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HOME MORTGAGES

Recent Performance of Nonprime Loans Highlights the Potential for Additional Foreclosures

Statement of William B. Shear, Director
Financial Markets and Community Investment



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Chair Maloney and Members of the Joint Committee:

I am pleased to be here today to discuss the performance of the nonprime mortgage market as of March 31, 2009, which includes subprime and Alt-A loans.¹ Nonprime loans accounted for an increasing share of the overall mortgage market from 2000 through 2006, rising from 12 percent to 34 percent. Over this period, the dollar volume of nonprime mortgages originated annually climbed from \$100 billion to \$600 billion in the subprime market and from \$25 billion to \$400 billion in the Alt-A market.² However, in the summer of 2007, the subprime and Alt-A market segments contracted sharply, partly in response to a dramatic increase in default and foreclosure rates for these mortgages. As of the first quarter of 2009, approximately 1 in 8 nonprime mortgages were in the foreclosure process. These developments have prompted greater scrutiny of lending practices in the nonprime market, a number of government efforts to modify troubled loans, and proposals to strengthen federal regulation of the mortgage industry.

My statement is based on a report being released at this hearing, titled *Characteristics and Performance of Nonprime Mortgages*.³ To prepare the report, we analyzed data from LoanPerformance's (LP) Asset-backed Securities database for nonprime loans originated from 2000 through 2007. The database contains loan-level data on nonagency securitized mortgages in subprime and Alt-A pools.⁴ About three-quarters of nonprime mortgages have been securitized in recent years, and the LP data cover the vast majority of them. The report includes a detailed description of our scope and methodology. We conducted our work in accordance with all sections

¹Although the categories are not rigidly defined, subprime loans feature higher interest rates and fees and are generally made to borrowers who have tarnished credit histories. Alt-A loans are generally for borrowers whose credit histories are close to prime, but the loans have one or more high-risk features such as limited documentation of income or assets.

²See Inside Mortgage Finance, *The 2009 Mortgage Market Statistical Annual*, (Bethesda, Md., 2009), 4.

³GAO, *Characteristics and Performance of Nonprime Mortgages*, [GAO-09-848R](#) (Washington, D.C.: July 28, 2009).

⁴LP is a unit of First American CoreLogic, Incorporated. Nonagency mortgage-backed securities (MBS), also known as private-label MBS, are backed by nonconforming conventional mortgages securitized primarily by investment banks. Nonconforming mortgages are those that do not meet the purchase requirements of Fannie Mae or Freddie Mac because they are too large or do not meet certain underwriting criteria.

of GAO's Quality Assurance Framework that are relevant to our objectives.

My statement discusses (1) trends in the loan and borrower characteristics of nonprime mortgages originated from 2000 through 2007; (2) the performance of these mortgages by market segment, product type, and geographic location as of March 31, 2009; and (3) the performance of recent nonprime loan cohorts as of that date.⁵

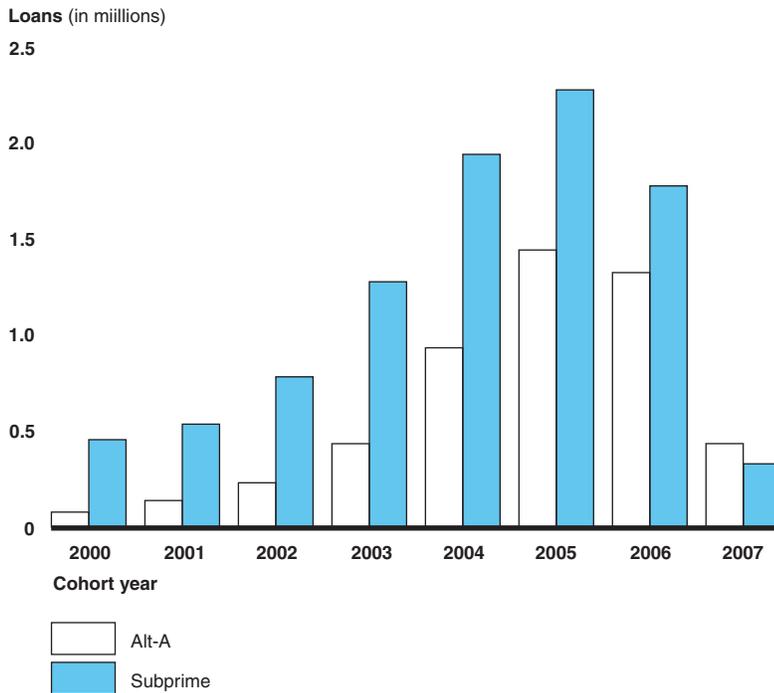
Nonprime Mortgage Lending Increased from 2000 through 2006 and Included Many Loans with Features Associated with Poor Loan Performance

Nonprime mortgage originations grew rapidly from 2000 through 2005 before sharply contracting in mid-2007 (see fig. 1). Subprime mortgages accounted for approximately two-thirds of the increase in nonprime originations over that period rising from 457,000 in 2000 to 2.3 million in 2005 before declining somewhat in 2006.⁶ Alt-A originations, although a smaller share of the nonprime market, increased at an even faster rate than subprime originations, increasing 18-fold from 2000 through 2005. From 2000 through 2007, an increasing proportion of subprime and Alt-A mortgages had loan and borrower characteristics that have been associated with a higher likelihood of default and foreclosure. These characteristics include adjustable interest rates, less than full documentation of borrower income and assets, and higher borrower debt burdens. For example, from 2000 through 2007, the percentage of Alt-A mortgages that did not have full documentation rose from 60 percent to 80 percent. For subprime loans, the proportion of such mortgages grew from 20 percent to 38 percent, then decreased to 33 percent. This loan feature was originally intended for borrowers who have difficulty documenting their income, such as the self-employed, but it eventually became more widespread. Such loans can be problematic if borrowers or loan originators overstate income or assets to qualify borrowers for mortgages they may not be able to afford.

⁵A loan cohort is a group of loans originated in the same year.

⁶As previously noted, the data we used for our analysis do not cover the entire nonprime market but do cover the large majority of nonagency securitized mortgages within that market. Nonprime mortgages that were not securitized (i.e., mortgages that lenders held in their portfolios) may have different characteristics and performance histories than those that were securitized.

Figure 1: Number of Subprime and Alt-A Originations by Cohort Year, 2000-2007



Source: GAO analysis of LP data.

Serious Delinquency Rates Were Highest for Subprime Loans and Certain Adjustable Rate Mortgages and Varied by State

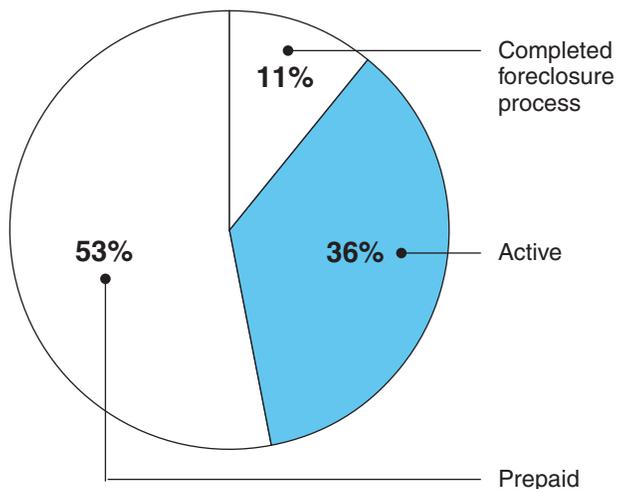
Approximately 1.6 million of the 14.4 million nonprime loans originated from 2000 through 2007 had completed the foreclosure process as of March 31, 2009. Of the 5.2 million loans that were still active at the end of March—that is, that had not been prepaid or completed the foreclosure process—almost one-quarter were seriously delinquent, meaning they were either 90 or more days behind in payments or already in the foreclosure process (see fig. 2).⁷ As a result, hundreds of thousands of additional nonprime borrowers are at risk of losing their homes in the near future. Within the subprime market segment, about 28 percent of active loans were seriously delinquent, and within the active Alt-A segment, the serious delinquency rate was about 17 percent. Within both segments, serious delinquency rates were even higher for certain adjustable-rate

⁷In comparison, as of the first quarter of 2007, active nonprime loans originated from 2000 through 2005 had a serious delinquency rate of 7.4 percent.

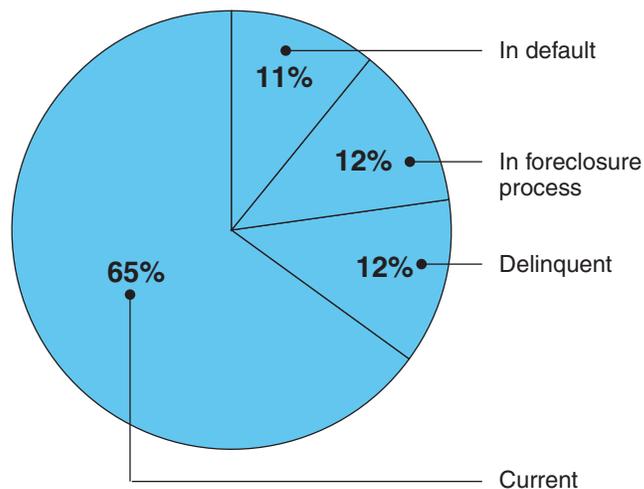
mortgages (ARM). For example, in the subprime market the serious delinquency rate for short-term hybrid ARMs—which feature a fixed interest rate for 2 or 3 years and an adjustable rate thereafter—was 38 percent as of March 31, 2009. In the Alt-A market, the serious delinquency rate for payment-option ARMs—which allow borrowers to make payments lower than what would be needed to cover any of the principal or all of the accrued interest—was approximately 30 percent. The rates varied widely by location. At the state level, California, Florida, Illinois, Massachusetts, Nevada, and New Jersey had the highest rates as of March 31, 2009. Each state had rates above 25 percent, and Florida’s rate of 38 percent was the highest in the country. In contrast, 12 states had serious delinquency rates of less than 15 percent, including Wyoming’s rate of 9 percent, which was the lowest in the country.

Figure 2: Percentage of All Nonprime Loans and All Active Nonprime Loans Originated from 2000 through 2007, by Performance Status, as of March 31, 2009

All nonprime loans



Active nonprime loans



Source: GAO analysis of LP data.

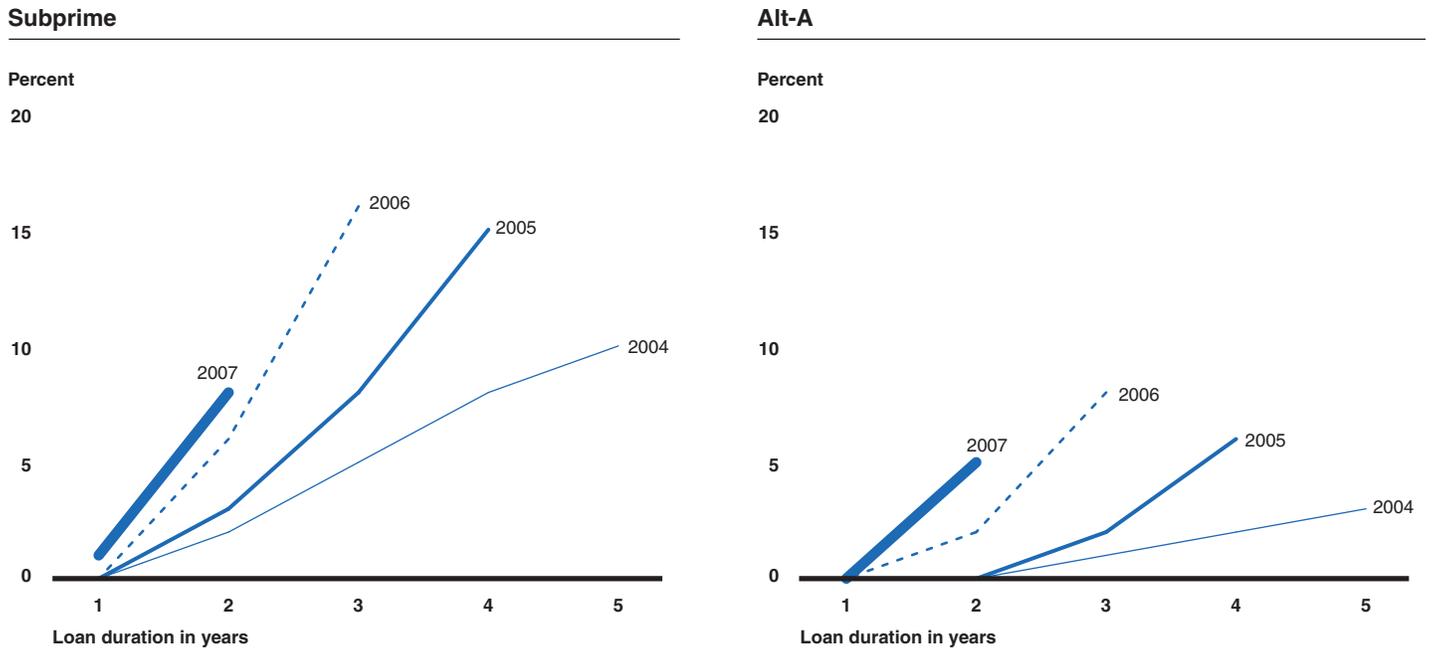
Recent Loan Cohorts Accounted for Most of the Serious Delinquencies and Had Successively Higher Cumulative Foreclosure Rates

Mortgages originated from 2004 through 2007 accounted for the majority of troubled loans. Of the active subprime loans originated from 2000 through 2007, 92 percent of those that were seriously delinquent as of March 31, 2009, were from those four cohorts. Furthermore, loans from those cohorts made up 71 percent of the subprime mortgages that had completed the foreclosure process. This pattern was even more pronounced in the Alt-A market. Among active Alt-A loans, almost all (98 percent) of the loans that were seriously delinquent as of March 31, 2009, were from the 2004 through 2007 cohorts. Likewise, 93 percent of the loans that had completed the foreclosure process as of that date were from those cohorts.

Cumulative foreclosure rates show that the percentage of mortgages completing the foreclosure process increased for each successive loan cohort (see fig. 3). Within 2 years of loan origination, 2 percent of the subprime loans originated in 2004 had completed the foreclosure process, compared with 3 percent of the 2005 cohort, 6 percent of the 2006 cohort, and 8 percent of the 2007 cohort. Within 3 years of loan origination, 5 percent of the 2004 cohort had completed the foreclosure process, compared with 8 percent and 16 percent of the 2005 and 2006 cohorts, respectively. The trend was similar for Alt-A loans, although Alt-A loans foreclosed at a slower rate than subprime loans. For example, within 3 years of origination, 1 percent of Alt-A loans originated in 2004 had completed the foreclosure process, compared with 2 percent of the loans originated in 2005, and 8 percent of the loans originated in 2006.⁸

⁸Three-year foreclosure rates for the 2007 cohort will not be available until 2010. However, as of March 31, 2009, the subprime and Alt-A cumulative foreclosure rates for the 2007 cohort were 10 percent and 7 percent, respectively.

Figure 3: Cumulative Percentage of Subprime and Alt-A Loans that Completed the Foreclosure Process by Cohort Year, 2004-2007



Source: GAO analysis of LP data.

This trend is partly attributable to a stagnation or decline in home prices in much of the country beginning in 2005 and worsening in subsequent years. This situation made it more difficult for some borrowers to sell or refinance their homes to avoid default or foreclosure. In addition, borrowers who purchased homes (particularly for investment purposes) but now owed more than the properties were worth, had incentives to stop making mortgage payments in order to minimize their financial losses. The deterioration in credit quality for the successive cohorts may also reflect an increase in riskier loan and borrower characteristics, such as less than full documentation of borrower income and higher borrower debt burdens.

Our full report provides additional information on the performance of nonprime loans, including breakdowns by Census division and congressional district. In two subsequent reports we are preparing at the request of the Chair and Vice Chair of the Joint Committee, we will provide additional information on the condition of the nonprime mortgage market. These reports will include examinations of the extent of negative home equity among nonprime borrowers; the influence of different loan,

borrower, and economic variables on the likelihood of default; and sources of data on nonprime loans. The reports will also update the information we are issuing today on the performance of nonprime loans.

Madam Chair, this concludes my prepared statement. I would be happy to answer any questions you or other members of the Joint Committee may have.

Contacts and Staff Acknowledgements

For further information about this testimony, please contact William B. Shear, Director, at 202-512-8678 or shearw@gao.gov. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Steve Westley (Assistant Director), Eric Charles, Colleen Moffatt, Jamila Kennedy, DuEwa Kamara, John Mingus, and Marc Molino.

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