

RESEARCHBUZZ

High rate of foreclosures in Indiana

BY OZER ERDEM

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Indiana, Ohio, Michigan and Kentucky are among the top 10 states in the country with the highest foreclosure rates at the end of the 2nd quarter of 2006, with Indiana having the highest rate. However, the percentage of foreclosures started in Indiana in the 2nd quarter of 2006 declined to 0.87 percent of all mortgage loans, however down from 1.07 percent in the 1st quarter. The percentage of initiated foreclosures generally declined for most other states in the same quarter. Indiana had the largest decline, with 0.2 percent. Nationally, a foreclosure started on 1 out of every 250 mortgage loans. For Indiana, it was 1 out of every 115 mortgage loans.

The number of Indiana houses in foreclosure was also very high at the end of the 2nd quarter of 2006, at 2.78 percent. Ohio, with 3.12 percent, was the only state with a higher foreclosure percentage. The national average was 0.99 percent. Since the 3rd quarter of 2001, Indiana had either the highest percentage of foreclosure inventories or the second

highest. Although the percentage of foreclosures in Ohio and Indiana hasn't increased, there was a decline in foreclosures for other states. During the 2nd quarter of 2006, Michigan was the state with the 3rd highest percentage of foreclosure inventory, with 1.88 percent. This number is 0.9 percent lower in than Indiana.

One could expect higher foreclosure rates among subprime loans. As can be seen in the charts, the percentage of loans in foreclosure and new foreclosures are considerably higher for subprime loans and FHA (Federal Housing Administration) insured loans. The FHA does not provide loans but it provides insurance in case a buyer defaults. The high rate of foreclosure in FHA insured loans could mean that lenders are giving more risky loans than they would otherwise give without FHA insurance. The national trend of higher foreclosure rates in subprime and FHA insured loans also applies to Indiana.

At the end of the 1st quarter of 2006, the percentage of loans in foreclosure was 8.75 percent for subprime loans. For prime loans, it was only 1.26 percent. However, for both

Chart 1. Total loans past due by loan type

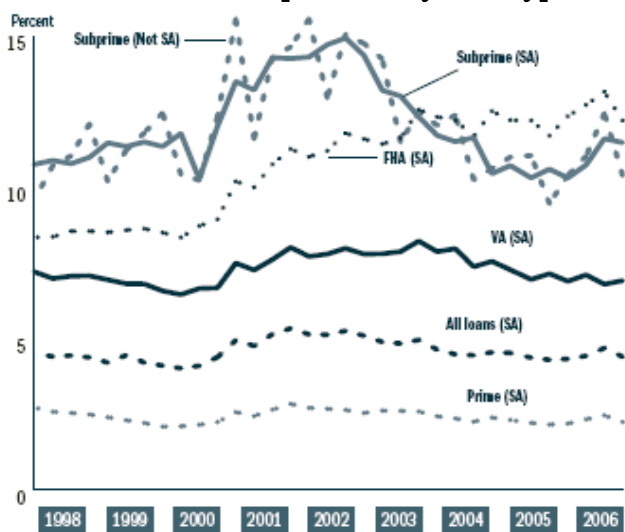
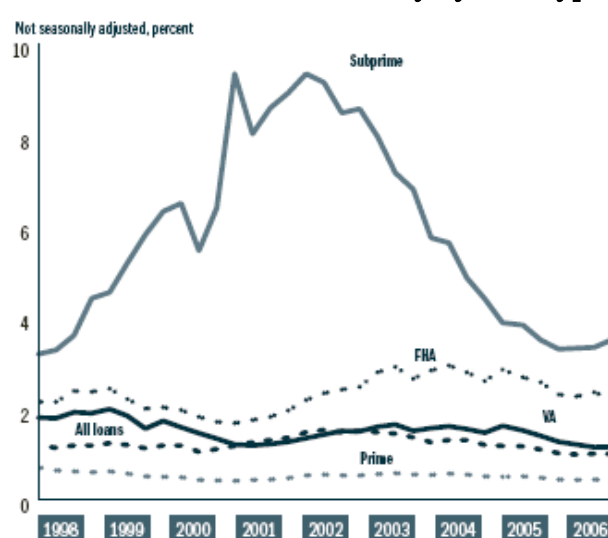


Chart 2. Foreclosure inventory by loan type



Source: National Delinquency Survey from the Mortgage Bankers Association as of March 31, 2006.

cases, national averages for subprime and prime loans, 3.5 and 0.4 percent, were far below Indiana's. There were a total of 21,884 loans in foreclosure in Indiana. Although, subprime loans only constitute 15.4 percent of total mortgage loans in Indiana, 10,294 or 47 percent of loans in foreclosure were subprime loans. In addition, among the newly initiated foreclosures, 45.7 percent were in subprime loans. Moreover, there has been a large increase in the number of subprime loans. There were 117,648 subprime loans in Indiana at the end of the 1st quarter of 2006, compared to 8,557 subprime loans in the 1st quarter of 1998. However, the same trend has taken place throughout the nation. In the same time period, the number of subprime loans both in Indiana and the nation grew at an annual rate of 44 percent.

Among the subprime loans, 42.1 percent were fixed rate mortgage (FRMs) loans and 49.7 percent were adjustable rate mortgage loans (ARMs). The percent of loans in foreclosure is usually higher for adjustable rate mortgage loans. The one-year adjustable interest rate increased from 3.52 in June 2003 to 5.44 percent in December 2006. So, as new rate adjustments take place, they impact the dollar amount of mortgages homeowners are paying. We can expect to see increases in foreclosures.

The percentage of loans in foreclosure is also higher for the prime ARM category. Unlike subprime loans, the majority (77.3 percent) of prime loans were fixed rate mortgage loans. This may mean that the majority of applicants in the subprime lending category were not able to come up with the initial down payment amount required for fixed rate mortgage loans or wanted to make relatively small mortgage payments initially, thinking that their rates will not change for a while. It is also possible that in a housing market with increasing prices, borrowers might have expected high house price appreciation and believed that they could sell their house at a later time with a profit if a hardship arose. Unfortunately, with increasing interest rates

and a cooling housing market, both of those expectations have proved to be mistaken.

Economic factors and the low rate of house price appreciation might have also played a role in the high foreclosure rates in Indiana. According to the Office of Federal Housing Enterprise Oversight's house price index, which is a measure of the movement of single-family house prices, Indiana, along with Ohio, Michigan and Kentucky, had annual house price appreciation well below the national average. For example, if we take out the effect of inflation, while the price of an average house in the US increased from \$100,000 in 1995 to \$185,797 in 1995 prices at the end of 2005, it increased to only \$122,212 and \$130,247 in Indiana and Ohio, respectively. The low rate of house price appreciation impacts the foreclosure rate. If a borrower is having a hard time paying his or her mortgage, with a low rate of house

Table 1: Subprime loans has the highest percentage of foreclosure rate

Indiana	Inventory at the end of quarter	Started during quarter
Prime*	29.5%	30.9%
Prime FRM	21.9%	20.5%
Prime ARM	4.6%	4.4%
Subprime*	47.0%	45.7%
Subprime FRM	17.7%	13.7%
Subprime ARM	26.6%	28.6%
Total*	100%	100%

*Totals include other categories not listed here.

Source: National Delinquency Survey from the Mortgage Bankers Association as of March 31, 2006.

price appreciation, it is most likely that the owner will be with small or no chance to sell the house to pay off the loan. In addition, it will be difficult for sellers to tap into home equity lines, since there is less likely to be home equity available.

Home values are also affected adversely by foreclosures. According to a report¹ by Woodstock Institute, each conventional foreclosure within an eighth of a mile of a single family home resulted in a 0.9 percent de-

cline on value in the Chicago area. Although we don't know the exact effect of foreclosures on Indiana home values, this study provides an example of how foreclosures could depress the home values in a neighborhood. Higher foreclosure rates result in lower house prices and lower house prices again result in further foreclosures.

Both Indiana and Ohio's real per capita earned personal income (RPCEPI) have been declining relative to the nation's RPCEPI. At the end of the 2nd quarter of 2006, Indiana's RPCEPI was 88.71 percent of the national average, the lowest since 1989. Ohio's was at its lowest level since 1948 at the end of the 1st quarter of 2006. Although Indiana's population and personal income levels are still growing, the growth rate has been slower compared with the rest of the nation. Slower growth rates in average wages of Indiana workers can explain the lower levels of RPCEPI growth rates.

Indiana had one of the highest homeownership rates in the nation with 75 percent in 2005 according to the Census 2005 Housing Vacancies and Home Ownership Annual Statistics². Subprime loans give borrowers with limited financial resources a chance to buy houses. However, the high rates of foreclosures in subprime lending, close to 10 percent in ARM loans, suggest that lenders are granting more loans than those borrowers can handle. Another reason for the high foreclosure rates in subprime loans can be due to predatory lending. More research is needed in this area to determine what needs to be done to protect homeowners from predatory lending activities in the future.

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¹. Daniel Immergluck and Geoff Smith, "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values," Woodstock Institute, June 2005

². Table 13, Census 2005 Housing Vacancies and Home Ownership Annual Statistics

Article Summary: "Are We Making the Grade? A National Overview of Financial Education and Program Evaluation"

Lyons, Angela C., Lance Palmer, Koralalage S. U. Jayaratne, and Erik Scherpf, *The Journal of Consumer Affairs*, vol. 40, no. 2, 2006, pp. 208-235.

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Through a combination of focus group research and a national survey promoted via professional listservs, Angela Lyons et al have undertaken the important task of assessing the state of program evaluation for financial education initiatives around the US. Several findings for financial literacy practitioners and their programs are documented in this article, including that:

- ◆ Providers are often unable to identify program outcomes, lack a capacity for program evaluation, and specifically lack knowledge about design of relevant evaluation instruments; and
- ◆ A national evaluation strategy is critical but, due to lack of evaluation capacity and resources in the field, is difficult to achieve. It is crucial for any such evaluative strategy to take into consideration the "front line" challenges of financial education providers.

The research of Lyons and her colleagues reveals that the flourishing number of financial literacy programs and initiatives has outpaced measures of effectiveness. Program goals are generally intended to improve consumers' financial well-being but there is little quantitative or qualitative substantiation as to whether that goal is being met, generally due to a lack of time, staffing, resources and knowledge of how to conduct appropriate evaluation. Yet only

evaluation establishes impact, and proof of impact is essential for new or continued funding of financial education programs. Strong and successful programs may be unable to stand out against more mediocre offerings, absent documentation of the impact of their efforts.

Overview of the state of financial education, program evaluation and its critical gaps

A review of the literature examining the impact of financial education programs reveals that, first, most programs target specific populations (youth, low-income families, military families, etc.) and absent national consensus of what measures of effectiveness should be used, and due to a lack of evaluation experts and resources, most programs measure impact mostly by “program output” factors such as numbers of participants, number of program delivered, or quantity of materials distributed. Numbers may establish levels of outreach but do not touch on educational effectiveness. For that, attitudinal and behavioral measures must be assessed, such as “knowledge gain, confidence levels, planned and actual behavior changes, dollar changes, qualitative responses, demographics” (Lyons et al 2006). A US Government Accountability Office (GAO) 2004 forum concluded that:

[E]valuation should focus on behavior change rather than just changes in knowledge and skills. The forum also indicated the need for setting standardized benchmarks and developing a federal evaluation infrastructure to help non-profits and other organizations build evaluation capacity. (Lyons et al 2006)

The authors’ methodology for this study was a two-stage data collection process, using first focus groups and second an online survey. A total of 8 focus groups consisting of local front-line providers in Georgia and Illinois, plus some national experts gathered via teleconference, were held in the first half of

2004. These groups focused on questions of how programs are currently evaluated (if at all), barriers and challenges to evaluation, components of effective evaluation, and presentation and use of evaluation data. A fall 2004 online survey, circulated to national listservs populated by financial professionals and educators, garnered a final sample of 387 observations.

The overarching observation from focus groups is the unsatisfactory state of program evaluation and the need for it to receive greater professional attention. The three major areas of deficiency are, first, a general lack of evaluation capacity and know-how; second, evaluation being imposed on programs as an afterthought rather than built into program planning, design, training and implementation; and third, a need for a national “industry standard” for evaluation. What evaluation is being done is, on a general level, about “changes in skills and confidence levels . . . intended and actual behavior, and . . . in attitudes and satisfaction levels” (Lyons et al 2006). More recently, some programs are moving to more specific measures such as dollar changes, financial plans, spending habits, and credit report and score improvements.

Common barriers and challenges for program evaluation

Effective evaluation is stymied most often by 1) lack of grassroots evaluation capacity, 2) lack of attention given to evaluation at all program levels, 3) lack of time (60% cite this issue), staffing and financial resources (cited by 48% of respondents), and 4) expense of evaluation relative to operating expenses, especially for small non-profits. Evaluations that feature a contrasting control group population are often the most statistically valid, but cost and logistical impediments to control group studies can be prohibitive as well.

Within the program delivery mode, when already squeezed for time, instructors often jettison evaluation in favor of more content delivery. Additionally, evaluation of financial education is often dependent on participant willingness to divulge sensitive personal information about income levels, personal net worth, and education, sources of income, indebtedness, and so forth. And while evaluations can take stock of a program if administered as a concluding part of a program, the most worthwhile data about impacts on actual, as opposed to intended, behavioral changes cannot be documented until some amount of time has passed since program conclusion. Tracking program participants over an extended timeframe is often prohibitively difficult; 52% of respondents cite this as a problem.

Quantitative results of survey

For purposes of reporting results, the authors' provide a data breakdown for the sum total of respondents and subsequently by respondents with and without university affiliations (non-university respondents include those from government, non-profits, the private sector or the military). The breakdown was significant because, in general, university-affiliated programs tend to have more evaluation capacity and resources. 88.4% of respondents indicate that their organizations provide financial education, and the majority of respondents (about 73%) are involved in program delivery and had an average of 12.3 years of experience in the field. A majority of 60.6% of respondents identifies low-income target populations for their programs, though the range includes the general population, young people, and the elderly, and most reach their target populations through a variety of means, including printed materials, group events such as workshops and seminars, and individual counseling sessions.

Respondents totaling 80.5% report some involvement with program evaluation (university-affiliated programs at a rate

about 20% higher than non-university programs). The survey examined documentation and uses of program evaluations and respondents indicate a range of methods for collecting data, with most relying on a survey method such as pre- and/or post-tests. Most common indicators include number of participants in programs, followed by changes in participants' knowledge levels and then by changes in attitude, skills and satisfaction levels. Non-university programs are significantly less likely to study indicators related to intended or actual behavioral change.

Respondents generally release data via reports, executive summaries, and news releases. Additionally they present findings at conferences and to other professional audiences, with non-university programs admitting no impact reporting, or lack of impact finding dissemination, at rates up to about 20% higher than university-affiliated programs.

Capacity building through resource development, training and awareness

The research of Lyons et al, plus prior research, indicates the need for national standards for measuring program impact, both in order to improve the effectiveness of evaluations and help the profession to better rank comparative programs. However, programs differ radically in terms of content, delivery methods, and target audiences and, consequently, one-size-fits-all evaluative approaches cannot reliably measure impact on consumer financial literacy. For this reason, evaluation toolkits must exhibit flexibility, adaptability, and ease of use. An example might be a combination of an online tool allowing for customized evaluation instruments based on a range of potential outcomes and indicators, accompanied by an evaluation manual for providers that contains guidelines on instrument design plus presentation and use suggestions for evaluation results. These online and

manual tools would need to be accompanied by national training workshops for financial educators. Organizations, on their part, must also accurately assess their ability to undertake evaluation. In particular, they must be realistic about 1) how extensively their organization can commit to an evaluation scenario, 2) which programs and primary program goals that might most benefit from evaluation, and 3) the expectations they have for participants' willingness to participate in evaluations.

On the awareness-building front, grassroots providers indicated, in both focus group and survey data, that they see a need for state and national leadership, in collaboration with front-line practitioners, to build evaluation capacity and raise awareness about the importance of program evaluation. Writes Lyons et al, "The implication is clear—better communication is needed at all levels to overcome the disconnect between program instructors, program administrators, researchers, funders, and policymakers" (2006).

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Policy Brief Summaries: "In Search of Corporate Governance"

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Attendees of November 28th NFI Financial Forum "In Search of Corporate Governance" were treated to impressive presentations by Professors Kenneth Lehn (University of Pittsburgh), Roman Weil (University of Chicago), and Lawrence White (New York University). A summary of each policy brief follows:

Reforming Regulation of Corporate Governance by Kenneth Lehn

General wisdom in the aftermath of the accounting scandals at Enron, Worldcom, and other high profile companies suggested that investor confidence in the U.S. was in crisis. Ken Lehn challenges this view and the ensuing political response, the fast-tracked Sarbanes-Oxley Act of 2002. In addition to dramatic increases in SEC enforcement resources and substantial penalties for noncompliance, Lehn calls the Act "the first major federal attempt to micromanage the internal governance procedures of U.S. corporations." Section 404 of the Act, Lehn argues, imposes compliance costs higher than any possible benefit that could be realized by investors.

Lehn's analysis of major stock indices in the U.S., U.K., Germany, France, and Japan contradicts the theory of an investor confidence crisis. Drawing on Nobel-prize winning economist Gary Becker, from the University of Chicago, Lehn suggests that the propensity for accounting fraud increases when the perceived benefit of such fraud outweighs the perceived risk. In the 1990s, securities markets grew at a higher rate than SEC enforcement capabilities, firms with intangible assets saw remarkable growth, and the increased use of executive stock options created the perception for

some that the benefits of fraud outweighed its risk.

Twenty-plus year jail sentences for former Enron executives and the increased enforcement capabilities of the SEC have changed this perception. A key unintended consequence of Sarbanes-Oxley on U.S. corporations and financial markets is that perceived risk now so outweighs perceived benefit that it has undercut entrepreneurialism and other legitimate business risk. Lehn suggests that a one-size-fits-all approach to fraud, found in Section 404 of the Act, is counterproductive. Instead, Lehn suggests an opt-in/opt-out provision for Section 404 of the Act, which would allow firms to employ the corporate governance structures and procedures they need to be compliant and the flexibility they need to succeed.

“Audit Committee Financial Literacy: What Might It Mean and Why Bother?” by Roman L. Weil, Douglas J. Coates, and M. Laurentius Marais

In 1999, the New York Stock Exchange and the National Association of Securities Dealers assembled the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. The Blue Ribbon Committee report called for increased financial literacy among audit committee members. Given the report’s recommendations, Dr. Roman Weil suggests they really meant accounting literacy. Even more important for audit committees, the Sarbanes-Oxley Act of 2002 requires firms to have an Audit Committee Financial Expert and established the Public Company Accounting Oversight Board (PCAOB).

With a backdrop of calls for increased financial literacy and oversight in the form of the PCAOB, Weil developed several tests to measure the financial (accounting) literacy of audit committee members. The results of a financial literacy quiz taken by over 2,000 accounting and audit committee members im-

plied that more than half of the respondents had inadequate financial (accounting) literacy. A rating of audit committees of 300 Fortune 1000 firms found a wide variance in audit committee financial literacy.

In the end, Weil stops short of recommending “externally-imposed standards for audit committee membership.” He believes this function is best left to nominating committees, but he urges that the benefits of having literate audit committee members needs to be further publicized. Companies whose audit committees showed improvement in financial literacy from 2000 to 2004 realized superior stock market returns compared to firms whose audit committees did not.

“Focusing More on Outputs and on Markets: What Financial Regulation Can Learn from Progress in Other Policy Areas “by Lawrence J. White

Dr. White taps into the wisdom of non-financial regulatory success stories to provide a compelling argument that financial regulation needs to move from a “command-and-control” model “toward a focus on outputs and a greater reliance on markets.” White provides two examples (and added a third in his presentation) of how financial regulation might benefit from a move towards an “outputs and markets” orientation. In terms of environmental regulations, the cap-and-trade program for controlling sulfur dioxide emissions provides an example of the “outputs and markets” model.

Original “command-and-control” clean air efforts sought to specify standards for each source of emissions. Moving to “performance standards” involved specifying total allowable emissions. Making the final transition to outputs and markets ensures that emissions stay within aggregate goals at a lower regulatory cost. A limited amount of permits are issued which total the aggregate allowable emissions. Permits

are allowed to be traded among emitters creating a market for permits and incentive for emission-reduction efforts.

The Community Reinvestment Act (CRA) initially focused on individual regulators rating each bank in order to encourage local investment. In the 1990s, CRA was revamped to focus on overall lending levels. Modeled after the sulfur dioxide cap-and-trade model, Dr. White shares Stanford Law Professor Michael Klausner's outputs and markets proposal for CRA. A local investment quota would be set for each bank. Banks could then buy and sell quotas between themselves. Aggregate lending goals would be met at a lower regulatory cost, and banks would enjoy a flexible marketplace. White contends that more areas of financial regulation would benefit from a move towards outputs and markets.

■ Dr. Kenneth Lehn is the Samuel A. McCullough Professor of Finance in the Katz School of Business at the University of Pittsburgh, where he teaches courses in financial economics. He is also an affiliated professor of law at the University of Pittsburgh's School of Law.

■ Dr. Roman L. Weil is the V. Duane Rath Professor of Accounting at the Graduate School of Business of the University of Chicago and Director of the Chicago/Wharton/Stanford Law School Directors' Consortium.

■ Dr. Lawrence J. White is the Arthur E. Imperatore Professor of Economics at New York University's Stern School of Business and Deputy Chair of the Economics Department at Stern.

The full text of the three policy briefs and other publications are available on NFI's website: (www.networksfinancialinstitute.org). Click "Research" and then "Publications/Papers."

■ Matt Muckler is a Graduate Fellow at Networks Financial Institute.

Save the date NFI Event: China - A Two-Way Street

On January 24th, 2007 at Westin Hotel in Indianapolis

Join Indiana State University, Liaoning University of Liaoning, China and Networks Financial Institute on Wednesday, January 24 for a day-long conference to be held in downtown Indianapolis at The Westin Hotel. Discussion on China's Economic Growth and Opportunities for Indiana will be led by nationally recognized speakers. This conference will focus on two topics:

◆ Why China? A panel of Indiana business leaders will lead an exchange of ideas and information on the opportunities and benefits to Indiana from developing relationships and conducting business with the Chinese, especially related to capital investment and trade.

◆ How to work with China. A panel of executives will discuss their experiences in creating and growing successful business relationships with the Chinese. Experts will address specific issues such as Chinese tax law and acquisition, labor law and more. Conference attendees will have the opportunity to interact with Chinese business leaders interested in doing business in and with the U.S.

Keynote speakers:

Ted C Fishman, author of the bestselling book [China, Inc., How the Rise of the Next Superpower Challenges America and the World.](#)

Jack Perkowski, the Chairman and CEO of ASIMCO Technologies, one of the largest Chinese foreign-invested manufacturing organizations in China.

Registration is required and space is limited. To register and for more details, please go to:

www.networksfinancialinstitute.org