



## Meeting the Challenge of Preventing Foreclosures

**Todd Frederick Swanstrom**, University of Missouri, St. Louis

When one house in a neighborhood catches fire, firefighters arrive right away – to save that home, if possible, and also to make sure the flames do not spread to adjacent homes and businesses. Firefighters do not stop to ask if the homeowner was smoking in bed. They act to save lives and property, no matter who is to blame for the fire.

Why don't we see the same sense of urgency in America's current mortgage foreclosure crisis? Some say we shouldn't help people who have made bad choices in the housing market, because helping homeowners in trouble will only encourage others to get in over their heads financially. But like fires, foreclosures can easily hurt neighbors and entire communities. We should act to protect the public.

### The Spillover Costs of Foreclosures

Families that go through a foreclosure bear many costs. Forced to move, their social networks are disrupted. Access to credit is damaged. The shame of failure hangs over their heads. And many of the victims are innocent children. Over eight million youngsters have already been directly affected by foreclosures. Children lose their bearings, friendships fall away, and schooling is disrupted. The entire community pays when children do less well in school and life.

Surrounding families often suffer too, even if their finances were originally in perfect order. Though often unnoticed, spillover effects can be even greater than direct costs:

- **Declining property values.** Research documents losses in value of about one to two percent for every property within one-eighth of a mile (660 feet) of a single foreclosure. Concentrated foreclosures in a neighborhood can devastate property values across the board. In the current crisis, homeowners who never went through a foreclosure have suffered trillions of dollars of lost property values. Many end up "underwater," owing more on their mortgage than their home is worth. This of course brings more foreclosures.
- **Social disorder and crime:** Foreclosures are associated with increases in violent crime. The disruption of the community spurred by foreclosures destroys social capital and undermines people's capacity to work together on public problems.
- **Stress for local governments:** Amidst spreading foreclosures, local governments face increased costs even as they collect less from property taxes. A foreclosed home that is quickly resold may cost a municipality only about \$400 in administrative costs. But a vacant and abandoned structure can cost the local government over \$34,000 in added costs – for example, for extra firefighting services or

demolition costs.

## Governments Can Act

To prevent future foreclosure epidemics, the new federal Consumer Financial Protection Bureau can outlaw the kinds of predatory loans that started the current crisis. A predatory loan is one whose high interest rate or fees are not justified by the additional risk to the lender. Many types of loans and mortgage practices make no sense, such as penalizing borrowers for paying off a loan early or giving bonuses to loan officers who urge borrowers to take more expensive mortgages.

But what can the federal government do about homeowners who are facing foreclosure now? The goal should be to modify loans so that more families can stay in their homes. In many cases, loan modifications would help both the homeowners and the investors who own the mortgage (because a foreclosed home loses 50 percent or more of its value). Borrowers can stay in their homes and lenders still end up ahead – a win-win situation. Here are ways to do it:

- **Encourage loan modifications.** The Obama administration's Home Affordable Modification Program provides incentives to lenders and homeowners to modify loans. Although too few have been helped so far, up to a million homeowners will eventually benefit, and the program can be expanded.
- **Include foreclosures in personal bankruptcies.** Current federal loan modification programs have carrots and no sticks. If judges could reduce principal or interest on home loans in personal bankruptcies, then lenders would have more motivation to modify loans.
- **Help homeowners with government-owned mortgages.** The U.S. government backs enterprises such as Fannie Mae that own millions of mortgages. Such taxpayer-backed enterprises should agree to reduce the principal owed in cases where homeowners are underwater but could still afford to make regular monthly payments. Research shows this approach can save the government money while helping many families and communities.
- **Expand counseling to people facing foreclosures.** The federal government has funded nonprofit groups to provide free foreclosure counseling, and funding should be expanded. According to a recent study, compared to people who receive no counseling, homeowners who receive counseling see monthly payments reduced and are 70 percent more likely to avoid foreclosure.

Local governments can also take useful steps. Locally supported counseling efforts, such as those in Cleveland and Chicago, have proved cost-effective. Programs in which lenders and borrowers appear before a neutral mediator to work out a mutually agreeable solution have helped in states like Nevada and cities such as Philadelphia. Regional data systems can provide an early warning of cascading foreclosures, so early interventions can prevent the worst.

## It's Not Too Late

Many people think that the foreclosure crisis is behind us. It isn't. Although delinquencies are down from the peak, the foreclosure rate nationwide has remained at historically high levels for years now. Millions of American families are likely to suffer through foreclosures in the next few years. Now is the time to head off

deeper and longer-lasting harm – not just for those families, but for their neighbors and communities, too.