

Community Development Policy Summit

Federal Reserve Bank of Cleveland

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“How do we safely reach the other side?” is the question put to this panel.

If by “other side” you mean: of the foreclosure mess, and by safely you mean: without a collapse in real estate values, other panel participants will tell you about tools for communities and borrowers that can help stabilize markets.

If the “other side” is a step beyond that: re-establishing a healthy flow of homeownership finance to households and communities, then first, that will clearly take some good, thoughtful regulation, and those prospects have been a topic of much discussion at this conference. It will also take some lending tools, and we can share some research that might give us a sense of what those look like:

In the same time period that subprime rose from small niche, bubbled and burst, and FHA did almost the reverse, a CDFI in North Carolina called Self-Help, in partnership with Fannie Mae and the Ford Foundation, created a secondary market for “CRA”-type mortgages. To date, they have funded some 50,000 loans: All with minimal cash to close, with a credit score profile that is not typical for prime portfolios; The median income of a

borrower is 64% of area median, and more than 40% of the loans are to minority borrowers, and more than 40% to female headed households. These loans were made by banks and bank-owned mortgage companies across the country, quite a few of them here in Ohio. All the loans were prime - that is, 30-year, fixed rate mortgages, with escrow. All fully underwritten - sometimes alternative methods were used to document income - but that is not the same as no-doc or stated income. I submit that this is what happens in the legitimate response to CRA. Some suggest that CRA led lenders to make high cost mortgage with balloons and prepayment penalties or exploding adjustable rates without documenting ability to repay...I'm not sure I accept that. I would like to hear from the institution who said "I would never do such a loan if it wasn't for CRA."

So far, these loans have significantly outperformed the subprime market - even when controlling for risk factors. The CAP program is a long-cycle program. Next year will mark 10 years. In this model, capital was brought to the table, loan loss reserves were priced into the loans, risk was shared with originators (at the front end) and managed by institutions who they did not follow the market on short-term fads.

Another key feature, they recognized from the outset that flexibility on the front end required flexibility on the back end. Self-Help implemented aggressive management of servicers' loss mitigation activities (quite in contrast to the "brain dead trusts" in the private MBS market who generally do not direct servicer actions). They also call borrowers in early stages of delinquency. Our research indicates that this is having measurable benefits.

To date, Self-Help is not experiencing the huge loss levels that characterize other parts of the market. I would venture that many other CRA portfolios would exhibit similar performance.

And from the borrower standpoint, and I have to admit that it is too early to call because the subprime meltdown could drag down whole communities with it, but up to this point, there has been a broad asset building effect. Particularly for those who bought earlier, experienced more equity growth, and can sustain more decline. But as of the first quarter of 2008, the average borrower had equity of \$29,000, compared to an average initial investment of less than \$1,000; that is a big boost.

So I'm hopeful that, if undertaken for the long term cycle, by both investor and borrower, housing can still, ultimately, be an effective wealth building strategy. And that is something to keep our eye on as we try to "get to the other side" of this mortgage credit crunch: with lessons learned from the Self-Help/Fannie Mae program: underwriting, risk management linked to institutional capital, and loan servicing that adapts to the underwriting. That's just basic banking.

If the question is how do "I" -- representing the research community -- get to the other side, we need to advocate strongly for the public availability of data. Data has enabled a "shadow regulatory" function where advocacy and consumer groups and academic institutions monitor and report on the activities of the institutions. This has been one of the key market disciplinary tools of CRA. We need to take this opportunity to be the voice

for access to information, and further, use that data to help identify and document “what works and what doesn’t.”

And together, building on that knowledge, all of us, lenders and regulators alike, should anticipate the next problem area, as these things are all related, as we’re learning. Is the problem area payday loans? As an aside on payday lending, we documented a favorable consumer reaction to the banning of payday lending in North Carolina, and note that Ohio state lawmakers just moved to limit it here. Or is it credit cards or overdraft protection or auto leases or high fees on savings accounts or student loans that will be the next threat to households’ financial security?

But probably the most important question is “How do THEY get to the other side?” And now I mean, the households who are trying to play by all the rules, get a bank account, build a credit history, go to college, buy a house, but who seem to hit such pitfalls in trying to build assets.

One example we’re currently focused on is student debt: Since 1977, college enrollment has gone up by 44% while student loan volumes by 833 percent. 64% of students graduate with student loan debt, an average of over \$15,000. This debt burden disproportionately impacts young adults from low-income and minority communities, making it a greater challenge to realize the benefits of a higher education.

Another example is the credit score cycle: Our Center researchers are following the ways in which circumstances and characteristics affect the credit behaviors that in turn drive scores - we see, for example, that, certain

borrower characteristics are associated with a divergence in credit scores over time. This may be evidence of how disadvantages get embedded into credit scores. And then if these circumstances lead to lagging scores, and then more costly borrowing terms such as higher priced loans, which are harder to pay, this in turn causes a further gap in scores and results in a reinforcing loop. If this loop begins at age 18 with a disproportionate college debt burden, you begin to see how asset building prospects suffer over a lifetime. So here is an area for further attention.

So, in closing...I have at least managed to get to the other side of these comments, and just want to close with a plea that, when the financial markets ultimately begin to recover, we do not lose our sense of urgency about the issues we discuss today.