



POLICY BRIEF
California Economic Outlook:
Greater Foreclosures Loom,
Threaten to Delay Economic Recovery
November 2009

Reckless and abusive lending practices have left California victim to a foreclosure crisis with catastrophic consequences for families, communities, and the state economy. Recent assessments and reports from policy analysts, industry insiders and the media suggest that the catastrophe is over: a bottoming of the housing and stock markets, the end of the recession, and the “green shoots”¹ of recovery are all on the horizon. But the crisis is far from over in California. Indeed, with over one million mortgage foreclosures looming, continuing record levels of unemployment and a worsening state budget² that will bring more reductions in state and local services, California is not yet out of the woods.

A number of factors combine to suggest that the California foreclosure crisis will worsen before it improves, including record levels of unemployment, record levels of mortgage delinquencies, and precipitous declines in housing values combined with defective mortgage products that have left an alarming percentage of California borrowers in mortgages that exceed the value of their homes. For these homeowners who are “under water,” loan modifications are more difficult and less likely to succeed. California is also home to the largest share of very risky loans called Payment Option Arms, which the data show are not faring well. Many of those types of loans, made primarily in 2004-2007, will have their payments reset in the next few years, drastically raising mortgage payments for borrowers and leading to a new wave of foreclosures.

Threats to California’s Economic Recovery

Economy

Key economic indicators make clear the extent of the economic challenges facing California. From the start of 2008 through September 2009, more than 375,000 families lost their homes. Nearly one million more foreclosures are projected over the next few years. Moreover, these foreclosures are estimated to cost Californians living in neighboring homes over \$600 billion in lost equity. On top of this unemployment is high and rising, causing more existing homeowners to default on their loans, while making new home loans risky for lenders.

Foreclosures:	2008 + ¾ 2009: 375,276 homes already lost 2009-2012 (projected): 1,538,600 ³
Spillover Impact (Projections)⁴	2009: 11.3+ million homes; ~\$170 billion in lost equity 2009-2012: 12.2+ million homes; ~\$627 billion in lost equity
Unemployment	July 2009: 12.2 percent (and rising) ⁵

The September 2009 UCLA Anderson Forecast calls the unemployment situation in California “ugly” and notes that the still-contracting state and local government sector only compounds the unemployment problems.⁶ Anderson predicts that the unemployment rate will grow to a high of 12.2 percent for the 4th quarter of 2009 and will average 11.6 percent for the year, translating into a contraction in employment of 3.7 percent for 2009.⁷ Anderson estimates that employment will grow by a tiny rate of 0.2% in 2010.⁸ According to the Forecast, although the state economy will be growing by 2011, it will not produce enough jobs to get the unemployment rate below double digits until the end of that year.⁹

The bleak economic outlook is part of the spiral of bad news for California. Although the housing and mortgage crisis catalyzed the recession, as the economy worsens and unemployment increases, more unemployed homeowners are unable to pay their mortgages, leading to more foreclosures. These unemployment-driven defaults are putting further downward pressure on the housing prices and preventing a more robust economic resurgence. Preventing avoidable foreclosures is therefore at the heart of economic recovery, which can put a brake on downward housing prices, and prevent unnecessary community blight that arises from concentrations of vacant homes.

Large Pool of Future Foreclosures Will Keep Housing Prices Down

Figure 1

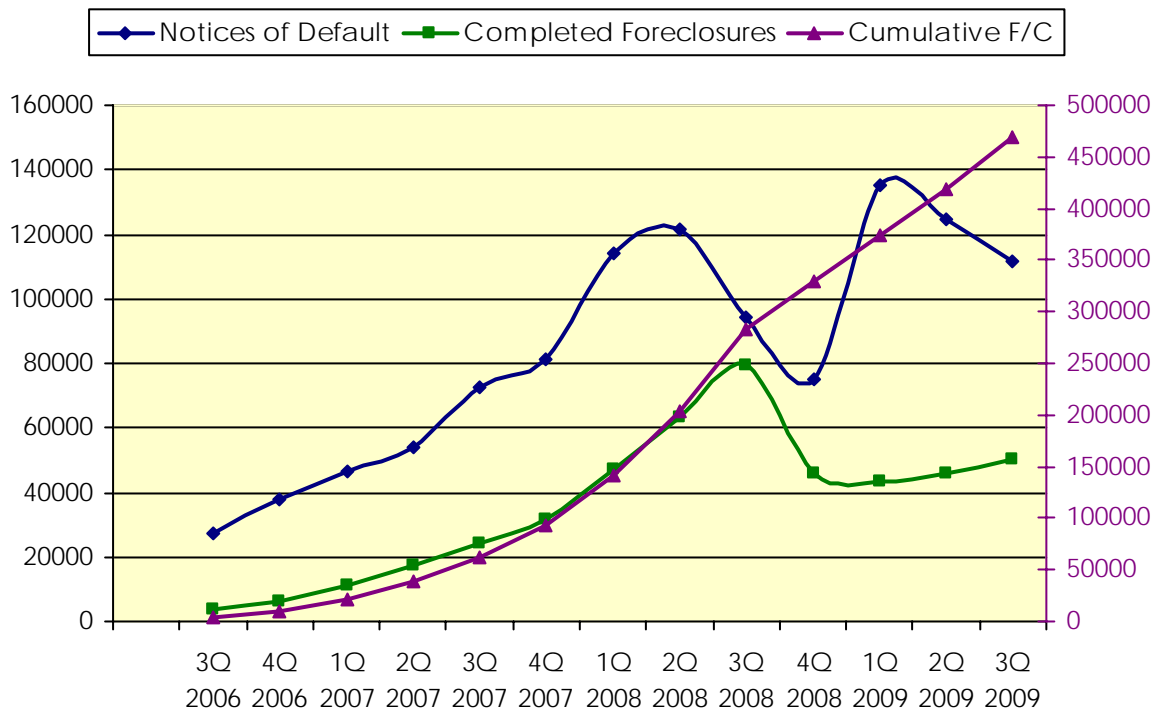


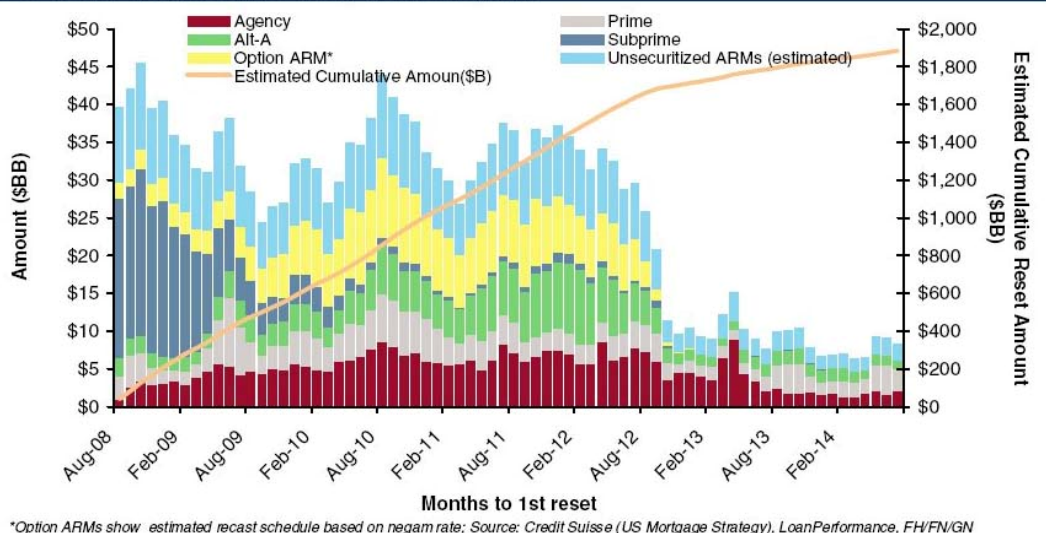
Figure 1 above shows the growing gap between notices of default and completed foreclosures, suggesting a backlog of homes that are somewhere in the process of foreclosure. For example, for the January to July 2009 period, there were 89,287 actual foreclosures, but there were nearly three times as many – a remarkable 259,993 – notices of default.¹⁰ According to the Mortgage Bankers Association, 10.8 percent of all California loans, nearly 850,000 loans, were 60+ days delinquent or started the foreclosure process as of 2Q 2009.¹¹ The wide gap between those entering the process and actual foreclosures cannot be explained by loan modifications and self-cures alone. Instead, the gap is likely due to delays in the foreclosure process caused by understaffing, foreclosure-prevention efforts with borrowers,¹² and possibly calculations by servicers that foreclosures are less favorable than utilizing government toxic asset purchase programs.¹³ In any event, it is likely that the majority of this backlog will result in future foreclosures, as loan modifications are preventing foreclosures in fewer than one in five seriously delinquent loans.

The Next Foreclosure Wave – Alt-A Mortgages

On top of the expected rise in foreclosures from this growing pool of defaults, California is on the brink of a second wave of foreclosures in the Alt-A mortgage market. A second tier of risky loans – called Alt-A, or nontraditional loans – was made to near-prime quality borrowers. California accounts for more than 30 percent of the nation’s Alt-A loans originated between 2000 and 2007.¹⁴ In 2007, \$61.7 billion in Alt-A loans – 44.6 percent of all Alt-A loans – were made in California.¹⁵ According to loan data made available by the Federal Reserve Bank of New York, as of May 2009, there were 632,215 active Alt-A loans (over 190,000 of which are Option ARMs) outstanding in California (compared with 345,505 active subprime loans).¹⁶ Risky features of these loans included stated incomes, interest-only payments, and with Option ARMs, negative amortization. As subprime loans begin to pass their payment reset or recast dates, Alt-A loans will enter a period of dramatic payment shocks, starting in late 2009 through 2012.

Figure 2

Exhibit 41: Option ARM and Alt-A mortgage resets become a much bigger issue in mid-2009 as the trouble shifts away from subprime

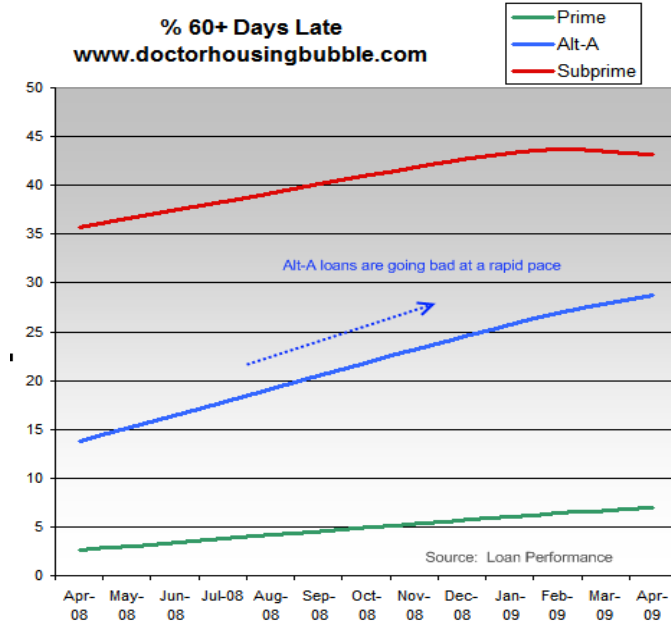


*Option ARMs show estimated recast schedule based on negam rate; Source: Credit Suisse (US Mortgage Strategy), LoanPerformance, FH/FN/GN

Source: Credit Suisse Structured Finance/RMBS Research Team

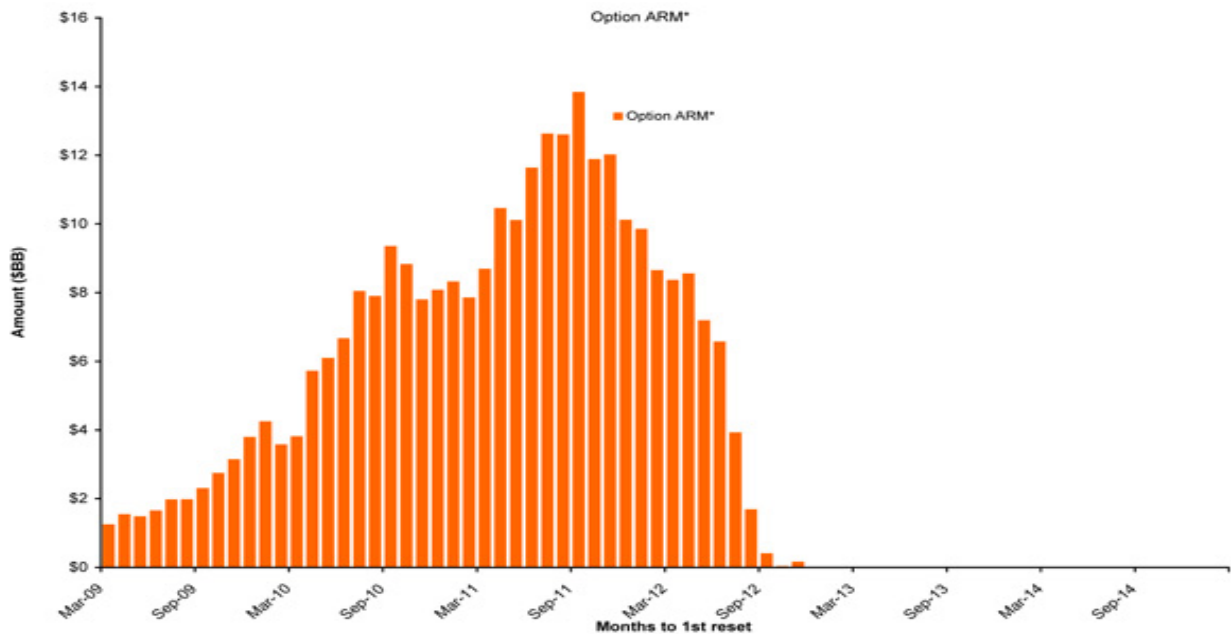
Option ARM loans have been facing sharp increases in delinquencies – even before facing payment recasts.¹⁷ According to an analyst at Barclay’s, “in a given month, between 4 percent and 5 percent of borrowers who are current on their Option ARMs taken out in 2006 and 2007 default in the following month...”¹⁸ Fitch recently observed that total delinquencies of 30+ days were at 46 percent, despite the fact that only 12 percent have recast and experienced an associated payment shock.¹⁹ Figure 3 illustrates that delinquencies on Alt-A loans are increasing at a much steeper pace than on prime and subprime loans. Alt-A 60+ delinquencies increased from less than 15 percent in April 2008 to nearly 30 percent by April 2009.

Figure 3



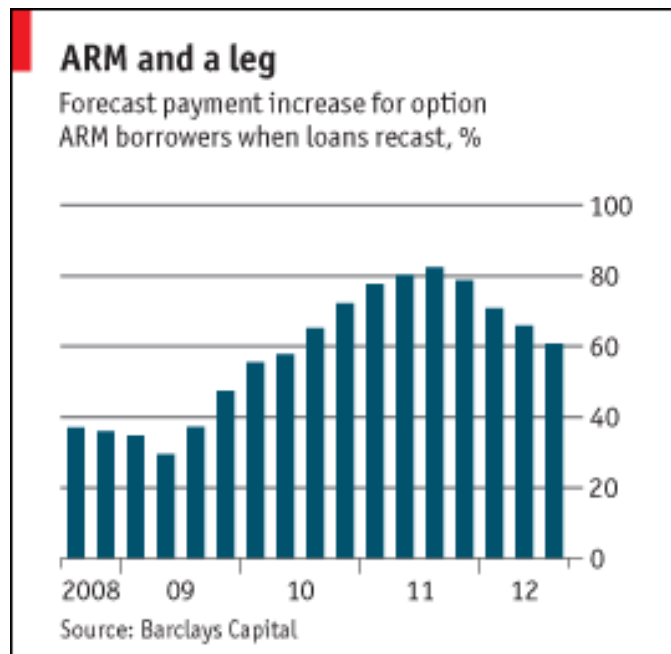
Alt-A loans include Option ARMs,²⁰ a very risky type of loan. California accounts for a majority of Option ARM loans nationally (e.g., in 2007, California originated \$31.4 billion in payment option ARMs, 55.9 percent of the national total).²¹ Figure 4 below isolates Option ARM loans to shows the impending rise in Option ARM recasts (nationally). As shown in Figure 5, due to declining housing prices and the negative amortization feature of these loans, the recasts on POARMs will cause payments to increase dramatically, as much as 60-80 percent or more during the peak periods (on top of the yearly increases referenced below).²²

Figure 4²³



*Option ARMs show estimated recast schedule based on current negam rate; Source: Credit Suisse (US Mortgage Strategy), LoanPerformance, FH/FN/GN

Figure 5²⁴



The growing delinquencies in Option ARMs can be attributed to risk layering in the loans themselves, together with economic factors of unemployment/underemployment, and an inability to refinance, presumably due to being underwater. First, the great majority of Alt-A loans were stated income loans, subject to no or very aggressive underwriting, and often based upon inflated incomes (typically by the broker or lender to get loans approved).²⁵ Second, the Option ARM loans also have a negative amortization feature, so that the loan balance grows as the borrower makes its payments. Approximately 75% of all Option ARM borrowers (and even higher for certain lenders) only make the minimum payment, leading to steady growth in the balance of the loan outstanding.²⁶ Third, even before recast, the (minimum) payments on the Option ARMs increase 7.5 percent per year which can be

substantial, especially where the loan was underwritten (if at all) based on lower payments, and potentially inflated income. On a loan where the minimum monthly payment in the first year is \$2,000, payments would increase to \$2,670.94 per month in the fifth year, a 30 percent monthly payment increase. With increasing monthly payments, growing loan balances, plummeting home values and rising unemployment, it is little surprise that these loans are facing higher delinquency rates.

High Levels of Underwater Mortgages Could Lead to Even More Foreclosures

An additional threat to recovery is the growing number and percentage of underwater mortgages, *i.e.*, mortgages in which the amount owed on the property exceeds the value of the property. Two recent studies provide estimates of underwater mortgages in CA. First American CoreLogic estimated that nationally, 32.2 percent of all mortgaged properties were in negative equity position as of June 30, 2009.²⁷ In California, 2.9 million borrowers, or 42 percent of all properties are underwater.²⁸ Of these borrowers, almost 60 percent owed at least 25 percent more on their mortgage than the current market value of the property. The aggregate value of California homes that are in negative equity was \$969 billion.²⁹

The estimates from Deutsche Bank—which uses more pessimistic housing price appreciation assumptions than does First American CoreLogic—are even more dire. Deutsche Bank projects that 48 percent of the national mortgage market, including 89 percent of all Option ARMs, will be under water by 2011.³⁰ For California, Deutsche Bank projects that as of Q1 2009, 54.3 percent California homeowners were underwater on their mortgages, and that within two years, 67.9 percent will be under water. As noted in Figure 6, the projections for areas like Modesto and Stockton are more extreme with 2011 estimates at nearly 90 percent.³¹

Due to the negative amortization feature of the loans, borrowers with Option ARMs are especially deep underwater. According to Fitch, due to the high concentrations of Option ARMs in California, Florida, and other states with rapidly declining home prices, average loan-to-value ratios have increased from 79 percent at origination to 126 percent today.³² Of particular concern, as of March 31, 2009, the average current loan-to-value ratio on Wells Fargo Option ARM loans in California was 151 percent.³³

Growing levels of underwater mortgages are likely to push more already financially-strapped borrowers into default and/or foreclosure, either because they are unable to refinance into more affordable mortgages, or because they choose to walk away.³⁴ Although data is lacking on the number of borrowers “walking away” from underwater homes, it is evident that some are.³⁵ Commentators have noted that as the level of negative equity increases (*i.e.*, as borrowers begin to owe \$100,000, \$200,000, \$300,000 more than their home is worth), the reality can set in that the borrower will never have the opportunity to dig out and gain equity in the home, and/or will not have needed equity to tap for making home repairs or covering other unexpected expenses. For some, the “rational” or only financially viable decision might be to walk away from the home even if the borrower can afford the mortgage payment, and rent or buy elsewhere.³⁶

Figure 6

Deutsche Bank's Estimation of Percent of Home Borrowers Underwater

MSA Name	Percent of Borrowers Underwater as of Q1 2009	Percent of Borrowers Underwater as of Q1 2011
Bakersfield, CA	78.8	87.4
Chico, CA	29.6	56.6
El Centro, CA	84.7	91.7
Fresno, CA	71.6	81.1
Hanford-Corcoran, CA	56.0	76.2
Los Angeles-Long Beach-Glendale, CA	51.1	62.4
Madera, CA	71.8	83.1
Merced, CA	85.4	91.2
Modesto, CA	83.5	89.8
Napa, CA	34.8	47.0
Oakland-Fremont-Hayward, CA	49.8	63.7
Oxnard-Thousand Oaks-Ventura, CA	36.9	47.0
Redding, CA	33.7	57.0
Riverside-San Bernardino-Ontario, CA	78.2	87.4
Sacramento-Arden-Arcade-Roseville, CA	64.9	74.6
Salinas, CA	51.3	62.5
San Diego-Carlsbad-San Marcos, CA	47.7	56.6
San Francisco-San Mateo-Redwood City, CA	8.8	15.0
San Jose-Sunnyvale-Santa Clara, CA	26.9	41.4
San Luis Obispo-Paso Robles, CA	21.9	39.0
Santa Ana-Anaheim-Irvine, CA	27.3	51.1
Santa Barbara-Santa Maria-Goleta, CA	41.9	47.5
Santa Cruz-Watsonville, CA	25.5	36.0
Santa Rosa-Petaluma, CA	42.7	51.3
Stockton, CA	80.5	88.0
Vallejo-Fairfield, CA	75.1	84.3
Visalia-Porterville, CA	70.5	79.4
Yuba City, CA	73.0	83.9
State Overall	54.3	67.9

Conclusion

In the final analysis, one major point is clear: California's economic recovery is not just around the corner. We cannot simply wait and let Washington solve our problems. If we are to get the economy on solid footing again, California must adequately address the mortgage crisis by preventing avoidable foreclosures and stabilizing the housing market for the long-term. Among the policies the state should adopt:

- Establish a foreclosure process that ensures that mortgage loan servicers carefully review and document their economic alternatives to foreclosures that will keep borrowers in their homes. This should include strict adherence to the Federal Home Affordable Modification Program guidelines, providing greater transparency to borrowers about the calculations used to make loan modification decisions and greater clarity about why loan modification applications are rejected.
- Given the large numbers of borrowers who are deep underwater, loan servicers should be encouraged to reduce outstanding principal balances in their loan modifications, so that borrowers can begin building equity in their homes. Principal reductions are likely to be key to ensuring that long-term sustainability of loan modifications in areas that have experienced steep price declines.

Without these actions, the shaky housing market will continue to infect the broader economy, and the drain of the economy will continue to hamper housing market recovery. Since the failures of the subprime market and the resulting massive foreclosures are at the root of the economic crisis, a faster, stronger recovery is impossible without mitigating the hundreds of thousands of preventable foreclosures. If we fail to do so, we can expect the impacts of massive foreclosures—devastated communities, depleted tax receipts and lost family and neighborhood wealth—to continue to wreak havoc on California's society and economy in a destructive cycle.

We must stop the foreclosures, and stop this cycle. Our economy depends on it.

¹ See, e.g., Daniel Gross, "Green Shoots: Is the Economy Really Showing Signs of Recovery?" *Slate.com* (Apr. 17, 2009), available at <http://www.slate.com/id/2215911/> ("Spring is the season of rebirth, so it was fitting that Ben Bernanke, chairman of the Federal Reserve Board, in mid-March told 60 Minutes that he detected 'green shoots' of economic recovery. Since then, the phrase 'green shoots' has sprouted and blossomed. Analysts and journalists, desperate for any sign of hope, have taken to repeating the phrase 'green shoots' as a soothing mantra. Economists are now walking around, eyes fixed on the ground like French rustics hunting for truffles, searching for verdant signs of growth.")

² California's budget shortfalls are projected to be nearly \$20 billion (18.8% of the general fund budget) for 2009, and \$38.9 billion (35% of the general fund budget) for 2010. See "State Budget Update: July 2009" (NCSL July 2009), available at <http://www.ncsl.org/documents/fiscal/StateBudgetUpdateJulyFinal.pdf>. See also "New Fiscal Year Brings No Relief From Unprecedented State Budget Problems," (Center on Budget and Policy Priorities Sept. 3, 2009), available at <http://www.cbpp.org/cms/?fa=view&id=711>. For articles relating to "Counties in Fiscal Crisis" see <http://www.csac.counties.org/default.asp?id=2084>.

³ "California Foreclosures: Impact and Opportunities" (CRL Jan. 2009), available at <http://www.responsiblelending.org/mortgage-lending/tools-resources/factsheets/ca-foreclosure-fact-sheet.pdf>.

⁴ See "Soaring Spillover: Accelerating Foreclosures to Cost Neighbors \$502 Billion" (CRL May 2009), available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf>. In addition to the devastating impact that foreclosures have on the affected households, they also cause a "spillover" effect by depressing the value of nearby homes—most owned by families who are paying their mortgages on time. *Id.*

⁵ "Regional and State Employment and Unemployment Summary," (Bureau of Labor Statistics Sept. 18, 2009), available at <http://www.bls.gov/news.release/laus.nr0.htm>.

⁶ See “Press Release: UCLA Anderson Forecast: Worst National Recession in Seven Years Likely Ended this Quarter, but Remains Impactful for the Rest of the Decade” (Sep. 16, 2009), available at http://www.uclaforecast.com/contents/archive/2009/media_91609_1.asp.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ DQ News 1Q & 2Q figures

¹¹ CRL calculations, based upon MBA Delinquency Data, 2Q 2009, grossing up to account for the fact that MBA data does not include 100% of the mortgage market.

¹² For example, Bank of America indicates that it has held off on completing the foreclosure process for some homeowners while it reviews eligibility under the Making Home Affordable Modification Program. See Calculated Risk, “CNBC: What Banks are doing with Foreclosures,” (Aug. 31, 2009), available at <http://www.calculatedriskblog.com/> (quoting Diana Olick, “What Banks Are Really Doing With Foreclosures” (Aug. 31, 2009), available at <http://www.cnbc.com/id/32630317>)).

¹³ Some suggest that a later surge of foreclosures from this “shadow inventory” is unlikely. See, e.g., Sean O’Toole, “Waiting To Catch A Wave? Surge Of REO Listings Is Unlikely,” available at <http://www foreclosuretruth.com/blog/sean/waiting-catch-wave-surge-reo-listings-unlikely>

¹⁴ Government Accountability Office, “Characteristics and Performance of Nonprime Mortgages” (July 28, 2009), available at <http://www.gao.gov/new.items/d09848r.pdf>.

¹⁵ “California Claims Nearly Half of 2007 Alt-A Lending,” *Inside B&C Lending* (Apr. 4, 2008).

¹⁶ CRL calculations based on Loan Performance data provided by the Federal Reserve Bank of New York, available (monthly) at <http://www.newyorkfed.org/regional/subprime.html>.

¹⁷ See, e.g., “Second Wave Of Mortgage Defaults On The Horizon?,” *60 Minutes* (Dec. 14, 2008), available at <http://www.cbsnews.com/video/watch/?id=4668112n> (video); <http://www.cbsnews.com/stories/2008/12/12/60minutes/main4666112.shtml> (transcript); “Assessing Risks to Global Financial Stability,” at 8, Fig. 1.7 (Credit Suisse monthly mortgage rate rests by loan type).

<http://www.imf.org/external/pubs/ft/gfsr/2007/02/pdf/chap1.pdf>

¹⁸ *Id.* See also Mara Der Hovanesian, “Option ARM Loan Modification Outlook Dismal,” *BusinessWeek* (July 27, 2009), available at

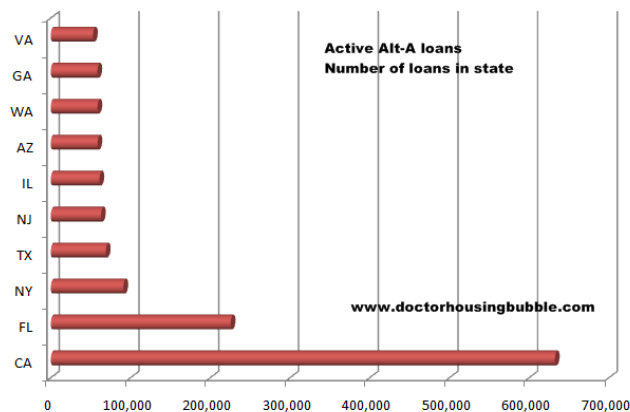
http://www.businessweek.com/investing/wall_street_news_blog/archives/2009/07/option_arm_loan.html

¹⁹ “Fitch: \$134B of U.S. Option ARM RMBS To Recast by 2011,” (Sept. 8, 2009), available at

http://www.businesswire.com/portal/site/google/?ndmViewId=news_view&newsId=20090908006052&.

²⁰ A payment option ARM (POARM) provides borrowers with at least three payment options each month: a fully amortizing payment, an interest only payment, and a minimum payment, which is less than interest due. Typically, the minimum payments are capped for the first five years, but adjust annually by 7.5 percent. The difference between the minimum payment and the full amount of interest due is added into the principal balance of the loan, so that the balance of the loan grows. This is called “negative amortization.” The payment then resets upon one of two triggers, either at five years, or when the loan balance grows to a certain threshold, usually 115 to 125 percent of the original balance. At that time, the monthly payment recasts, and requires the borrower to make a fully amortizing payment (principal and interest that will pay off the loan at the end of the loan term) on the larger loan balance.

²¹ “California Claims Nearly Half of 2007 Alt-A Lending,” *Inside B&C Lending* (Apr. 4, 2008). The following chart illustrates CA’s extreme concentration of Alt-A loans, even compared to Florida which has the next highest number of Alt-A loans.



²² Prashant Gopal, “Good News: Option ARM Resets Delayed,” *BusinessWeek* (Apr. 16, 2009) (citing Credit Suisse research), available at http://www.businessweek.com/lifestyle/content/apr2009/bw20090416_103126.htm.

²³ <http://www.doctorhousingbubble.com/option-arms-and-recast-shock-syndrome-toxic-financial-products-are-implosion-on-schedule-examining-the-impact-on-california/>

²⁴ http://www.businessweek.com/lifestyle/content/apr2009/bw20090416_103126.htm

²⁵ See, e.g., Government Accountability Office, “Characteristics and Performance of Nonprime Mortgages” (July 28, 2009), available at <http://www.gao.gov/new.items/d09848r.pdf>; Loan Performance data provided by the Federal Reserve Bank of New York, available (monthly) at <http://www.newyorkfed.org/regional/subprime.html>.

²⁶ Bob Tedeschi, “A Reckoning on Option Arms” *The New York Times* (Sept. 18, 2009), available at http://www.nytimes.com/2009/09/20/realestate/20mort.html?_r=1

²⁷ “Summary of Second Quarter 2009 Negative Equity Data from First American CoreLogic” (First American Core Logic Aug. 13, 2009), available at http://www.loanperformance.com/infocenter/library/FACL_percent20Negative_percent20Equity_final_081309.pdf.

²⁸ *Id.*

²⁹ *Id.*

³⁰ Karen Weaver & Ying Shen, “Securitization Reports: Drowning in Debt – A Look at ‘Underwater’ Homeowners” at 3, Figure 2, 5, Figure 5 (Deutsche Bank Global Markets Research Aug. 5, 2009).

³¹ Deutsche Bank calculations provided to CRL.

³² “Fitch: \$134B of U.S. Option ARM RMBS To Recast by 2011,” (Sept. 8, 2009), available at http://www.businesswire.com/portal/site/google/?ndmViewId=news_view&newsId=20090908006052&.

³³ See Wells Fargo SEC 10-q filing for period ending June 30, 2009, published August 2009 and available at <http://investing.businessweek.com/research/stocks/financials/drawFiling.asp?docKey=137-000095012309032191-0S37HTHIFQ17BPACA9Q7CLN7O3&docFormat=HTM&formType=10-Q>.

³⁴ See *id.* at 15 (estimating that, at a minimum, underwater status creates a 7 percent added likelihood of default). See also Peter Coy & Theo Francis, “The Risk from Underwater Homeowners,” *BusinessWeek* (Feb. 18, 2009) (citing research by Yale professor John Geanakoplos that the default rate is about nine times higher among underwater borrowers than for those with substantial equity in their homes), available at http://www.businessweek.com/bwdaily/dnflash/content/feb2009/db20090218_423745.htm.

³⁵ A recent study estimated found that “strategic defaulters make up about 18% of all borrowers who went 60 days past due on their mortgage in the fourth quarter of 2008,” up 128% from 2007. See Oliver Wyman, “Experian-Oliver Wyman Market Intelligence Report: Understanding Strategic Default in Mortgages Part I” (2009). A study by economists at the Federal Reserve Bank of Boston estimates that the number of underwater borrowers losing their homes to foreclosure will be relatively small, and that the issue of homeowners walking away has been exaggerated. See Christopher L. Foote, et al., “Negative Equity and Foreclosure: Theory and Evidence” (Federal Reserve Bank of Boston June 8, 2008), available at <http://www.bos.frb.org/economic/ppdp/2008/ppdp0803.pdf>.

³⁶ See, e.g., Martin Feldstein, “How to Save An Underwater Mortgage” *The Wall Street Journal* (Aug. 7, 2009), available at <http://online.wsj.com/article/SB10001424052970204908604574330883957532854.html>. For a discussion on why more people are not walking away, see Bob Lawless, “Why Don’t More Walk Away,” *Credit Slips* (Apr. 23, 2008), available at <http://www.creditslips.org/creditslips/2008/04/why-dont-more-w.html>