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American dreams built on a shaky foundation of subprime loans

By PAUL WENSKE - The Kansas City Star

Willie Clay remembers the day a loan broker showed up and sold him on consolidating his debts by refinancing his south Kansas City home.

The former Vietnam War paratrooper, who lives mainly on government disability checks, jumped at the chance to pay off medical, car and credit-card bills. That was in 2004.

Now he realizes it was "a big mistake." In October, his 8.2 percent interest rate on the new $101,000 home loan shot to 11.2 percent. It is set to rise to 12.2 percent in March — and higher yet in subsequent months.

"If the rate goes up again, I can't afford it," said Clay, who lives in a tidy ranch home in Ruskin Heights with his wife, Ina. "We'll have to move to an apartment."

Welcome to subprime hell, where interest rates are going through the roof and the bottom is falling out of home values.

The ZIP code in which Clay lives has had more than 500 foreclosures — one of the highest rates in the city, according to RealtyTrac, a national firm that tracks foreclosures. On his block, many neighbors' homes are empty. Clay worries his may be next.

Clay, who thought his adjustable rate could go down but would never go up, is another victim of the subprime implosion. He and millions of other low- to moderate-income Americans bought or refinanced homes with creative terms that began with lower "teaser" interest rates designed to rise after several years.

At the time, it seemed like a good deal. Home values were soaring. Lenders seemed to have barrels of money to lend — even to borrowers with less-than-perfect credit — stoking the American dream of homeownership and fueling the torrid housing market from 2004 to 2006.

But housing prices cooled in late 2006, just as adjustable rates started to creep upward. Now many loans are going bad as families find they can't afford their monthly payments and can't get refinanced by lenders who have tightened credit. Foreclosures are at record highs, with Kansas City's foreclosures up 80 percent just since last year.

Thousands of Americans could lose their homes when at least 2 million subprime-loan interest rates are set to rise again this spring. President Bush recently announced a plan to freeze the rates on as many as 1.2 million of those loans. Some experts estimate the eventual cost to the economy will be more than $223 billion.

For many, the help comes too late.

In metropolitan Kansas City, more than 34,290 adjustable-rate loans are ready to reset, putting more homes at risk, according to an analysis of mortgage data by the Center for Responsible Lending.

"What this foretells is foreclosures will get worse before getting better," said Kelly Edmiston, a senior economist at the Federal Reserve Bank of Kansas City, who has crunched the numbers. "We haven't really seen the peak yet."

What went wrong?

Blame is easy to spread around for the subprime mess, said William M. Dana Jr., the president and CEO of Central Bank of Kansas City and the immediate past chairman of the Missouri Bankers Association.

Dana cited lax underwriting standards, borrowers who didn't understand the terms of their loans, and regulators who weren't paying enough attention.

Consumer advocates, however, said borrowers with little experience in home buying got caught up in a frenzy, fed mainly by nontraditional lending institutions and thinly regulated brokers who were more intent on making fat commissions than making quality loans. Big national banks also dove into the market with subprime subsidiaries.

FORECLOSURE RATE BY CENSUS TRACT

Source: Federal Reserve

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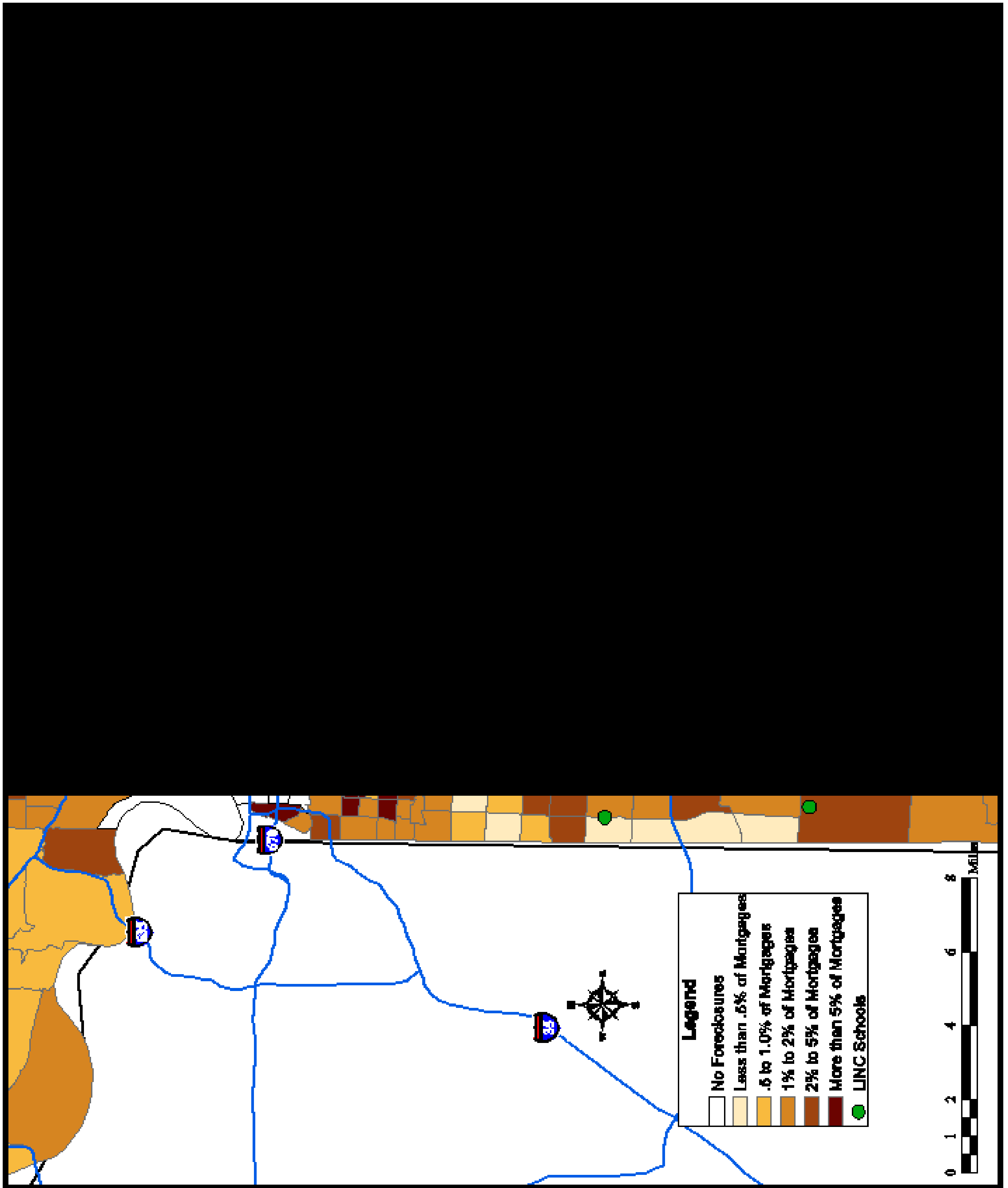
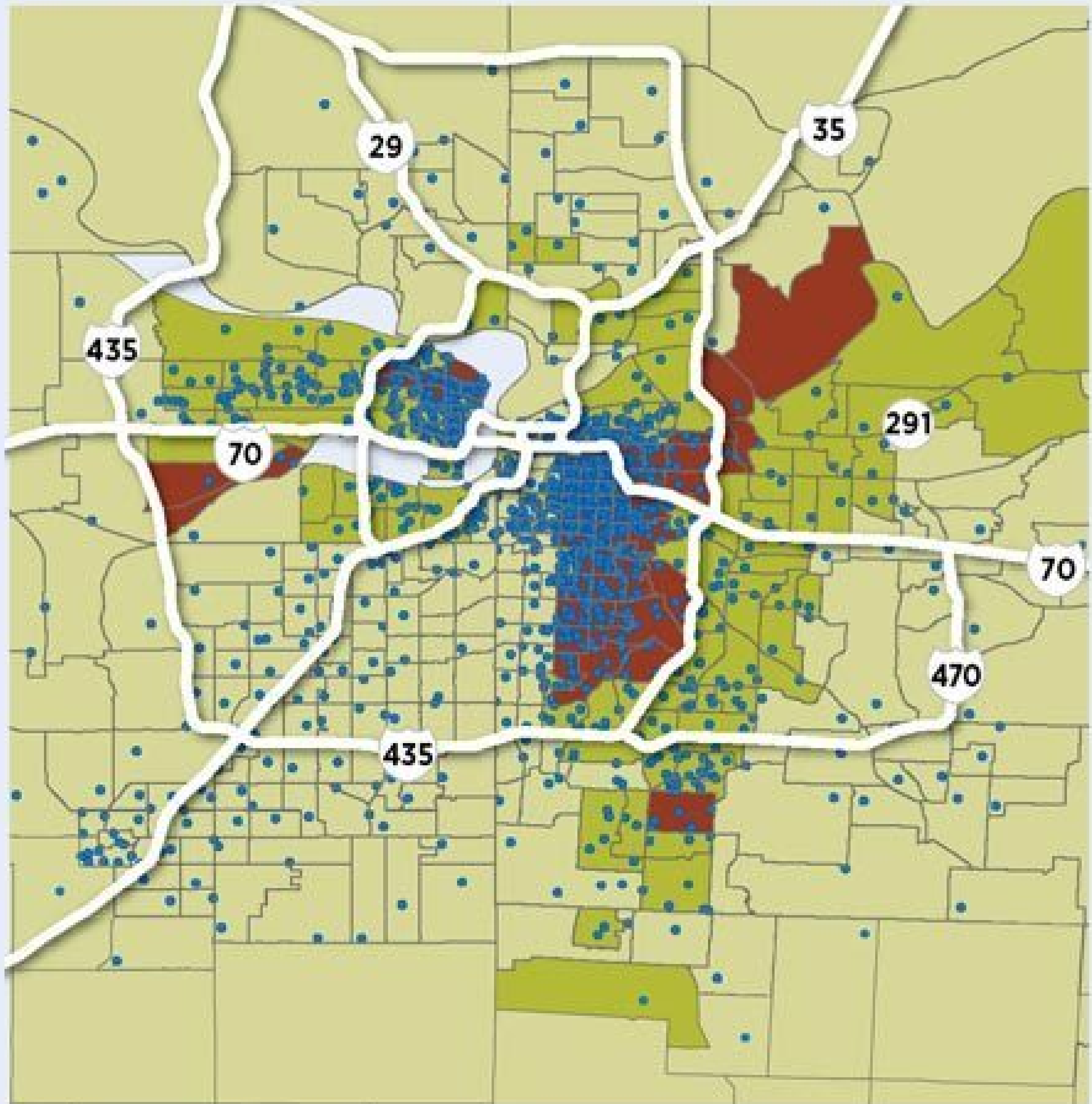
Foreclosures: LINC Caring Communities Sites




PERCENT SUBPRIME BY CENSUS TRACT
0 to 25%
25% to 50%
50% to 100%
29
35
435
70
291
70
470
435
Source: Federal Reserve
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“You had an army of salespeople who were hired to go door to door and sell these things very aggressively,” said Michael Duffy, the managing attorney of Legal Aid of Western Missouri, who noted that subprime loans are more complex than conventional loans, yet borrowers often received less loan-disclosure information.

Elma Warrick, the executive director of the Kansas City Home Ownership Center for HomeFree-USA, said: “People were just happy to be told they could get a home. Quite frankly, they didn’t know what questions to ask.”

Clay acknowledged that he never fully understood how an adjustable rate worked when a Wells Fargo Financial broker sold him on the deal.

“I didn’t have the education to understand it,” Clay said. “And they didn’t explain it to me. I thought if the interest went down, your payment went down. If the interest rate went up, your payment stayed the same.”

What’s more, Clay’s loan included thousands of dollars in added charges and carried a $2,500 prepayment penalty, which tied him to the debt for at least three years.

Steve Carlson, a spokesman for Wells Fargo Financial, a division of Wells Fargo & Co., said that while he could not comment specifically on Clay’s case, the company does not make home loans “unless we believe the customer has the ability to repay the loan.” Carlson said the bank works with customers to avoid foreclosure and find options “based on the customer’s financial ability to repay the debt.”

Adjustable-rate loans aren’t new, but they had been used primarily by borrowers with good credit who didn’t intend to hold on to a house long, because they planned to sell it or move.

In recent years, a new breed of lenders and brokers saw a way to use the subprime market to keep home sales revved up.

Lenders targeted urban neighborhoods where new borrowers were itching for the chance to buy. Because those neighborhoods usually had lower average credit scores, often reflecting riskier credit, lenders felt justified to charge more. And they did.

Nearly 28 percent of the home-purchase loans made in Jackson County from 2004 to 2006 were subprime, federal mortgage records show. That compares with less than 10 percent in more affluent Johnson County.

Teaser rates made the loans appear affordable. “These loans wouldn’t have been made without the teaser rate,” Edmiston said.

From 2003 to 2004, adjustable-rate mortgages nearly doubled — growing to more than 50 percent of all originations in Kansas City, according to Federal Reserve data.

Loan offers became increasingly creative, offering no money down or interest-only payments that began low, but skyrocketed nearly 200 percent in a few years. TV ads induced consumers to borrow against 125 percent of the value of their home — a recipe for disaster for most cash-strapped borrowers.

Subprime sales even took off in middle-income tracts, according to a study of Kansas City’s 5th Congressional District by Compliance Technologies, a Washington firm that provides lending intelligence services to financial institutions.

Critics say that raises questions about whether some borrowers were steered to subprime loans when they might have qualified for cheaper conventional loans.

While most mainstream banks in Kansas City resisted the subprime stampede, newer lenders rushed in. More than 98 percent of the loans that H&R Block’s Option One Mortgage Corp. made in Kansas City from 2004 to 2006 were subprime, federal loan figures show. More than 97 percent of NovaStar Mortgage’s loans were subprime in that time.

In contrast, only a small percentage of loans sold by established local banks were subprime. None of the nearly 1,000 metro loans that Kansas City mortgage banker James B. Nutter & Co. made was subprime.

Ironically, Clay bought his Ruskin Heights home in 2000 with a conventional 30-year loan from Nutter & Co. It was for $76,000 with a fixed 6.5 percent interest rate.

Company president James Nutter Jr. questioned why Clay was directed into a costlier subprime loan when he refinanced his house in 2004. Nutter said that Clay— even with more debt — probably would have qualified for a cheaper conventional loan from his company or another local lender.

“Especially with him being a veteran,” Nutter said, noting that some brokers appeared to steer lower-income borrowers into subprime loans “to make more money.”

Wall Street connection

Soaring subprime profits quickly attracted Wall Street investors.

As fast as brokers sold more teaser-rate loans, they quickly bundled them into packages and sold them like securities to investors, who pumped even more money into the subprime market.

The Compliance Technologies study showed that more than half of the subprime loans made in Kansas City's 5th District were securitized and sold off to investors.

"Originators were making loans based on quantity rather than quality," said Kurt Eggert, a law professor at Chapman University in Orange, Calif., who served on the Federal Reserve's consumer advisory counsel. "They made loans even when they didn't make sense from an underwriting standpoint."

Mark Duda, a research affiliate at Harvard University's Joint Center for Housing Studies, said that because brokers were so intent to quickly sell off loans to investors, they had little incentive to make sure the loans were suitable for borrowers.

"They were setting people up to fail," Duda said.

By sheer numbers, more whites got subprime loans — but as a percentage, blacks were more likely to be steered into subprime loans and usually paid more for them.

An analysis by *The Kansas City Star* of home-purchase loans from 2004 to 2006 in the metro area showed that blacks were placed in subprime loans nearly 50 percent of the time and Hispanics about 32 percent of the time. Whites, however, got subprime loans only 16 percent of the time.

These findings are supported by Compliance Technologies' analysis. Examining a larger pool of both home-purchase and refinance loans in the 5th District, the firm found that last year blacks were placed in subprime home-purchase or refinance loans nearly 66 percent of the time.

That compared with 41 percent for Hispanics and 29 percent for whites.

Blacks also were consistently charged an interest rate that was at least a half a percentage point higher, said Maurice Jourdain-Earl, the managing director of Compliance Technologies — meaning, "all things being equal, their monthly mortgage payments are going to be higher."

U.S. Rep. Emanuel Cleaver, a Democrat who represents the 5th District, contends that brokers knew some minorities were less sophisticated about buying homes.

"This was designed to ensnare Latinos and African-Americans," said Cleaver, a member of the House Financial Services Committee. "These brokers get their money on the front end. So they don't care. They're gone."

Subprime implosion

As adjustable interest rates climbed, many subprime borrowers could not make their payments. In some cases, homeowners and real-estate investors also had tapped all the equity from their homes. As prices fell, they owed more than their homes were worth.

When the new homeowners couldn't sell or refinance their homes, they often walked away from them. As the inventory of unsold houses grew, prices plummeted even more.

In 2004 and 2005, homes nationally were appreciating, on average, more than 12 percent a year, according to Federal Reserve data. By 2007, they were *losing* about 1.5 percent in value each year. Kansas City homes went from appreciating an average of 4.5 percent a year to dipping nearly 1 percent in value.

Wall Street investors now are left holding worthless real-estate securities. Subprime lenders are stuck with billions of dollars in bad loans, which they have had to write off. Many are going broke.

"It's like any Ponzi scheme," said Duffy of Legal Aid. "Artificially high values drive more investments, that drive more artificially high values, that drive more investments, until the values get unrealistically high and the whole scheme collapses. That's what you see now."

Ruben Flores, a Johnson County real-estate investor, worked as a loan officer in NovaStar's loss-mitigation office in May when things started collapsing.

"It was like triage," he recalled.

Flores said that loan officers — each handling portfolios of 200 or more borrowers — worked 70 to 80 hours a week trying to salvage as many souring loans as possible.

But the losses have left once-high-flying NovaStar struggling to stay out of bankruptcy. Option One has shuttered its business and plans to write off $125 million in bad loans. Wells Fargo and other big national banks have cut back or stopped making new subprime loans.

Meanwhile, Congress is grappling with ways to help homeowners clean up the mess and make sure it doesn't happen again — including tougher regulations and penalties.

The good news is that tighter underwriting standards are being restored. The bad news is that foreclosures probably will continue to haunt neighborhoods such as Clay's for at least another year.

Foreclosures, however, ripple throughout communities, lowering home values, decreasing tax revenues, and inviting blight and crime. So even if you didn't have a subprime loan, you probably will feel their pain in 2008.

"Subprime problems have become everyone's problem," said Martin Eakes, the chief executive officer of the Center for Responsible Lending.

A look at where subprime loans and foreclosures are most prevalent in the KC metro area. **| A15**

WHAT'S A SUBPRIME LOAN?

Subprime loans are generally defined as those given to borrowers with weak or damaged credit. Lenders charge higher interest rates because the loans are seen as riskier.

METHODOLOGY FOR THE DATA ANALYSIS/MAPS

The home-loan data used for this analysis comes from the Home Mortgage Disclosure Act database, which is compiled by the Federal Financial Institutions Examination Council.

The data include millions of records from all home-loan applications, but for the purposes of this study, much of the information was not considered. The only records that were analyzed were for loans in Kansas or Missouri that were used to purchase a one- to four-family home, which means homes that were not apartment buildings.

Refinancing loans, home-improvement loans and loans not secured by a first lien were not considered.

Only records from 2004 through 2006 were analyzed because prior to 2004 the Federal Financial Institution Examination Council did not have an indicator for subprime loans.

A subprime loan is any loan with an interest rate 3 or more percentage points higher than the Federal Treasury yield on securities, according to the Federal Financial Institutions Examination Council.

The home-mortgage data were joined to the map based on census tract numbers and state and county identifiers. The maps accompanying this story were assembled using census tract shape files obtained from the Missouri Spatial Data Information Service and the Kansas Geospatial Community Commons.

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Renters get caught in mortgage crunch

By PAUL WENSKE - The Kansas City Star

Michelle Johnson never expected to lose her home in the subprime mortgage mess.

After all, she rents.

So she was stunned last month when she was served eviction papers at her Kansas City home of five years — not because she did anything wrong, but because her landlord defaulted on his loan.

“It’s outrageous. It’s unfair,” said Johnson, who works as a medical billings clerk and was packing last week with her daughter Monica, 14. “We paid our rent.”

Many Americans losing their homes in the country’s foreclosure crisis are like the Johnsons. They never signed an unaffordable mortgage. Their only mistake was renting from a landlord who did.

When the homes slid into foreclosure, lenders — who argue that they aren’t prepared to manage a portfolio of rental properties — evict tenants, sometimes giving them only days to clear out.

While there are no solid statistics, experts are convinced that the number of tenants evicted because of foreclosures is rising, yet another troubling sign of the subprime pain rippling through the U.S. economy.

Experts say an estimated 1.4 million homes expected to enter foreclosure resulted not just from overextended homeowners with shaky credit but from overleveraged investors who sought to profit from the housing boom, then walked away when the market and their investments tanked. Losses could exceed $223 billion.

A recent Mortgage Bankers Association survey found that about one in five foreclosed homes involves borrowers who do not live at the same address. Missouri and Kansas statistics reflect those findings.

Poorer neighborhoods often fared the worse. More than half the foreclosures in some urban ZIP codes in Kansas City involve owners with different mailing addresses, according to RealtyTrac, an online Web site that follows foreclosures.

“At first we just saw homeowners. Now we’re seeing more tenants at risk of being homeless,” said Pat Gilmore-Wilkins, executive director of the Greater Kansas City Housing Information Center, a counseling agency. “People call us frantic — from both sides of the state line.”

Judith Liben, housing attorney at the Massachusetts Law Reform Institute in Boston, said evicted tenants are collateral damage of a speculative market gone awry — leaving behind devastated families and scarred neighborhoods where vacant houses attract crime and force property values down.

Some states have adopted measures to give such tenants more time to remain in a home. Proposals pending in Congress would require new owners to keep a lease in effect for six months after a foreclosure.

John Meacham, a Mortgage Bankers Association spokesman, acknowledges there’s a growing problem. But he said lenders’ hands are often tied.

“The problem is that lenders aren’t qualified to be landlords,” Meacham said, noting that most lenders want to sell the foreclosed homes as fast as they can and recover their losses.

Besides, he added, most landlords know at least 90 days in advance that their properties are facing foreclosure.

“The landlord has the moral duty to tell the tenant,” Meacham said.

But sometimes they don’t. Johnson, her daughter, and fiance Terry Standifer paid $750 a month for their two-bedroom rental home in the 7300 block of Wabash Avenue.

“We loved living here,” Johnson said. “We always took care of the home like it was ours.”

She said they didn't suspect anything until they began getting letters last year addressed to someone she didn't know — who she said she later learned was her landlord.

Then the Johnsons received notice on Dec. 18 from a St. Louis law firm giving them 10 days to vacate the premises. If they didn't leave, the notice said, they would be forcefully evicted by the sheriff and face damages, attorney fees and "double the rental value" of the house until they did.

Court records show their landlord had defaulted on one of two loans on the property, which together totaled about $100,000. Records also showed Johnson's landlord had at one time owned three other urban Kansas City houses, at least two of which also are in foreclosure.

The landlord, Scott Devita, declined comment on the foreclosure. Johnson said she never met or talked with him.

Records show one of the loans on Johnson's home had been sold by the original lender to the Federal National Mortgage Association — better known as Fannie Mae, the giant quasi-governmental entity that buys billions of dollars in mortgages in what's referred to as the secondary loan market.

It's the buying and selling of high-cost loans like stocks that many experts say accounted for problem subprime loans spreading quickly through the economy and causing the current financial emergency.

Fannie Mae officials declined to comment on proceedings against Johnson. They did, however, offer Johnson $500 to cover moving costs if she agreed to leave quickly, part of a program known as "cash for keys." Fannie Mae officials said they help tenants work "through their transition to a new home."

But Johnson refused the offer.

"You can't move anywhere on $500," she explained.

Instead, she went to court. In Missouri and Kansas, tenants have fewer rights when a lender starts eviction proceedings based on a loan foreclosure than they do in situations where a landlord is kicking them out for other reasons. Because of that, experts say, many tenants take the moving money instead of going to court.

At a recent eviction hearing, Johnson and Standifer won a delay until Thursday, giving them time to pack and find a new place to live.

Charles L. Stitt, a retired Jackson County Circuit Court judge who continues to hear landlord-tenant cases to ease the workload on other judges, said he's seeing more foreclosure evictions.

"These cases are harder," Stitt said. "Lenders are suing the owner of the property, and they don't know who the tenant is."

Frank O'Gara, a court deputy in the civil process department, said he is handling more foreclosure evictions than ever.

"You really feel bad," O'Gara said. "They (tenants) say, 'Hey, I've been paying my rent.' I explain it's regrettable. However, payments haven't been made to the banks."

Kelly Edmiston, a Federal Reserve economist, said it's not surprising many investment properties are falling into foreclosure. Edmiston said many investors were overleveraged, obtaining first and second mortgages to cover 100 percent of the houses they bought.

"They were betting the houses would continue to appreciate," he said. "It's like a stock in the sense that for a lot of people it was just an investment."

Because such purchases posed more risk, lenders charged investors higher interest rates, akin to the subprime rates they charged first-time homebuyers with poor credit. So when the housing bubble burst, many investors "owed more on their properties than they were worth" and abandoned them, Edmiston said.

In fact, a Mortgage Bankers Association study found that real estate investors were faster than first-time homebuyers to allow a loan to default.

"Rather than throwing good money after bad by continuing to make payments, these borrowers will stop making payments rather abruptly," according to the study.

Making matters worse is that many inexperienced investors bought multiple homes, in some cases a dozen or more, said Tim Harrison, an Overland Park real estate consultant who is on a task force dealing with Kansas City's vacant houses.

Harrison said that in many cases houses were bought and sold in ways that resulted in their values becoming artificially higher than other homes in the neighborhood.

"For years, everyone knew what was going on," he said. "Houses were treated like commodities instead of homes."

Johnson and her family have found another rental home in the same neighborhood — but it's costing them $2,000 to move.

"I can't believe no one can do anything about this," Johnson said. "We can't be the only ones this is happening to."

To help avoid a surprise foreclosure eviction, renters can:

•Make sure they know how to contact their landlord.

•Research their landlord in county property records, often available online.

•Check online civil court records that may also show foreclosures.

•Seek counseling from a lawyer who handles tenant disputes.

If served with an eviction notice:

•Often a lender will offer cash — between $500 and $1,500 — to leave early.

•You might negotiate with a lender for more time to find another place to live.

•You can try to buy the house from the lender or out of foreclosure.

•You can choose to go to court to seek a delay of the eviction.

•For housing questions, call the Greater Kansas City Housing Information Center at 816-931-0443.

To reach Paul Wenske, call 816-234-4454 or send e-mail to pwenske@kcstar.com.

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