Struggling to Stay Afloat: Negative Equity in Communities of Color in the Chicago Six County Region

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Introduction

The prevalence of homes with negative equity—in which homeowners owe more than their homes are currently worth—prolongs the foreclosure crisis and delays economic recovery. Homeowners with negative equity are often referred to as being underwater. This report illustrates the extent of negative equity in Chicago region communities of color and makes policy and practice recommendations to help homeowners with underwater mortgages who are struggling to stay afloat.

Home values across the nation have dropped by more than 30 percent over the course of the foreclosure crisis.[1] This drop can be explained, in part, by the large number of foreclosed properties which, with few exceptions, fail to sell at auction and are often listed at significant discount. Foreclosed homes, particularly vacant properties, can become blighted and contribute to higher levels of violent crime that further reduce property values.[2]

The foreclosure crisis hit the Chicago region hard, particularly in communities of color and low-wealth communities. New foreclosures in the Chicago six county region (Cook, DuPage, Kane, Lake, McHenry, and Will Counties) grew by 205 percent from 21,302 in 2005, before the onset of the foreclosure crisis, to 64,877 in 2011. Since 2007, the region has seen more than 40,000 foreclosure filings every year, with a high of 70,122 in 2009. At the same time that foreclosures grew increasingly prevalent across the region, home values fell substantially. Between December 2006 and December 2011, home values fell by 34 percent in the Chicago Metropolitan Statistical Area.[3]

Woodstock Institute research shows that the foreclosure crisis has disproportionately burdened the Chicago region's communities of color and low-wealth communities. For example, as of the end of 2008, 64 percent of Chicago's vacant, lender-owned properties were concentrated in highly African American communities and those properties remained on the market 25 percent longer and lost more value than did similar properties in other communities.[4] In addition, there is an extreme concentration in Chicago's African American communities of abandoned properties in the process of foreclosure.[5] The characteristics of vacant properties that negatively influence community stability are therefore concentrated in Chicago's communities of color, putting them at increased risk of greater property value declines compared to other communities in the region.

The cumulative effect of elevated levels of foreclosure contributes to declining home values, affecting homeowners seeking to move, as well as those struggling to make payments on mortgages which, for many homeowners, exceed the value of their home. Research shows that foreclosures reduce the value of nearby properties by 1 to 10 percent.[6]

[1] S&P/Case-Shiller Seasonally Adjusted U.S. National Index Levels, fourth quarter of 2006 to fourth quarter of 2011.

[2] See Immergluck, Dan and Geoff Smith. "The Impact of Single Family Mortgage Foreclosures on Neighborhood Crime." Woodstock Institute, Chicago. 7 April 2005. See also Gould Ellen, Ingrid, Johanna Lacoe, and Claudia Ayanna Sharygin. "Do Foreclosures Cause Crime?" Furman Center for Real Estate and Urban Policy, New York University. 23 June 2011.

[3] S&P/Case-Shiller Seasonally Adjusted Home Price Index Levels, December 2006 to December 2011.

[4] Smith, Geoff and Sarah Duda. "Roadblock to Recovery: Examining the Disparate Impact of Vacant Lender-Owned Properties in Chicago." Woodstock Institute, Chicago. 29 September 2009.

[5] Smith, Geoff and Sarah Duda. "Left Behind: Troubled Foreclosed Properties and Servicer Accountability in Chicago." Woodstock Institute, Chicago. 12 January 2011.

[6] See Immergluck, Dan and Geoff Smith. "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values." Woodstock Institute, Chicago. 14 June 2005. See also Whitaker, Stephan and Thomas J. Fitzpatrick. "The Impact of Vacant, Tax-Delinquent, and Foreclosed Property on Sales Prices of Neighboring Homes." Federal Reserve Bank of Cleveland, September 2011.

More than 11 million homes with mortgages across the country now have negative equity totaling $717 billion in negative equity nationwide.[7]

The following analysis examines patterns of negative equity in communities of different racial and ethnic compositions in the Chicago six county region. It combines 2011 data on negative equity in Chicago region ZIP codes with U.S. Census data on the racial/ethnic composition of ZIP Code Tabulation Areas (ZCTA). It finds that negative equity is disproportionately concentrated in the Chicago region's African American, Latino, and majority minority neighborhoods, and that borrowers in communities of color have much lower equity than do borrowers in predominantly white communities. This report concludes with recommendations to reduce the impact of declining property values and the number of homeowners with negative equity, including broader use of principal reduction loan modifications and short sales.

Negative equity and community stability

Negative equity is a destabilizing force in communities for a number of reasons. Negative equity is a significant driver of foreclosure. In many cases, negative equity can create a cycle in which a growing number of concentrated foreclosures exacerbates the decrease in property values, which further weakens the financial condition of neighboring homeowners, which can lead to additional foreclosures. Research indicates that while it is unlikely that slightly underwater homeowners will default if they can still afford the monthly payments, homeowners with a loan-to-value (LTV) ratio exceeding 110 percent (meaning that the outstanding mortgage debt is 10 percent more than the value of the property) are more likely to default on their loans.[8] The likelihood of default increases with the extent of negative equity; a report from the Government Accountability Office found that homeowners with LTV ratios exceeding 150 percent were seven times as likely to go into foreclosure than homeowners with some equity in their homes.[9]

Negative equity also influences the outcomes of foreclosure prevention actions. If a homeowner is able to avoid foreclosure by obtaining a loan modification, his or her chances of defaulting on the loan modification (called "re-defaulting") is much higher if the issue of negative equity is not addressed. One study examining subprime mortgagees who received loan modifications estimated that a homeowner with negative equity is one-quarter as likely to re-default on his or her loan modification if the modification includes a reduction of mortgage principal.[10]

Negative equity also appears to be correlated with mortgages that contain exotic, less sustainable characteristics. One study found that 80 percent of nonprime borrowers with payment-option Adjustable Rate Mortgages (ARMs) and 75 percent of nonprime borrowers with short-term hybrid ARMs had negative equity in their homes, compared to 39 percent of nonprime borrowers with fixed-rate mortgages.[11]

Even when negative equity does not result in default and foreclosure, it can reduce neighborhood wealth and stability and limit opportunities for homeowners to use home equity to finance retirement, higher education, or entrepreneurship. Underwater homeowners also encounter challenges when trying to sell their homes, since the sale is often contingent upon the loan servicer approving a short sale. Options to refinance underwater loans are often limited as well, though policymakers have recently expanded programs designed to facilitate refinancing of loans with negative equity. Additionally, research indicates that homeowners with underwater mortgages are less inclined

[7] "Corelogic Reports Negative Equity Increase in Q4 2011." Corelogic, 1 March 2011.

[8] See Bhutta, Neil, Jane Dokko, and Hui Shan. "The Depth of Negative Equity and Mortgage Default Decisions." Federal Reserve Board Finance and Economics Discussion Series, May 2010. See also Guiso, Luigi, Paola Sapienza, and Luigi Zingales. "Moral and Social Constraints to Strategic Default on Mortgages." University of Chicago Financial Trust Index, July 2009.

[9] "Troubled Asset Relief Program: Further Actions Needed to Fully and Equitably Implement Foreclosure Mitigation Programs." Government Accountability Office, June 2010.

[10] Haughwout, Andrew, Ebiere Okah, and Joseph Tracy. "Second Chances: Subprime Mortgage Modification and Re-Default." Federal Reserve Bank of New York Staff Reports, December 2009 (Revised August 2010).

[11] "Loan Performance and Negative Home Equity in the Nonprime Mortgage Market." Government Accountability Office, 16 December 2009.

to invest in the maintenance of their property, which contributes to neighborhood destabilization.[12] The destruction of assets caused by negative home equity may disproportionately threaten the economic security of people of color because home equity is a larger proportion of their net worth than it is for whites. More than half of the net worth of Latinos and African Americans in 2009 was attributable to home equity, compared to 38 percent for whites.[13] As home values continue to fall, and fall disproportionately in communities of color, homeowners of color have fewer resources to cushion the blow of lost wealth than their white counterparts have.

Data

This analysis uses proprietary data on home equity, property values, and outstanding mortgage debt on residential properties in the Chicago six county region as of the end of 2011. The data classify properties with mortgages based on the LTV ratio, aggregated by ZIP code. Within each zip code and LTV range, the data include the number of parcels with mortgages, total home value, total dollar amount of outstanding mortgage debt, total number of mortgages, and total dollar amount of equity. This data set was then merged with ZCTA data on population race and ethnicity from the 2010 Decennial Census in order to assess the extent of negative equity in communities of color in the Chicago region.

Findings

Nearly one in four residential properties in the Chicago six county region is underwater, with just under $25 billion of negative equity. Of the 1,649,389 residential properties with mortgages in the Chicago six county region in the fourth quarter of 2011, 405,413 are underwater. There is a total of $24.7 billion of negative equity in the Chicago six county region, for an average of $60,987 of negative equity per property. The average underwater property has 31.8 percent more outstanding mortgage debt than the property is worth.

Almost half of the properties in communities of color are underwater or nearly underwater. In highly African American communities in the Chicago six county region, 40.5 percent of borrowers are underwater, while another 5.4 percent are nearly underwater (see Fig. 1). Similarly, 40.3 percent of properties are underwater in predominantly Latino communities and 5.3 percent are nearly underwater. In communities where people of color comprise between 50 and 79.9 of the total population, 38.1 percent of borrowers are underwater and 5.4 percent of properties are nearly underwater.

In contrast, only 16.7 percent of properties in predominantly white communities are underwater, with another 4.4 percent nearly underwater. Borrowers in communities of color are more than twice as likely as are borrowers in white communities to have little to no equity in their homes.

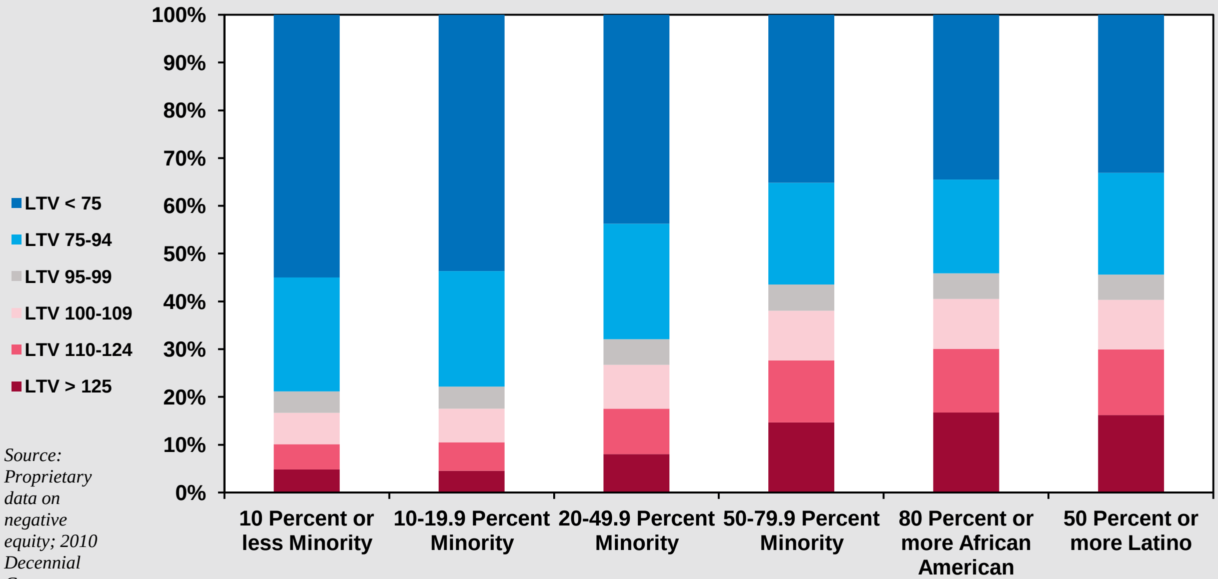
Almost one-third of the loans in communities of color are severely underwater. Research suggests that once the loan-to-value ratio is greater than 110 percent, a borrower is more likely to default on his or her loan.[14] In predominantly African American communities, 30.1 percent of properties have LTVs exceeding 110 percent, while that figure is 30 percent in predominantly Latino communities and 27.7 percent in majority minority communities. In contrast, just 10.1 percent of the properties in predominantly white communities have LTVs exceeding 110 percent. Almost three times as many properties in communities of color are severely underwater compared to properties in white communities.

Only about one-third of homeowners in communities of color have significant equity in their homes. In predominantly African American communities, 34.5 percent of borrowers have LTVs less than

[12] Melzer, Brian T. "Mortgage Debt Overhang: Reduced Investment by Homeowners with Negative Equity." Kellogg School of Management at Northwestern University Working Paper, August 2010.
[13] Kochhar, Rakesh. "Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics." Pew Research Center, 26 July 2011.
[14] See Bhutta, Dokko, Shan. See also Guiso, Sapienza, Zingales.

75 percent, while 35.2 percent of borrowers in majority minority communities and 33.1 percent of borrowers in Latino communities have more than 25 percent equity in their homes. Fifty-five percent of borrowers in predominantly white communities have more than 25 percent equity, meaning that borrowers in white communities are more than one and one-half times more likely to have significant equity in their homes as are borrowers in communities of color.

Figure 1. Loan-to-value ratios of properties with mortgages in Chicago six county region, fourth quarter of 2011

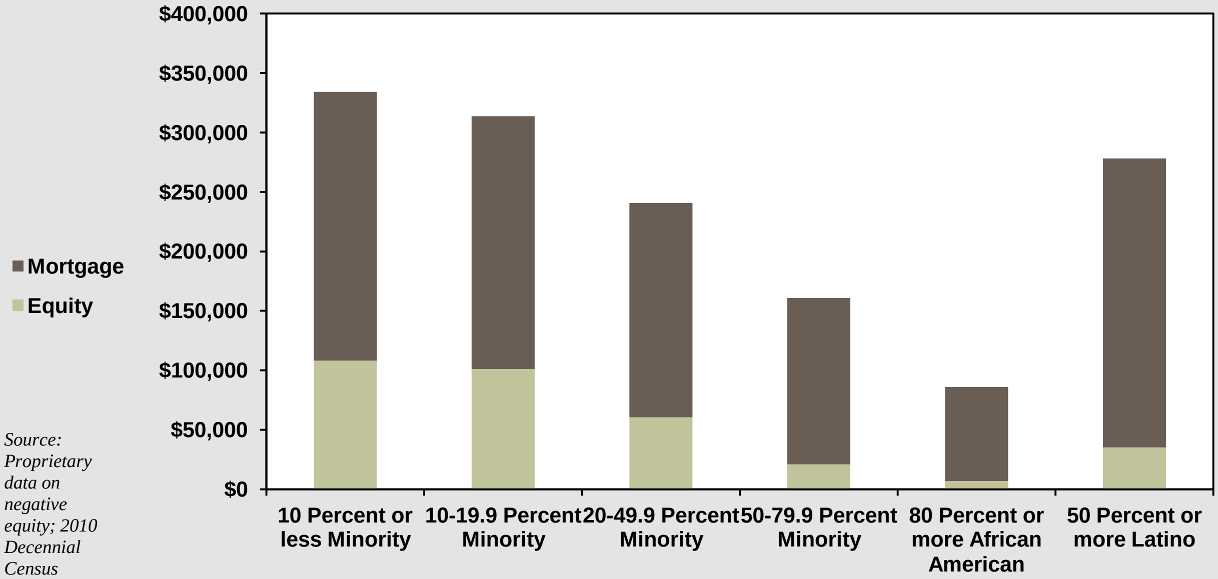


Source: Proprietary data on negative equity; 2010 Decennial Census

Borrowers in communities of color have much higher average loan-to-value ratios than do borrowers in predominantly white communities.

As Figure 2 shows, the average home value in predominantly white communities in the Chicago six county region is $334,292, which is almost four times the average home value in highly African American communities ($85,967), 1.2 times the average home value in Latino communities ($278,163), and 2.1 times the average home value in majority minority communities ($160,928). Compared to borrowers in communities of color, borrowers in white communities also have significantly higher home equity, both in terms of dollar amount and as a percentage of home value. On average, borrowers in predominantly white communities have $108,069 in home equity, which is 15.9 times the $6,800 average home equity in predominantly African American communities, 3.1 times more than the $35,174 average home equity in largely Latino communities, and 5.2 times the $20,761 average home equity in majority minority communities. The average LTV ratio is 92.1 in predominantly African American communities and 87.4 in Latino communities, compared with an average LTV ratio of 67.7 in predominantly white communities (see Table 1).

Figure 2. Average home equity and outstanding mortgage debt per property in the Chicago six county region, fourth quarter 2011



Source: Proprietary data on negative equity; 2010 Decennial Census

Table 1. Average home equity, values, and outstanding mortgage debt in the Chicago six county region, fourth quarter 2011

	Equity	Value	Mortgage	LTV
10 Percent or less Minority	$108,069	$334,292	$226,223	67.7%
10-19.9 Percent Minority	$101,152	$313,581	$212,429	67.7%
20-49.9 Percent Minority	$60,379	$240,833	$180,455	74.9%
50-79.9 Percent Minority	$20,761	$160,928	$140,167	87.1%
80 Percent or more African American	$6,800	$85,967	$79,167	92.1%
50 Percent or more Latino	$35,174	$278,163	$242,989	87.4%
Chicago six county region	$72,272	$260,847	$188,575	72.3%

Recommendations

The above analysis demonstrates that negative equity and its associated impacts are highly concentrated in the Chicago region's communities of color. The destabilizing effects of negative equity include increased likelihood of foreclosure, property disinvestment, diminished returns from foreclosure prevention programs, and decreased family and neighborhood wealth. The concentration of these elements in communities of color raises concerns that these communities will face particularly high barriers to economic recovery and neighborhood stabilization. Despite the established connection between negative equity and default, principal reduction loan modifications remain a widely underutilized tool in public and private foreclosure prevention programs. Loan servicers should reduce principal when doing so would increase the likelihood of preventing foreclosure. Some ways to address the problems of highly concentrated negative equity include:

- **Servicers should use principal reduction as a foreclosure prevention tool more broadly.** Currently, mortgage servicers rarely incorporate principal reduction when modifying troubled mortgages, opting instead to lower payments by reducing interest rates or extending loan terms.[15] While reducing interest rates and extending loan terms may be appropriate for borrowers experiencing problems with affordability, they do not adequately address the factors that contribute to default for underwater homeowners. Servicers should use principal reduction loan modifications more often when they reduce the likelihood of default on underwater loans. To alleviate concerns about moral hazard, servicers could incorporate a shared equity component to the modification in which investors receive a portion of the home value appreciation at resale.

- **The Federal Housing Finance Authority (FHFA) should permit loans backed by Fannie Mae and Freddie Mac to be eligible for principal reductions.** One reason why principal reduction loan modifications have been so scarce is that the conservator of Fannie Mae and Freddie Mac (Government Sponsored Enterprises, or GSEs), the Federal Housing Finance Authority, does not permit principal writedowns on loans backed by the GSEs. The GSEs have a significant market share, comprising 60 percent of all loans serviced.[16] This means that a large percentage of underwater borrowers do not have access to a principal reduction loan modification, even if it could prevent foreclosure. The FHFA should explore ways to make principal reduction an option for GSE-backed loans, especially in light of recently announced incentives to encourage GSEs to write down principal as part of the Home Affordable Modification Program.[17]

- **Servicers should streamline processes for short sales.** Negative equity poses challenges when a homeowner wants to sell his or her home, since it is unlikely that the homeowner will be able to sell the home at a price that will cover the outstanding mortgage debt. A short sale allows the homeowner to sell at a price lower than the outstanding debt, while the servicer agrees to forgive, forbear, or set up a payment plan for the remaining debt not covered by the sale price. While this option can benefit both servicers and homeowners by avoiding the costly process of foreclosure, short sales often take longer to complete than conventional sales, which can deter potential buyers. Servicers should continue initiatives to streamline the short sale process.

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[15] "OCC Mortgage Metrics Report: Disclosure of National Bank and Federal Savings Association Mortgage Loan Data, Third Quarter 2011." Office of the Comptroller of the Currency, December 2011.
[16] Ibid.
[17] Massad, Tim. "Expanding our efforts to help more homeowners and strengthen hard-hit communities." U.S. Department of the Treasury Blog, 27 January 2012.