Under Pressure: The Arizona Residential Real Estate Market and Loan Foreclosures

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1. Introduction and Scope

Foreclosures are a problem that extends beyond the individual buyers and investors who lose their home, wealth, and credit rating. Foreclosures also impact the owners of neighboring properties, of businesses that see less spending, and of entire communities as they experience a decline in spending and other economic investment. Foreclosures impact all levels of government as reduced property values and less spending and economic investment means reduced revenues and fewer resources for infrastructure and essential services, even as the demand for services increases due to the loss of personal wealth and the impacts of abandoned properties.

This report is a compilation of existing data, research and expert opinion regarding current and future estimates of foreclosure in Arizona and includes:

1. Market factors that increase foreclosure risk in Arizona;
2. Estimates of current and projected foreclosures;
3. Geographic and demographic distribution of foreclosure risk;
4. Impacts of foreclosure on individuals and communities; and
5. A Glossary of key lending and foreclosure terms.

2. Why Arizona is Vulnerable to Increasing Foreclosures

To date, Arizona foreclosures have been lagging national statistics, yet both industry experts and recent data suggest that Arizona will be among the states with the most foreclosures over the next two years. There are two major market conditions that explain why experts are predicting that Arizona is likely to experience more significant increases in foreclosures than most of the country:

1. A high rate of investor, subprime and Adjustable Rate Mortgage loans in recent years, which means more recent buyers are vulnerable to foreclosure risk due to high initial interest rates or resets; and

2. A significant imbalance of supply and demand that will make it extremely difficult to sell properties at prices sufficient to cover outstanding mortgages.

As a result, many recent homebuyers and investors are and will be confronted with the classic dilemma that leads to foreclosure – **can't pay, can't refi, can't sell.**

2.1. High Exposure to Risky Subprime and ARM Loans

Although foreclosures are occurring across all types of mortgages – Fixed Rate (FRMs) and Adjustable Rate (ARMs), prime and subprime – the delinquency and foreclosure rates are higher for subprime and adjustable rate loans, and are highest for subprime ARMs. Nationwide:

- Subprime loans (both FRMs and ARMs) constitute 54% of loans in foreclosure;
- ARMs (both subprime and prime) constitute 53% of all loans in foreclosure; and
- Subprime ARMs constitute 11% of all loans, but 36% of all loans in foreclosure.

The foreclosure risk is highest for ARMs, where adjustments of these loans from the initial low "teaser" rate can have significant impacts on homeowners:

- 60% of ARMs that have adjusted since 2004 have increased monthly housing payments by more than 25%, and 20% increased monthly payments by more than 50%; [1]
- In an AFL-CIO survey, 40% of the ARMs that had already adjusted increased the average monthly mortgage payment by $291; [2]
- Among 2004-06 ARMs, 25% are projected to be in situations of negative equity (which limits the ability of homeowners to refinance). [3]

The reliance on subprime and adjustable rate loans is even more pronounced in Arizona, which has a larger portion of subprime and ARM loans in all respects:

- Arizona has a **23% higher share of subprime loans** than the US overall – 16% of all loans in Arizona versus 13% of US loans;
- Arizona has a **43% higher share of ARMs** than the US overall – 31% of loans versus 21% of US loans;
- 68% of Arizona subprime loans are ARMs, versus 49% nationwide; and
- 26% of Arizona prime loans were ARMs, versus 18% nationwide. [4]

Consequently, Arizona has more of the types of loans that are most vulnerable to foreclosure. This vulnerability is beginning to show in the Arizona delinquency and foreclosure statistics as of the end of the third quarter of 2007:

- 7.38% of subprime ARMs in Arizona were in lender inventory or in foreclosure, up from 6.42% in the second quarter;
- 13.53% of subprime ARMs in Arizona were delinquent, up from 11.24% in the second quarter; and
- 8.18% of ARMs – prime or subprime – in Arizona were delinquent, more than two and half times the 3.04% rate for all FRMs. [5]

Although the number and proportion of new subprime loan originations is down (dropping almost 33% for the first eight months of 2007 versus 2006), there were still a large number of ARMs created, and these loans had a default rate of 8.05% within the first 8 months of the loan. [6]

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1 Christopher Cagan, Core Logic, as reported by Bloomberg.com, September 26, 2007
2 AFL-CIO Press Release, Survey Finds Homeowners Confused, Worried About ARMs, October 15, 2007
3 Cagan, Core Logic
4 MBA, National Delinquency Survey 2007 Quarter 3 (as of 9/30/07).
5 MBA, National Delinquency Survey.
6 New York Times, October 16, 2007, based on data from Friedman, Billings, Ramsey.

2.2. *Supply / Demand Imbalance*

Softness in the market from excess supply is the other major market condition in Arizona that has led experts to predict that Arizona will experience an expanding foreclosure problem. Demand has fallen as investors have retreated. Builders have slowed production, but not enough to maintain a balance between supply and demand.

2.2.1. Investors Have Left the Market

Investors were a key component of the spike in demand and rise in prices during 2004 - 2005, and the withdrawal of investors from the housing market is playing a major role in the buildup of inventory and decline in prices. Since about the middle of 2005, investors have been withdrawing from the market as buyers, and dumping properties through short sales and foreclosures.

The investor portion of the market in Arizona was much higher than in the rest of the country, and their withdrawal has had a more dramatic effect:

- Investors constituted 30-35% of the buyers of houses in metropolitan Phoenix during 2005, when prices in Arizona rose dramatically. Nationwide, 23% of buyers during this period were investors. [7]
- Speculative investors probably inflated prices by 25% during that period, according to Jay Butler of the Arizona Real Estate Center at ASU.
- The number of investor purchases in Arizona declined 27% from 4th quarter 2005 to 4th quarter 2006. [8]
- As of June 30, 2007, the non-owner occupied share of defaulted loans (90+ days past due or in foreclosure) in Arizona was 26%, double the 13% rate in the rest of the nation. [9]

Speculative investors are still trying to exit the market, increasing the supply of properties on the market through short sales and mortgage defaults, and continuing to exacerbate the supply/demand imbalance in Arizona.

2.2.2. New Housing Production Has Dropped – But Not Enough

Even as the for-sale existing housing stock continued to increase because of foreclosures and investor withdrawal, builders continued to produce housing. Production declined, but was still above the pace that could be absorbed by shrinking demand. In fact, the industry continues to produce housing at roughly the growth in demand, which means that the excess supply is not being absorbed.

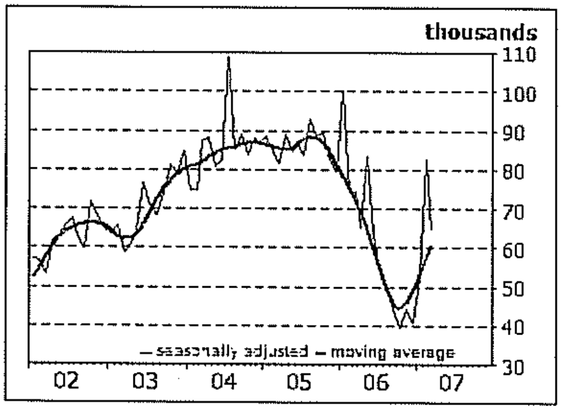
There is evidence nationally as well as in Arizona that the major national builders recognized the downturn and began to curtail production in late 2005. Residential building permits were down in nearly all Arizona counties from 2005 to 2006. [10] However, it takes months for units in the production pipeline to come onto the market, so there is a lag of a half-year or more between adjustments in production and

[7] Freddie Mac, reported in AZCentral, 1/21/06
[8] Lawrence Yun, Senior Economist, National Association of Realtors, 5/17/07.
[9] David Duncan, MBA, 9/6/07
[10] Realty Studies, Arizona State University

a drop in new residential units being delivered to the market. By late 2005 when builders began to adjust, the pipeline for production was already full and builders delivered new homes to the market well into 2006 in numbers far in excess of demand.

It should also be noted that building permit statistics indicate that some builders appeared to be gearing up in early 2007, but permits again show a downward trend in the latter part of 2007 – possibly indicating that this was a premature response on the part of the builders. [11] Other factors, such as increased development impact fees and other pending regulatory requirements may also have prompted builders to draw permits before fees and requirements took effect.

Total Housing Unit Permits Issues - Arizona
annual rate



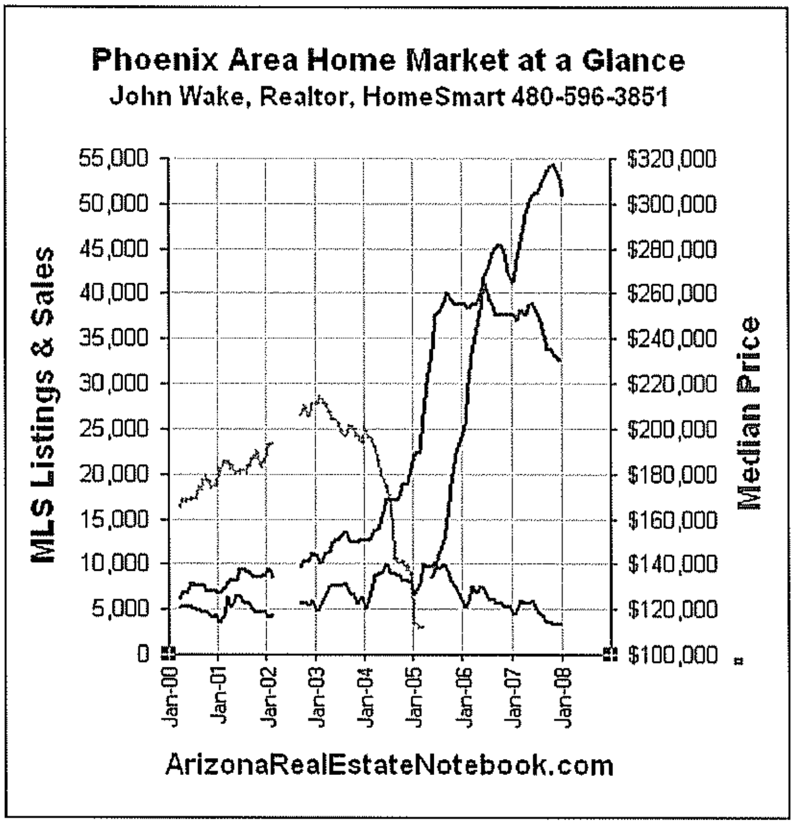
Arizona	Apr-07	May-07	Jun-07	Jul-07	Aug-07	Sep-07
Total # of Units Authorized	4,294	4,547	5,425	3,763	3,627	3,383
% chg vs. year ago	-34.8	-41.9	-17.7	-23.9	-22.3	-17.9

Based on these changes in production, it is difficult to predict how long it will take the market to absorb the current excess supply and achieve a better balance between supply and demand.

2.2.3. The Result: A Slowing Market and Declining Values

Maricopa County, which has experienced the largest amount of foreclosures to date, has a major gap between supply and demand. In response to rising demand from homebuyers and investors for Arizona real estate, the supply expanded dramatically, but may have been overbuilt in light of the recent downturn in demand. The accompanying graph by realtor John Wake of Phoenix depicts the supply – demand imbalance that has emerged in the Phoenix metro area.

[11] Economic & Business Research Center, Eller College of Management, University of Arizona



Note three simultaneous conditions emerging beginning in mid-2005: [12]

- A dramatic rise in the number of properties available for sale beginning in mid 2005 (**red** line) that continued into 2007
- A drop in sales volume (**blue** line) beginning in mid-2005
- A leveling (and then decline) of median sales prices (**green** line) that coincides closely with the divergence of the listings line from the sales line.

The chart shows that the sales inventory is finally beginning to decline. However, even if builders continue to produce new units at a much lower level, it will take many months, if not years, to absorb the inventory. During that time of absorption, prices are likely to be stagnant at best.

According to Arizona State University Realty Studies, single-family home sales activity in Maricopa County (from the 3rd Quarter of 2006 to the 3rd Quarter of 2007):

- Resale volume declined 28% to 11,625 units – the lowest volume since 1st Quarter 1998;
- New construction sales volume declined 32% to 6,550 units - along with 2nd Quarter 2007, the lowest volume since 1st Quarter 2002; and

[12] To read this graph, note the following key:
Red line – the number of listings (using left axis) by month
Blue line – the number of sales (using left axis) by month
Green line – the median price of homes sold (using right axis) by month
Gaps in the lines reflect gaps in available data in 2002

- In the face of these declines in sales, the median price of a resale unit declined 1% to $256,975, and the median price of a new unit declined 11% to $276,000 – the lowest median prices since 3rd Quarter 2005. [13]

3. Estimates of Foreclosures in Arizona

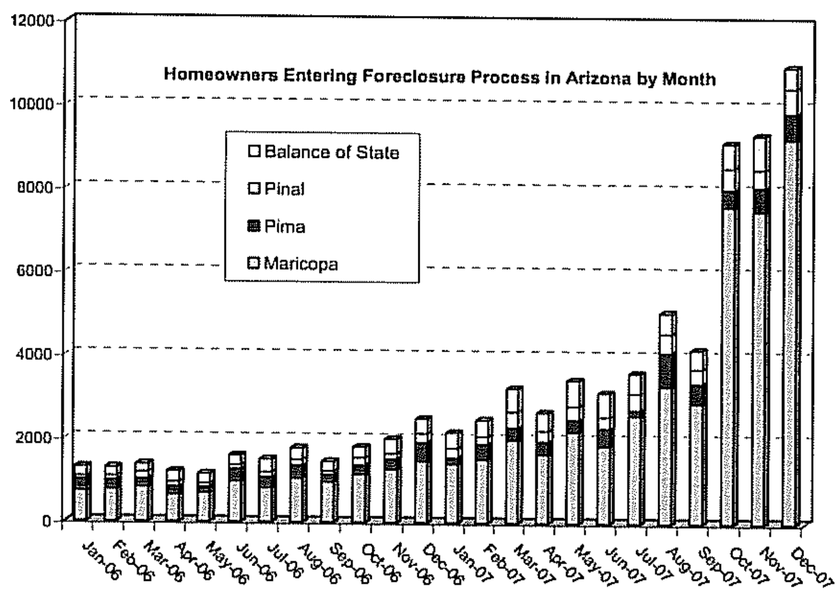
3.1. *Estimated Housing Units Foreclosed or In the Process of Foreclosure*

As of January 14, 2008, the website foreclosures.com reports:

- **51,204** Arizona single-family properties are owned by lenders from foreclosures and deed in lieu of foreclosures (referred to as Real Estate Owned, or REOs); and
- **103,741** Arizona single-family properties are in some stage of the foreclosure process (referred to as "Pre-Foreclosures"). [14]

The foreclosure.com data indicate that roughly **one in every 25 Arizona housing units** (4.11%) entered the foreclosure process during 2006 – 2007, but much of this foreclosure activity occurred late in 2007:

- **38%** of units entered the process during the last quarter of the 2007; and
- The number of units entering the foreclosure process in December 2007 was more than **eight times** the number in January 2006: 10,949 properties in 12/07 v. 1,308 in 1/06. [15]



13 Arizona State University Polytechnic Realty Studies, Greater Phoenix Real Estate Market Housing Sales and Median Prices Quarterly 1995 - 2007
14 foreclosures.com
15 foreclosures.com

The bulk (70%) of the two-year foreclosure activity was in Maricopa County, where approximately 60% of the State's population resides. Activity during the last quarter of 2007 was even more concentrated in Maricopa County – **83%** of units entering the foreclosure process during the last quarter of 2007 were located in the County.

3.2. Projected Foreclosures 2008 – 2009

Predictions of future foreclosures are difficult in all circumstances, but especially challenging with the converging risk factors in Arizona. To date, Arizona foreclosures have been lagging national statistics, yet both industry experts and recent data suggest that Arizona will be among the states with the most foreclosures over the next two years.

According to the Mortgage Bankers Association (MBA):

> *"The four states of California, Florida, Nevada and Arizona have more than one-third of the nation's subprime ARMs, more than one-third of the foreclosure starts on subprime ARMs, and are responsible for most of the nationwide increase in foreclosure actions. "There are special circumstances driving conditions in those four states that will likely make things worse:*
>
> > *Declining home prices make refinancing of these ARMs difficult, particularly if the borrower originally put down little if any down payment. Home prices have dropped in all four of these states and 52 of the 59 MSAs in the four states saw home price declines during the second quarter according to the Office of Federal Housing Enterprise Oversight (OFHEO).*
> >
> > *The root of the home price problem there is that the inventory of new homes available for sale in the Western Region hit an all-time record high at the end of the second quarter....*
> >
> > *These four states have a disproportionately high share of investor loans, or loans to buyers who do not plan to live in the house. As of June 30, the non-owner occupied share of defaulted loans (90 days of more past due or in foreclosure) was 32 percent in Nevada, 25 percent in Florida, 26 percent in Arizona and 21 percent in California, compared with 13 percent in the rest of the nation. These investors are much more likely to default on their mortgages if they see the value of their investments falling due to falling home prices.*
>
> *"Therefore, the problems in these states will continue...."* [16]

The Third Quarter 2007 Mortgage Bankers Association National Delinquency Survey indicates that in Arizona: [17]

- Another 8,900 Arizona properties entered into the foreclosure process during the third quarter;
- More than 57,000 single family properties in Arizona had mortgage delinquencies as of the end of the quarter, up 15,000 properties or 36% over the previous quarter; and
- Over 24,000 properties are in serious delinquency, and therefore imminently likely to enter into the foreclosure process, representing a 54% increase over the previous quarter. [18]

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[16] Doug Duncan, MBA's Chief Economist and Senior Vice President of Research and Business Development, 9/6/07 on release of the 2007 2nd Quarter National Delinquency Survey

[17] Mortgage Bankers Association 2007 3rd Quarter National Delinquency Survey.

[18] MBA, National Delinquency Survey 2007 Quarter 3 (as of 9/30/07).

Delinquencies and Foreclosures in Arizona as of September 30, 2007 [19]							
	Total Past Due	30 Days	60 Days	90+ Days	Lender Inventory	Started Foreclosure in Quarter	Seriously Delinquent
Arizona #	57,620	34,673	12,331	10,255	14,407	8,912	24,662
Arizona %	4.69%	2.84%	1.01%	0.84%	1.18%	0.73%	2.02%
US %	5.81%	3.41%	1.15%	1.26%	1.69%	0.78%	2.95%

The number of properties entering the foreclosure process is expected to continue to grow in the coming months, as a large number of delinquent mortgages have not yet been started in the foreclosure pipeline. According to the National Association of Realtors, about 23% of prime loans and 41% of subprime loans that become delinquent will result in foreclosure. [20] Therefore, the 57,000 delinquencies that were reported as of 9/30/07 could be expected to produce **an additional 17,700 foreclosures.**

This does not include any loans that have become delinquent since 9/30/07 (the number of which is accelerating) or are expected to become delinquent during 2008 – 2009. Assuming that the majority of adjustable rate mortgages made during 2006 were 2/28 or 3/27 hybrid ARMs, most of the first interest rate resets on 2006 and 2007 loans, whether subprime or prime, will occur in 2008 and 2009. Given that many months elapse between rate adjustments, delinquency and ultimate foreclosure, foreclosures on the most recent loans are likely to occur in 2008 and beyond.

One early predictor of future delinquencies and foreclosures is the demand for delinquency and foreclosure counseling services. Results from a September 2007 survey of twenty-one housing counseling agencies indicated that call volume from homeowners seeking foreclosure counseling has **tripled in the past year** for most agencies. [21]

The Congressional Joint Economic Committee of the US Congress issued a report in October 2007. In this report, the Joint Economic Committee estimates that Arizona will have the 12th highest foreclosure rate, the 8th highest number of foreclosures, and the 9th highest loss of property value as the result of foreclosures over the next two years. [22] The Joint Committee further estimates that in Arizona:

- **52,347 subprime loan foreclosures are predicted to occur from July 2007 through the end of 2009.**
- **Overall housing price declines could approach 20%** and this greater price decline could increase the foreclosure rate by as much as 25%, bringing the number to **as many as 65,650 subprime foreclosures** during this 2.5 year period.

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[19] MBA, National Delinquency Survey 2007 Quarter 3 (as of 9/30/07).
[20] Dr. Lawrence Yun, Chief Economist, National Association of Realtors, Economic Issues and Residential Real Estate Business Trends Forum, November 13, 2007.
[21] Survey conducted October 15-22, 2007 by Community Reinvestment Solutions, Inc., under contract to ADOH.
[22] The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here, Majority Staff of the Joint Economic Committee of the US Congress.

The Joint Economic Committee report addresses only subprime loan foreclosures, and not prime loans. Adding prime loan foreclosures would increase the number of predicted foreclosures during 2008 – 2009.

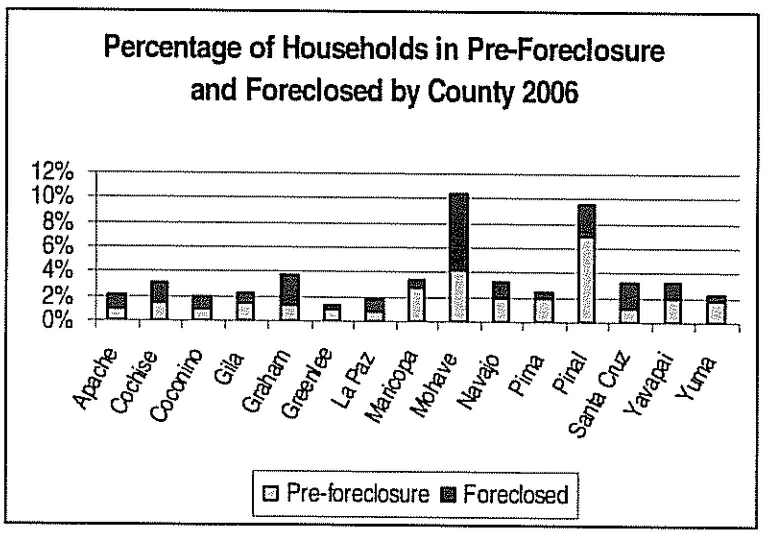
- Applying the Mortgage Bankers Association third-quarter 2007 National Delinquency Survey prime loan foreclosure inventory rate of 0.79% to loans in Arizona, an **additional 7,500 prime loan foreclosures** might be predicted above and beyond the subprime foreclosures projected by the Joint Economic Committee. [23] It should be noted that the foreclosure inventory rate increased in the third quarter of 2007 and is higher than in past years. Still, given current market conditions the rate may not have yet peaked and this number may be higher.
- Alternatively, by applying the national statistic that 23% of prime loans in delinquency ultimately end in foreclosure, the 24,600 delinquent prime loans at the end of the 3rd quarter of 2007 would mean about 5,700 additional foreclosures in addition to the 3,000 foreclosures started during the quarter, yielding an **estimated 8,700 additional prime foreclosures.**

Given the above data and analysis, it is reasonable to project **between 60,000 and 75,000 additional foreclosures in Arizona during 2008 and 2009**, or 4 – 6 % of single family properties in Arizona.

4. Geographic and Demographic Distribution of Foreclosures

4.1. Geographic Distribution of Foreclosures

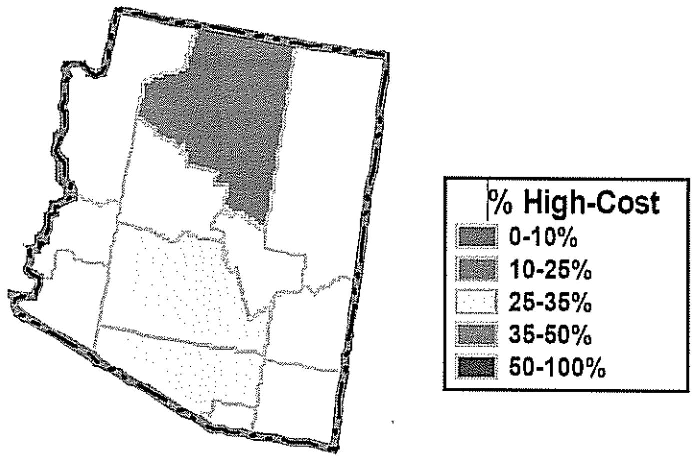
A county-level analysis of 2006 foreclosures in Arizona revealed that the volume of foreclosures is highest in Maricopa and Pima counties. However, the rate of foreclosure (percentage of households) is highest in Pinal and Mohave counties, where approximately 10% of households were in foreclosure or had been foreclosed upon. [24]



[23] MBA, National Delinquency Survey 2007 Quarter 3 (as of 9/30/07).
[24] Foreclosures.com

Using the Home Mortgage Disclosure Act definition of a "high-cost loan", the incidence of subprime loans in 2006 was highest in Phoenix, trailed slightly by Tucson. [25] High-cost loans exist throughout Arizona, but are concentrated in the Phoenix and Tucson metropolitan areas. [26]

This is comparable to foreclosure activity, which has been concentrated largely in Maricopa County, but is also significant in the Tucson metro region.



Further analysis of April 2007 foreclosure filings in four metro areas (Phoenix, Mesa, Glendale, Tucson) indicates that the highest foreclosure activity occurred in the following zip codes: [27]

Metro Zip Codes with Highest # of Foreclosure Filings (04/07)

Zip Codes	Metro Area/City	# Filings(4/07)
85037	Phoenix	57
85706	Tucson	56
85086	Phoenix/Anthem	54
85041	Phoenix	42
85308	Glendale	42
85032	Phoenix	36
85033	Phoenix	35
85204	Mesa	32
85051	Phoenix	31
85301	Glendale	31
85303	Glendale	31

In each of four metropolitan areas (Phoenix, Mesa, Glendale, and Tucson), the top 10 zip codes for April 2007 foreclosure filings revealed a combination of central city neighborhoods where subprime lending activity was particularly high, plus some outlying newer development areas where investor activity, flipping and aggressive lending activities have occurred over the last couple of years. These outlying development areas are one of the primary concerns going forward.

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[25] A high cost loan in HMDA is a loan originated with an Annual Percentage Rate (APR) of at least 3 points above the comparable rate on U.S. Treasury Securities

[26] ACORN, Foreclosure Exposure, September 5, 2007

[27] ACORN, Home Insecurity: Foreclosures in Phoenix, Mesa, Glendale & Tucson Neighborhoods, June 20, 2007, based on April 2007 foreclosure filings & 2006 HMDA data

First American Core Logic compiles an index of collateral risk, and this shows a much broader potential risk for mortgage foreclosures. Collateral risk is the risk associated with a property not being able to sustain its property value, and therefore putting the loan at risk of the property collateral being worth less than the outstanding mortgage balance. The newer loans in these areas are projected to have a much higher risk of sustaining property values, thereby jeopardizing the collateral value of the property in securing the mortgage, and increasing the probability of early payment default. [28]

While foreclosures to date have been concentrated in central city zip codes along with some outlying areas that experienced tremendous growth, from a perspective of collateral risk, geographic areas that are likely to experience high foreclosures include:

- The outlying areas of the Phoenix and Tucson metropolitan regions, including Pinal County;
- Near downtown Phoenix revitalization areas; and
- The Northern growth areas surrounding Lake Havasu, Kingman, Prescott, Verde Valley and the Eastern I-40 corridor.

4.2. Households Characteristics & High Cost Loans

Based on 2006 HMDA data analyzed by ACORN, the highest incidence of high-costs loans occurred for the following demographic categories: [29]

- **Latino borrowers** in the Phoenix and Tucson metro area - half of the 2006 loans were considered high-cost loans.
- **African-American borrowers** in Tucson, Phoenix and Flagstaff – around 40% had high cost loans.
- **Moderate Income and Middle Income borrowers** in Phoenix and Tucson – around 40% had high cost loans.

While it may be surprising that Low Income borrowers experienced lower incidence levels of high cost loans than buyers and owners with higher incomes, this may be explained in part by the public programs that assist many Low Income buyers. These programs usually include counseling, financial assistance or discounted prices, and limitations on the types of first mortgages permitted – especially the riskiest exotic ARM products. These results may indicate the importance of these public programs in helping buyers achieve stable homeownership.

The number of households with high housing cost burden is another way to look at the impact of high cost loans, whether or not subprime. Based on American Communities Survey data, the percentage of households with a housing cost burden has been growing, and 37.4% of Arizona homeowners spend

[28] Projections of Collateral Risk by First American Core Logic, October 2007, special analysis for ADOH. Key contributors to Core Logic's Collateral Risk Measure (CRM) are: the amount of flipping activity, false or excessive inflation of values above supported valuations, and potential fraud.

[29] ACORN, Home Insecurity: Foreclosures in Phoenix, Mesa, Glendale & Tucson Neighborhoods, June 20, 2007, based on April 2007 foreclosure filings & 2006 HMDA data. High cost loans are loans with interest rates more than 3% above the Treasury Bill rate, and thus presumed to be subprime loans.

more than 30% of their income on housing. That is, **roughly 570,000 Arizona homeowners are experiencing a high cost burden in their housing cost.** [30]

The percentage of owners with high cost burden showed a dramatic leap between 2005 and 2006 as housing costs soared – an additional 70,000 Arizona homeowners experienced housing cost burden during 2006.

	Housing										
	Owner Households							Renter Households			
	% of Owners Spending 30% + of				% Change in house prices			% Spending 30%+ of Income on			
	2003	2004	2005	2006	1 Year Change	5 Year Change	Change since 1980	2003	2004	2005	2006
Arizona	30.4	33.4	33.7	37.4	2.2	90.8	330	44.7	47.3	44.6	45.2
United States	30.3	32.4	34.5	36.9	3.2	50.8	309.4	43.2	44.1	45.7	46

The survey of Arizona housing counseling agencies provided the following information about homeowners requesting counseling assistance: [31]

- Households earning greater than 80% of the median income represented more of the call volume than lower-income households. This is consistent with data noting higher incidence of high cost loans among moderate and middle income owners than low income owners.
- Housing counseling agencies did not report a disproportionate volume of calls from racial and ethnic minorities.

Essentially, while minorities and low-income owners appear to be particularly vulnerable to high-cost subprime loans, the broader use of subprime and adjustable rate loans used to purchase increasingly costly housing have put strains on housing budgets at all income levels.

5. Why Care? Impacts of the Foreclosure Problem

5.1. Recent Homebuyers Are Caught in a "Can't Pay. Can't Sell. Can't Refi." Trap

The bottom line is that these converging market trends have placed recent buyers and owners in a bind. As homeowners begin to experience mortgage rate resets on adjustable loans, and over-leveraged short-term investors encounter a softening market, they are finding their choices extremely limited. Essentially, they are discovering that they:

1. **Can't pay** – Mortgage payments on risky financing have become unmanageable. Some are over-leveraged in no-doc mortgages with payment levels higher than they can truly afford. Many have "teaser rate" ARMs that were affordable for the first year or two, but mortgage rate resets are raising monthly payments by several hundred dollars. These are in addition to more typical family problems with other debt, employment and medical problems.

[30] US Census Bureau, American Communities Survey, 2003 – 2006

[31] Survey conducted October 15-22, 2007 by Community Reinvestment Solutions, Inc., under contract to ADOH.

2. **Can't sell** – A market slowdown from a supply-demand imbalance makes it difficult to sell property. There is a general reluctance to lower prices, particularly among recent buyers who have near 100% financing. A drop in sales prices leaves many in a negative equity position. Selling would require these households to pay off a portion of the mortgage out of personal funds, in addition to sales costs. This condition is referred to as being "upside down."
3. **Can't refinance** – Refinancing options have narrowed dramatically. Conventional lenders have tightened their underwriting standards, and subprime lenders have either gone out of business or sharply curtailed financing options. ARMs and jumbo loans are more expensive and difficult to obtain, exotic products that stretch qualifications are no longer available or available only to the best clients and strongest markets, and property values are dropping below outstanding debt to make refinancing unworkable.

When a household or investor can't afford the mortgage payments and can't sell or refinance the prospect of foreclosure or deed in lieu of foreclosure looms large.

The difficulty of the current situation is increased by the lack of homeowner understanding of the risks of the current situation and lack of plans to address pending rate resets that might be unaffordable. A September 2007 poll commissioned by the AFL-CIO presents evidence that ARM holders aren't fully aware of mortgage risks and how loan terms and adjustments can affect the household budget:

- Nearly half (49%) say they aren't very informed about their mortgage's terms and conditions;
- 18% don't know their current interest rate;
- 73% don't have a clue how much their monthly mortgage payment will increase the next time their rate rises;
- 47% don't know what factors determine the amount of their rate adjustment and only 20% correctly answered how their rate is determined; and
- 56% don't recall their lender telling them how much they would be paying with their interest rate resets. [32]

According to John Sweeney, President of the AFL-CIO, ***the ARM adjustment is "the trap door between the American Dream and the American Nightmare for homeowners***." [33]

5.2. *Impact on Housing Value and Wealth*

An October 2007 report by the Congressional Joint Economic Committee estimated the near-term (2008 – 2009) impact of subprime foreclosures in Arizona to be **over $2.8 Billion in lost housing value and housing wealth** -- $2.5 Billion in foreclosed homes and $0.3 Billion in nearby homes. [34] This report

[32] Survey conducted Sept. 13–25 by Peter D. Hart Research Associates for the AFL-CIO

[33] AFL-CIO Press Release, Survey Finds Homeowners Confused, Worried About ARMs, October 15, 2007

[34] The Committee considers this to be a conservative estimate of foreclosures, because: (1) this estimate addresses only subprime loans that were outstanding in the 2nd Quarter of 2007, and does not include either prime loans or subsequently originated subprime loans; and (2) conservative assumptions were used regarding the loss of property value overall (at only 6.9%), decline in the value of foreclosed properties (at 20%), and subprime foreclosures (at a rate of 18%.)

estimated these impacts based on a Chicago study that concluded that every foreclosure reduces home values within a 1/8-mile radius by 0.9%. [35]

An estimated 50,000 – 75,000 Arizona single family homes will be foreclosed during 2008 and 2009, and an additional 1.2 million properties (over 45% of the units in Arizona) may be impacted. This loss of wealth through declining property values could also result in a loss of about $7 Million in annual property tax revenues, and perhaps as much as $12 Million in annual sales tax revenues as owners reduce their spending.

5.3. *Economic Impacts on Communities*

Impacts aren't limited to just housing values on the foreclosed homes, or even the adjacent homes. It has economic and social impacts on the neighborhoods and the community. According to the Joint Economic Committee:

> *"Foreclosures can have a significant impact in a community in which the foreclosed property is located. This is particularly true when the factors that led to one foreclosure drive a concentration of foreclosures in the same neighborhood, for example in a spatial concentration of subprime lending. A concentration of home foreclosures in a neighborhood hurts property values in several ways. A glut of foreclosed homes for sale depresses home market values for the other owners. Neighboring businesses often experience a direct monetary loss from reduced sales and neighborhood landlords experience a loss or reduction in rental income. Moreover, the homes left vacant by foreclosure lower the desirability of the neighborhood since there is often an increase in crime associated with a vacant house."* [36]

The Congressional Joint Economic Committee estimated that Arizona communities will **lose $14.6 Million in property tax revenue** in just 2008 – 2009 as a result of foreclosures.

The Center for Responsible Lending (CRL) has projected a **long-run loss of tax base in Arizona approaching $5 Billion**, from 2005 – 2006 subprime lending. CRL also estimates that **1.2 Million single-family housing units** (about 46% of Arizona's 2.6 Million housing units) will be negatively affected by subprime foreclosures. [37]

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[35] D. Immergluck and G. Smith (2006). The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values

[36] Joint Economic Committee, p. 7.

[37] Center for Responsible Lending, Subprime Spillover: Foreclosures Cost Neighbors $202 Billion; 40.6 Million Homes Lose $5,000 on Average, Issue Paper 1/18/08

Arizona

County	Projected Number of Homes Ultimately Lost through Foreclosure on 2005/2006 Subprime Loans	Number of Houses Losing Value due to Nearby Subprime Foreclosures	Average Decrease in House Value	Decrease in County's House Values & Tax Base from Subprime Foreclosures (2005/2006 loans)
Coconino AZ	123	2,112	$2,811	$5,935,713
Maricopa AZ	27,629	961,548	$4,529	$4,354,493,937
Pima AZ	4,148	186,010	$2,315	$430,547,982
Pinal AZ	2,630	18,795	$3,183	$59,825,951
Yavapai AZ	671	8,293	$2,233	$18,520,938
Yuma AZ	561	24,568	$1,793	$44,049,898
Total/Average of	35,761	1,201,327	$4,090	$4,913,374,417

Property value declines can also be expected to affect sales tax revenues. Research has indicated that every dollar of property value lost will affect annual spending by 6 cents. [38] Therefore, a loss of $2.8 Billion in property value could produce a reduction in annual spending of $168 Million, which would mean about **$12 Million in annual sales tax revenue lost** (at a sales tax rate of $0.075.)

A study of foreclosed properties in Chicago in 2005 indicated that foreclosures resulted in between $27 and $34,000 of direct costs to the City. These costs encompassed a range of municipal services: recordkeeping, inspections, monitoring, police, fire and trash removal services. While these cost estimates may not be directly applicable to Arizona communities, it is nevertheless an important reminder that vacant structures create risks and possibly direct municipal costs. [39]

In addition, there are direct job losses related to construction and real estate. National statistics indicate that the economy added 1.3 Million jobs in the housing boom this decade, but has already lost 383,000 of those jobs. [40] Lost jobs mean lost income, unemployment benefits and decreased ability to spend.

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[38] National Center for Real Estate Research,

[39] W. Apgar, M. Duda, and R. Gorey (2005). The Municipal Cost of Foreclosures: A Chicago Case Study, Homeownership Preservation Foundation, Housing Finance Policy Research Paper Number 2005-1.

[40] New York Times 10/25/07.

6. The Bottom Line

The experts and the data both point to Arizona being among the top States for foreclosure going forward into 2008 and 2009. Two converging market factors support this conclusion:

1. A high rate of investor, subprime and Adjustable Rate loans in recent years, which means more recent buyers are vulnerable to foreclosure risk due to high initial interest rates or resets; and
2. A significant imbalance of supply and demand that will make it extremely difficult to sell properties at prices sufficient to cover outstanding mortgages.

Existing data and research regarding foreclosure and potential foreclosure in Arizona indicate that the current level of delinquencies and foreclosures is significant and rising:

- As of September 30, 2007, 51,204 Arizona single-family properties are owned by lenders from foreclosures and deed in lieu of foreclosures, and 103,741 Arizona single-family properties are in some stage of the foreclosure process.
- Roughly one in every 25 Arizona housing units (4.11%) entered the foreclosure process during 2006 – 2007.
- The number of units entering the foreclosure process in December 2007 was more than eight times the number in January 2006: 10,949 properties in 12/07 v. 1,308 in 1/06.
- 70% or more of the two-year foreclosure activity has been concentrated in Maricopa County, where approximately 60% of the State's population resides.

The data also suggest the size of the foreclosure problem in Arizona will continue to increase in 2008 - 2009

- During the 3rd Quarter of 2007 delinquencies rose 38%, serious delinquencies rose 54%, and another 8,900 Arizona properties entered into the foreclosure process.
- Calls to Arizona housing counseling agencies for delinquency and foreclosure counseling services tripled in the past year.
- Roughly 570,000 Arizona homeowners are experiencing a high housing cost burden.
- Congress estimates that over 52,000 subprime loan foreclosures will occur in Arizona from July 2007 through the end of 2009. Furthermore, if housing prices decline more than 20%, this number of subprime foreclosures could increase to 65,650.
- In addition, 7,500 – 8,700 of the existing prime loans that are delinquent are likely to be foreclosed. This number is likely to be increased by prime loans that fall into delinquency in 2008 – 2009.
- From a perspective of collateral risk, geographic areas that are likely to experience higher foreclosure rates include:
    - The outlying areas of the Phoenix and Tucson metropolitan regions, including Pinal County;

- Near downtown Phoenix revitalization areas; and
- The Northern growth areas surrounding Lake Havasu, Kingman, Prescott, Verde Valley and the Eastern I-40 corridor.

These statistics suggest that Arizona could experience 60,000 – 75,000 foreclosures during 2008 – 2009, depending on the level of price declines that occur.

If foreclosures approach the level predicted, the impacts will be felt beyond the owners that are foreclosed:

- The near term impact of subprime foreclosures in Arizona will be over $2.8 Billion in lost housing value and housing wealth.
- About 1.2 Million homes (46% of single family homes) in Arizona that are adjacent to foreclosures will be negatively affected, with lost value of $0.3 Billion in lost value.
- Congress estimates that Arizona communities will lose $14.6 Million in property tax revenue in just 2008 – 2009 as a result of foreclosures.
- The loss of $2.8 Billion in property value could produce a reduction in annual consumer spending of $168 Million, which could mean about $12 Million in annual sales tax revenue lost (at an average sales tax rate of $0.075.)

The foreclosure problem in Arizona is expected to grow in 2008 – 2009, and will have a far-reaching impact on homeowners, communities and state and local government.

7. Key Lending & Foreclosure Terms

Adjustable Rate Mortgage (ARM) – A loan with an interest rate that fluctuates during the term based on a specified financial index.

Cure – With respect to delinquent mortgage payments, all missed payments have been made and loan payments are current.

Deed-in-Lieu of Foreclosure (DIL or DILOF) – A process whereby an owner voluntarily conveys the title of the property to the mortgagee/beneficiary (lender) to avoid the negative credit consequences of a foreclosure. The title must be free and clear of any other encumbrances and the owners execute an affidavit acknowledging that they are acting volitionally, with informed consent.

Default – The failure to make loan payments in full and on time as agreed in the promissory note. The common usage of this term is when a mortgage is 60 - 120 days delinquent, and the lender can initiate foreclosure proceedings against the loan under the terms of the promissory note and mortgage. Lenders generally must record a notice of default to begin the foreclosure process.

Delinquency – Failure to make mortgage payments when mortgage payments are due. For most mortgages, payments are due on the first day of the month, and any late payment means the loan in delinquent. However, the more general use of this term is for mortgages that are more than 30 days delinquent. Then, most lenders report the late payment to one or more credit bureaus.

Fixed-Rate Mortgage (FRM) – A mortgage in which the interest rate does not change during the entire term of the loan.

Flipper – An investor who purchases homes with the intention of fixing them up and selling them quickly for a profit when housing prices are appreciating.

Foreclosure – The legal proceeding by which a lender sells or takes ownership of a property on which the mortgagor has defaulted. The foreclosure procedure brings the rights of all parties to a conclusion and passes the title in the mortgaged property to either the holder of the mortgage or a third party who may purchase the realty at the foreclosure sale, free of all encumbrances affecting the property subsequent to the mortgage.

Foreclosure Filing – The start of the foreclosure process when the lender files the necessary legal documents to begin the foreclosure proceedings.

Hybrid loans – Loans that combine elements of fixed and ARM loans. The most common is a loan that provides a fixed loan payment for several years, and then becomes an adjustable loan. The most common in recent years have been the 2/28 and the 3/27 hybrids – initial teaser rates are fixed for 2 or 3 years, and then convert to adjustable rates. Other versions include a one-time adjustment, often referred to as a Two-Step Mortgage. Other versions start as ARMs and are convertible to fixed loans.

Real Estate Owned (REO) -- Real estate owned by a lender, usually as the result of a foreclosure or deed in lieu of a foreclosure.

Refinance -- The process of paying off one loan with the proceeds from a new loan using the same property as security.

Short sale – A sale of a house in which the proceeds fall short of what the owner owes on the mortgage. The lender agrees to accept the proceeds of a short sale and forgive the rest of what is owed on the mortgage. By accepting a short sale, the lender avoids a lengthy and costly foreclosure.

Subprime loan – A higher cost mortgage loan that is made to an individual with poor or bad credit. These loans do not meet the borrower credit requirements of Fannie Mae and Freddie Mac, and are also called 'B', 'C' and 'D' paper loans (vs. 'A' paper conforming loans.) Historically, such loans have been offered to borrowers that may have recently filed for bankruptcy, foreclosure, have had late payments on their credit reports, or don't have an established credit history. However, these loans have been used more broadly in recent years as more buyers have been unable to fit within traditional lending standards due to high prices. The interest rates and programs vary, based upon many factors of the borrower's financial situation and credit history.