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# Subprime Lending/ Foreclosure Crisis

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Subprime mortgage lending in the USA is marked by its short and costly history that ended with a foreclosure crisis in which several million borrowers lost their homes and trillions of dollars of household wealth. The advent of subprime lending in the early 1990s was initially understood as a product of innovations like risk-based pricing, automated underwriting, and credit scoring that would expand access to credit and homeownership. Designed to meet the needs of borrowers whose credit scores fell below a certain threshold, subprime loans featured a higher interest rate to compensate lenders for higher risk of default. As subprime lending grew, estimates of the fraction of subprime borrowers eligible for prime loans rose from 10 to 35 percent in the early 1990s, to 30 to 50 percent in 2003, and 50 to 62 percent by 2006 (Mahoney and Zorn 1996; Brooks and Simon 2007).

After increasing from \$11 billion in 1994 to close to \$900 billion in 2006, subprime lending met its abrupt end in August 2007 (Figure 1). As subprime mortgage defaults skyrocketed, international markets for subprime securities seized up, primarily due to the lack of knowledge of counterparty risk bound up in opaque financial instruments built from bundles of subprime loans. The financial collapse sparked the worst foreclosure crisis since the Great Depression. By 2009, the subprime crisis had transformed and was driven by defaults largely on prime

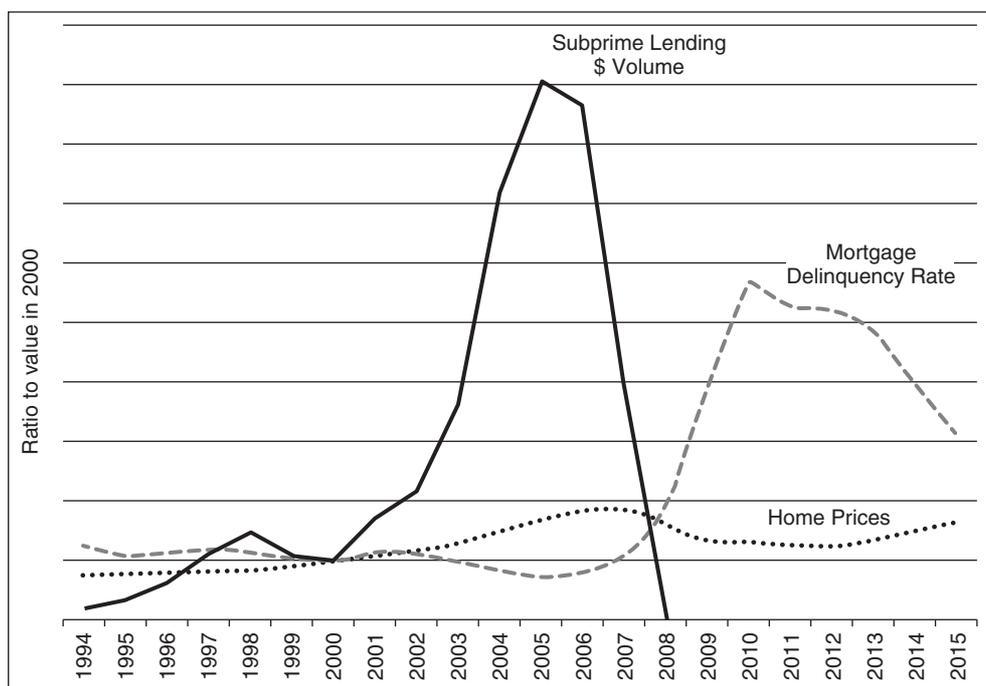
mortgages, due to tumbling home values and rising unemployment, which according to the US Bureau of Labor Statistics doubled from 4.6 percent to 10 percent in less than two years. The share of mortgages in foreclosure or 90 days past due multiplied six-fold from 1.6 percent in 2006 to 9.5 percent in 2010 (Figure 1). Between 2007 and 2012 there were 9–12 million foreclosure filings and 4–5 million completed foreclosures (Hall, Crowder, and Spring 2015). US households lost an estimated \$16 trillion in net worth in the crisis and conservative estimates peg the cost of the Great Recession at \$6–14 trillion. The rest of this entry considers the economic, social, and historical roots of the short-lived era of subprime mortgage lending and the effectiveness of policy responses to the foreclosure crisis.

Economic research isolates the house price bubble as the primary cause of the foreclosure crisis. From 1996 to 2006, real home prices grew by roughly 125 percent and then fell 38 percent by 2011 before recovering in 2012 (Figure 1). Other explanations – resets of adjustable mortgage rates, creditworthiness, low interest rates/excess credit, overbuilding, and government homeownership initiatives – have not withstood scrutiny or have been demonstrated to be secondary (e.g., household indebtedness, deterioration in underwriting standards, or principal-agent conflicts in the primary and secondary mortgage markets). To give one example, studies have dismissed the notion that federal regulations requiring lenders to extend credit to low and moderate income areas (e.g., the 1977 Community Reinvestment Act) could have caused the subprime foreclosure crisis. The main reason (one of several) that this explanation has faltered is due to the fact

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**Figure 1** Home prices, subprime lending, and delinquency: 1994–2015 (indexed to year 2000) (sources: Inside Mortgage Finance 2008; Federal Reserve Board of Governors; Standard & Poors)

that over 90 percent of subprime loans were originated by lenders not subject to such federal oversight (see Avery and Brevoort 2011 for a review). Palmer (2015) finds that about 60 percent of differences in default rates are due to home price changes, 30 percent to the shift to riskier loan characteristics over time, and less than 10 percent due to other factors. Ding et al. (2011) emphasize that subprime foreclosures were due more to a shift to risky products than risky borrowers. In sum, economic research has eliminated several spurious theories of the crisis but failed to address why the house price bubble arose in the first place. Moreover, this line of research focused on *causes* does not adequately explain the uneven distribution of subprime lending and the *consequences* of the foreclosure crisis across social categories, especially race.

Early scholarship strongly suggested that disproportionate subprime lending to black and Latino borrowers and neighborhoods was not explained by differences in income, education, and property values. More recent studies that control for credit scores, down payment ratios, and other variables confirm racial disparities in high cost subprime lending. According to national estimates by Reid et al. (2017), even among with those with higher credit scores, black and Latino borrowers were more likely than white borrowers to receive a higher priced subprime loan. These disparities in subprime lending led to large disparities in foreclosure. Reid et al. (2017) report that 23 percent of Latino households, 19 percent of black households, 11 percent of Asian households, and 9 percent of white households completed foreclosure as of early 2013.

In contrast to most work in economics, scholarship in urban history, geography, law, and sociology has tended to emphasize the interaction of race and space across the history of institutional exclusion and exploitation in explanations of the rise of subprime lending and the social distribution of the foreclosures crisis. This scholarship posits spatial segregation as the connection between past exclusion and contemporary exploitation. First, exclusionary mortgage redlining by federal interventions into the housing market in the New Deal era institutionalized racial segregation and racial segmentation of a dual housing market. Exclusionary practices racialized space and reduced levels *and* returns to wealth accrued from home equity in segregated communities that compounded racial inequality across generations of nonwhite neighborhoods, families, and individuals. Research has demonstrated that the experience of black middle-class homeowners has not been equivalent to white middle-class homeowners. The neighborhood income of middle-class black households earning \$50,000 is lower than that of poor white households earning \$20,000 (Reardon, Fox, and Townsend 2015). These disparities in neighborhood context are largest in the most segregated cities. Faber (2013) finds that, net of other factors, rates of subprime lending decrease for white homeowners as their incomes rise, but increase with incomes among black homeowners. A recent study based on one of the largest civil rights settlements of accusations of discriminatory subprime lending finds that black households with incomes over \$50,000 were estimated to be charged 6 percent more in loan rates (\$19,000 in payments over the life of a 30-year loan) than whites with similar incomes, credit scores, down payments, and other characteristics (Rugh, Albright, and Massey 2015).

The second explanation for racial disparities in subprime lending and foreclosure

rates emphasizes the spatial connection between redlining, segregation, and racial segmentation. Instead of credit exclusion, segregation serves as the basis for the targeting of segmented subprime credit to neighborhoods of color. Spatial segregation by race has been shown to structure market and economic outcomes like employment and poverty independent of individual factors, such as income, family structure, and education (Cutler and Glaeser 1997; Massey and Denton 1993; Sharkey 2013). Empirical research documents how racial residential segregation directly structured the causes and consequences of the foreclosure crisis by concentrating both subprime loans and subsequent foreclosures in communities of color (Hwang, Hankinson, and Brown 2015; Hyra et al. 2013; Rugh and Massey 2010).

Indirectly, distant federal housing interventions also structured inequality in subprime lending and foreclosures. Recent sociological work on the US political economy by Krippner (2011) and Prasad (2013) sharpens the connection by showing how social arrangements hardwired in early-twentieth-century laws and policies inherently led to inequalities in access to credit that in turn begat increasing reliance on mortgage debt. The early establishment of mortgage credit shaped later expansion as a right for black Americans, communities of color (Community Reinvestment Act), and women (Equal Credit Opportunity Act) in the 1970s. Bipartisan financial deregulation of the 1980s and a shared social consensus of homeownership combined with advances in underwriting, credit-scoring technology, risk-based pricing, and securitization in the 1990s to make the USA fertile for the growth of subprime lending. In the end, subprime lending did not narrow, but instead widened, inequalities in homeownership. The balance of defaults and foreclosures outweighed any remaining increase in ownership due to

subprime loans *before* the foreclosure crisis hit (Demyanyk and Kolb 2010). Recent evidence based on longitudinal data strongly suggests that the era of subprime lending destabilized homeownership, particularly among black households (Sharp and Hall 2014).

Federal interventions designed to protect neighborhoods and homeowners against the impact of the foreclosure crisis tended to exacerbate the disparate impact of the crisis by race, space, and class. Nearly all took place after the crisis shifted from subprime to prime mortgages in 2009, were too modest in scale, and were concentrated among borrowers who remained in their homes until home prices rebounded in 2011 to 2013. At the community level, the federal Neighborhood Stabilization Program met its target of approximately 100,000 properties; yet, its modest scale (roughly 2–3 percent of all completed foreclosures) and delays in implementation reduced its impact (Fraser and Oakley 2015; Immergluck 2015; Schuetz et al. 2015). The US Treasury launched several programs to modify mortgages of troubled homeowners but most remained limited to hardest hit states, second mortgages, the unemployed, or refinances of prime mortgages already held by government sponsored enterprises Fannie Mae and Freddie Mac (Immergluck 2015). From 2009 through 2013 the universal Home Affordable Modification Program recorded 927,000 active permanent loan modifications; about one in nine included reduction of mortgage principal and the typical reduction was \$67,000 (US Treasury Department 2014). In contrast, after 49 states settled with major private loan servicers for improper foreclosure practices in 2012, these servicers modified 393,000 mortgages in one year alone; moreover, 1 in 4 reduced principal balances, by an average of \$110,000 (Center for Responsible Lending 2013).

By the end of the crisis, foreclosure rates were highest in black areas in the Midwest and

northeast, and even higher in predominantly Latino and racially integrated neighborhoods in the south and west (Hall, Crowder, and Spring 2015). One major research challenge to the literature on the distribution of subprime lending and foreclosure crisis is to examine more closely the role of region, location, immigration, and other demographic factors (Rugh and Hall 2016). Another challenge is to understand better the causes of house price bubbles to better contain the impact of the collapse of the next one. Despite the recovery in home values since 2012, several consequences of the foreclosure crisis remain clear: homeownership rates are the lowest in almost a generation, wealth gaps by race and class are wider than they were before the crisis, millions of home loans have gone missing, reform of mortgage finance is very unlikely, and rules to safeguard consumer protections still hang in the balance.

SEE ALSO: Housing; Housing Policy; Spatial Segregation

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