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STUDY: PREDATORY LOAN TERMS INCREASE RISK OF SUBPRIME MORTGAGE FORECLOSURE BY UP TO HALF

Prepayment Penalties and Balloon Payments Found to Hike Foreclosure Odds by 20 Percent and 46 Percent Respectively; 1 in 5 Subprime Refinance Loans Originated in 1999 Entered Foreclosure

CHAPEL HILL, NC, January 25, 2005 – Predatory loan terms, namely prepayment penalties and balloon payments, increase the risk of mortgage foreclosure in subprime home loans, even after controlling for the borrower’s credit score, loan terms, and varying economic conditions, according to a report by the Center for Community Capitalism at The University of North Carolina at Chapel Hill (UNC). While previous studies have demonstrated a correlation between subprime lending and foreclosures, these findings are the first to demonstrate that specific abusive loan terms lead to additional home losses.

“The study demonstrates that subprime prepayment penalties and balloon payments place Americans at substantially greater risk of losing their homes,” stated Dr. Michael A. Stegman, Director of UNC’s Center for Community Capitalism, part of the Frank Hawkins Kenan Institute of Private Enterprise. “Given the significant financial and emotional costs associated with foreclosure on families and neighborhoods, policymakers should take note.”

Foreclosure has become central to public policy debates as the subprime market has expanded. Subprime loan originations grew more than nine-fold, from \$35 billion to \$332 billion between 1994 and 2003. In the fourth quarter of 2003, 2.13 percent of all subprime loans across the country *entered* foreclosure, which was more than ten times higher than the rate for all prime loans. Over time these foreclosure starts accumulate. For example, 20.7% of all first-lien subprime refinance loans originated in 1999 had entered foreclosure by December 2003.

Key findings of the Center for Community Capitalism study were as follows:

- **Prepayment penalties in subprime home loans increase the likelihood of foreclosure.**
Subprime home loans with prepayment penalties with terms of three years or longer faced 20 percent greater odds of entering foreclosure than loans without prepayment penalties. When these penalties were limited to a term of less than three years, the risk was slightly less elevated with borrowers facing 16 percent greater odds of foreclosure than their counterparts without prepayment penalties.
- **Balloon payments in subprime home loans increase the likelihood of foreclosure.**
Subprime home loans with balloon payments, where a single lump sum payment many times the regular payment amount is due at the end of the loan term, face 46 percent greater odds of entering foreclosure than loans without such a term.
- **Adjustable rates in subprime home loans increase the likelihood of foreclosure.**
Borrowers whose subprime loans include interest rates that fluctuate face 49 percent greater odds of entering foreclosure than borrowers with fixed rate subprime mortgages.

METHODOLOGY –The Center for Community Capitalism analysis utilizes 3,763,713 monthly observations from 122,456 loans in the Loan Performance Asset-Backed Securities database and is limited to first-lien refinance loans of owner-occupants nationwide originated in 1999 by retail lenders. The study period was from January 1999 to December 2003. The study uses a rigorous multinomial logistic regression model to estimate the effects of traditional underwriting criteria, loan terms, and economic changes on the competing risks of default and prepayment.

ABOUT THE AUTHORS

Michael A. Stegman is the McRae Professor of Public Policy, Planning, and Business at the University of North Carolina at Chapel Hill, and director of the Center for Community Capitalism at the Frank Hawkins Kenan Institute of Private Enterprise, part of UNC’s Kenan-Flagler Business School.

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ABOUT THE CENTER FOR COMMUNITY CAPITALISM

The Center for Community Capitalism (www.ccc.unc.edu), part of the UNC Kenan-Flagler Business School's Kenan Institute of Private Enterprise, engages in multi-disciplinary research and outreach activities that explore ways to apply private-sector approaches to the revitalization of America's distressed communities. The Center's work focuses on techniques that are both effective in building wealth and assets in disadvantaged communities and sustainable from a business perspective.

The study, supplementary tables containing state-level data, and news release are available at www.ccc.unc.edu.

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EDITOR'S NOTE: A streaming audio replay of a related news event will be available on the Web as of 6 p.m. EST on January 25, 2005 at <http://www.ccc.unc.edu>.

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