TD Bank Financial Group

TD Economics

Observation

April 23, 2009

DO STATE FORECLOSURE LAWS IMPACT MORTGAGE DELINQUENCY RATES?

The notion that any U.S. homeowner can mail their keys back to the bank at any time and walk away from their mortgage has become fairly prevalent, earning the term "jingle mail." In fact, there is a fair bit of diversity in foreclosure laws from state to state. The differences generally come down to two fundamental issues. Does a foreclosure require the involvement of the courts and who bears the loss if the mortgage value is greater than the value of the home, the bank or the borrower? While this still over-simplifies the differences, it does provide a useful framework for categorizing each state. There are nine states such as Massachusetts where the laws tend to be borrower-friendly, where the bank typically has little recourse to recoup any negative equity in the home. In a further 13 states, the borrower may be required to compensate the bank for negative equity, but every foreclosure requires going to court, which can be expensive for the lender. In a further 20 states and the District of Columbia, the laws are more favorable to the lender. In these cases, foreclosures may involve the courts, but they can also be contract-based and in either case, the bank may be able to recoup negative equity losses from the borrower. There are then a further eight states, six of which are in the west, where foreclosures may involve courts or be contract-based, but only the courts can make judgments regarding negative equity.

We would expect to find that states which make it easier for borrowers to walk away from a mortgage will, on average, tend to have higher mortgage delinquency rates. In fact, for any given unemployment rate, those states that have borrower-friendly foreclosure laws have tended to have mortgage delinquency rates 1-3 percentage points higher. However, the important question in the current

NATIONWIDE DIFFERENCES IN FORECLOSURE LAWS

WEST	NORTHEAST	SOUTH	MIDWEST
BORROWER-FRIENDLY *Foreclosure may or may not require courts, but bank can never recoup negative equity*			
	Massachusetts	Delaware Mississippi North Carolina West Viriginia	Iowa Missouri Nebraska South Dakota
LENDER-EXPENSIVE *All foreclosures require a court, but bank can recoup negative equity through the court*			
New Mexico	Connecticut Maine New Jersey Pennsylvania	Florida Kentucky Louisiana South Carolina	Indiana Kansas North Dakota Ohio
LENDER-FRIENDLY *Foreclosure may or may not require courts, and in either case bank can recoup negative equity*			
Colorado Hawaii Idaho Nevada Utah Wyoming	New Hampshire New York Rhode Island Vermont	Alabama Arkansas District of Columbia Georgia Maryland Tennessee Texas Virginia	Illinois Minnesota Wisconsin
AMBIGUOUS *Foreclosures may or may not require courts, but courts are needed to recoup negative equity*			
Alaska Arizona California Montana Oregon Washington		Oklahoma	Michigan

environment is whether these same legal differences lead to different dynamics as unemployment rates rise and more mortgages fall into a negative equity position. Does having a legal environment favorable to borrowers imply that more borrowers than in other states will become delinquent on their mortgage for the same increase in the unemployment rate?

On this crucial question, the evidence is limited but suggests this is not the case. Looking at the relationship between the change in the unemployment rate over the last two years and the change in the mortgage delinquency rate, those states which had lower delinquency rates to start with relative to other states (such as those with ambiguous laws) have seen the strongest push from rising unemployment rates to rising delinquencies. Meanwhile, those states where delinquency rates were already high (the borrower-friendly states) have seen the least increase in the delinquency rate relative to changes in unemployment. The dynamics here have so far been one of convergence, rather than aggravation.

The differing relationship between home prices and delinquencies, too, supports the notion that the legal environment plays only a negligible role. Outside of the borrower-friendly states, the larger the decline in prices over the last two years, the larger the increase in the delinquency rate. But in borrower-friendly states where you might expect borrowers to walk away sooner from a negative equity position, there has been no relationship between these declines and increasing delinquencies (though to be fair, these states on average have seen less home price declines). As a final check, after accounting for the fundamental factors described on page 15, there is no evidence that the differing legal environments had any influence on increasing any state's mortgage delinquency rate over the last two years.

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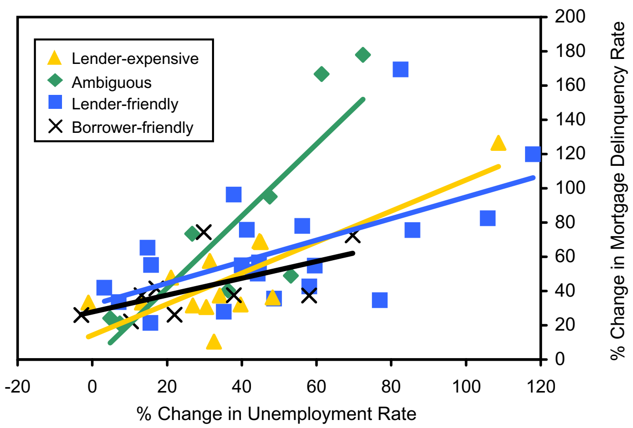
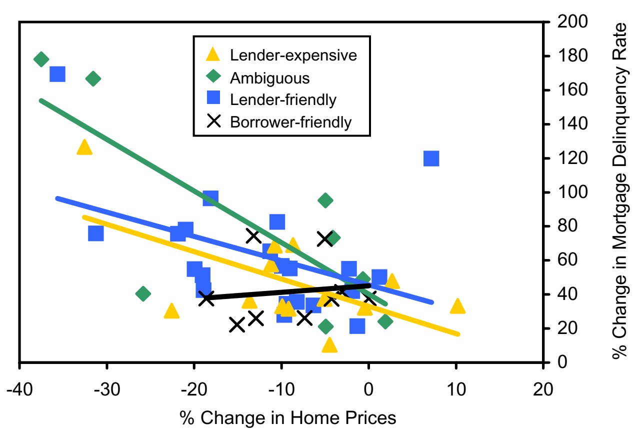
PERCENT CHANGE IN RATES FROM DECEMBER 2006 TO DECEMBER 2008



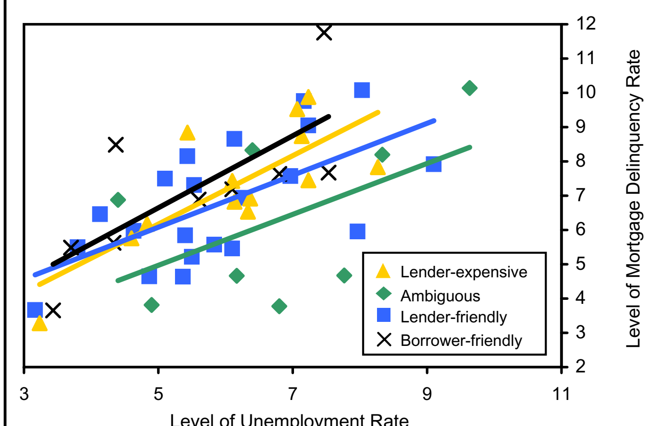
Source: BLS, MBS, Moody's Economy.com

PERCENT CHANGE IN RATES FROM DECEMBER 2006 TO DECEMBER 2008



Source: BLS, MBS, Moody's Economy.com

DECEMBER 2008 LEVELS OF UNEMPLOYMENT AND DELINQUENCY RATES IN U.S. STATES



Source: BLS, MBS, Moody's Economy.com