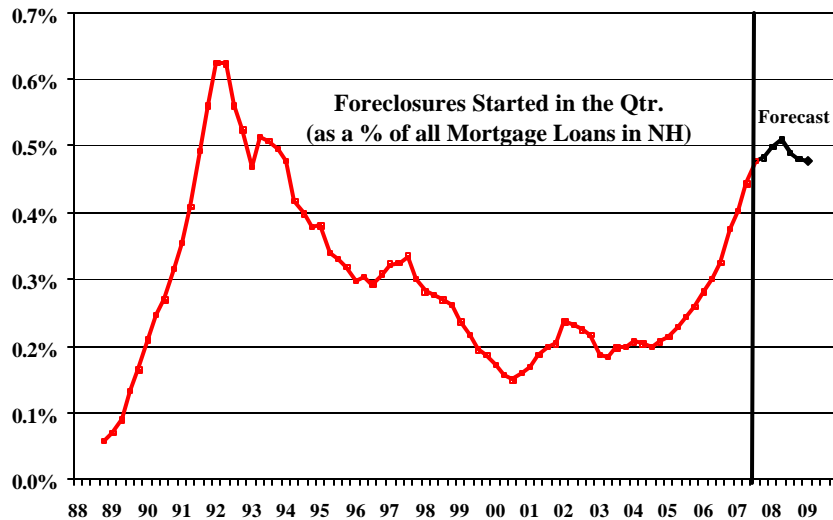


It is not the purpose of this report to forecast the number of foreclosures in New Hampshire but our analysis cannot escape questions about the implications of the trends highlighted here on the near term outlook for mortgage credit quality and foreclosures in New Hampshire. Based on the volume of

⁵ Loss severity is the net loss divided by the balance on the loan. LoanPerformance Inc. “The Market Pulse”.

mortgages by type (prime fixed, prime adjustable rate, subprime fixed, subprime adjustable), along with recent and expected default rates gleaned from a variety of sources, we produced a baseline estimate of approximately 1,800 foreclosures in 2007, rising to between 2,000 and 2,100 in 2008. However, a number of factors could significantly alter the level of foreclosures in New Hampshire and the range of estimates is wide. We offer these estimates simply as one scenario of the potential volume of foreclosures if current trends continue. As Figure 20 shows, we expect foreclosure starts to peak in the first half of 2008, at a level below the peak level of the early 1990s. In addition to lower foreclosure rates than the recession of the 1990s, the other major difference is that residential mortgage loans held by New Hampshire banks have delinquencies well below the state average and unlike many subprime lenders, the financial health of New Hampshire banks is not threatened by the current downturn in the real estate market.

Figure 20
 Foreclosure Rates Should Peak in the First Half of 2008
 (Below 1990's Recession Levels)



X. Policy Responses

Political pressures for action to stem the tide of rising foreclosures are mounting. Public sentiment toward corporations and financial business in particular is trending low and the heat of a presidential election season will focus increased public attention on timely public policy issues.

Combined, these factors create a policy environment conducive to actions that may overstep and that could unwittingly exacerbate some of the very problems they are designed to alleviate. In deciding what, if any, actions to take, policymakers should consider the following:

- ◆ Markets cannot eliminate past mistakes but they are often effective with forward looking changes. Markets have already addressed many of the causes of the crisis:
 - Lending standards have been dramatically tightened.
 - Loan products that are most associated with higher rates of default are being eliminated or curbed. Some lenders have announced the elimination of negative amortization loans and other products such as 2/28 ARMs.
 - Market forces have severely punished subprime lenders, eliminating many and reducing the value of many more.
 - Lenders have begun to understand the importance of loan adjustments and workouts to minimizing the damage created by the crisis.

- ◆ Federal regulators recognize the fine line that new regulations must walk between protecting borrowers and indirectly harming them by reducing the availability of mortgage credit that would reduce “effective demand” for housing and which might eliminate or reduce opportunities for homeowners to refinance out of problem loans. Eliminating all or most of subprime lending would immediately end all hope of refinancing out of problem loans for most subprime borrowers facing large payment resets.

- ◆ Because trends in home price appreciation will have a large impact on the level of foreclosures, any action that severely restricts mortgage credit availability will reduce the number of home purchases and hurt appreciation, tipping more loans into default.

- ◆ Understand the distinction between subprime and “predatory” lending. There is nothing fundamentally wrong with subprime mortgage lending. It is riskier than traditional lending, but it does open up the world of homeownership to more people who would otherwise not enjoy the benefits of homeownership.
 - Predatory lending is a subset of subprime lending.
 - *Predatory loans* are generally priced higher than is justified by the underlying risk of the loan. The lender is thus “taking advantage” of the borrower. Some practices often associated with predatory lending include:
 - Lack of transparency in disclosing terms and fees
 - Steering borrower to loans not in his/her best interests
 - Lender takes advantage of borrowers lack of financial sophistication
 - Encouraging “loan flipping” (rapid refinancing that results in more fees and/or loss of equity).
 - The vast majority of mortgage loans that default during the current mortgage credit crisis are not “predatory” mortgage loans and simply focusing on predatory lending practices will not mitigate the crisis.

Policymakers can take several actions that will help reduce future problems in mortgage credit markets:

- ◆ Require that the cost of borrowing (especially long term cost) be fully disclosed to borrowers.
- ◆ Require all lenders to report on the status of their loans with their annual HMDA filings. Banks already file reports on the status of their loans and all lenders file annual reports to monitor for mortgage discrimination. Better information will better highlight problem lending practices and lenders.
- ◆ Expand programs like FHA, VA, NHHFA that are designed to increase homeownership to replace exiting lenders.
- ◆ It is difficult to make good public policy in the eye of the storm and while the pain of families losing their homes surrounds the political process. Reducing or eliminating excessive lending practices without curtailing legitimate subprime mortgage credit is difficult but is the key to avoiding greater damage to the housing market and NH economy.

XI. Conclusions

Current problems in the mortgage credit market and rising foreclosure rates are not unprecedented in New Hampshire. Mortgage foreclosures today are largely a function of the increased use of non-traditional mortgage products and higher risk factors associated with them. Many of these lending practices have already been eliminated or severely curtailed but the legacy of past practices will continue to have negative effects on the housing market in New Hampshire and increase foreclosures again in 2008. New Hampshire banks, however, will not experience the negative consequences of many mortgage lenders in New Hampshire because in maintaining more prudent lending standards they have sacrificed market share but avoided the lending practices that have contributed to the current rise in defaults. There is little that policymakers can do to mitigate problems resulting from past lending practices but they can help wring out some of the excesses in mortgage lending markets. In doing so, extreme care must be taken to avoid actions that eliminate options for homeowners facing default and actions that precipitate further declines in the housing market and a concomitant increase in mortgage loan defaults.