

Outlook

The Preventable Foreclosure Crisis

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As of this writing, some 5 million households are in default or some stage of foreclosure,¹ and the U.S. financial system, once the envy of the world, seems to be falling apart. What went wrong?

Everyone seems to have a favorite suspect. Some blame borrowers who bet that house prices would always go up and overextended themselves. Others blame lenders or other participants in the home sale and origination process (brokers, real estate agents, appraisers, builders) for focusing on short-term profits without considering borrowers' ability to pay.

Some blame Wall Street for recklessly going about the business of securitization. Others blame investors for lack of due diligence when purchasing private securities and derivatives or the credit rating agencies that evaluated investments backed by risky mortgages or the companies that insured these investments. Still others blame the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.

Finally, some have accused former Federal Reserve Chairman Alan Greenspan of being the chief enabler of the crisis. Concerned with the risk of deflation in 2003, the Federal Reserve reduced a key interest rate to 1 percent and kept it there for a year, thus encouraging overleveraging in all aspects of the market.

¹ The National Delinquency Survey (NDS, a subscription service of the Mortgage Bankers Association of America [MBA]) shows that 8.97 percent of mortgages were past due or in the foreclosure inventory for the second quarter of 2008. With an estimated 51 million mortgages outstanding, this means that close to 5 million borrowers are behind in their payments. MBA quarterly NDS reports indicate that an estimated 2.5 million mortgages entered foreclosure from the beginning of 2007 through the second quarter of 2008 (some of these are still in the current foreclosure inventory). According to Abromowitz (2008), "5 million borrowing households [are] overextended to the point of default or foreclosure."

To some extent, we think that everyone is right: In the context of an extended period of low rates and plenty of cheap credit feeding irrational exuberance in the housing markets, many parties from borrowers to Wall Street got carried away in pursuing their own short-term interests.

When the pursuit of short-term gains by market participants is detrimental to the long-term common good, there seems to be a clear case for government regulation.² Unfortunately, despite repeated warnings, the regulators were silent and did not act during the gestation of this crisis.³ Not until 2006 did regulators issue guidelines for interest-only and negative amortization loans; moreover, it took until mid-2008 for the Federal Reserve to finally amend the Truth in Lending Act (Regulation Z) to effectively ban many of the practices that characterized so-called “toxic” mortgages.⁴ In announcing the final rule, current Federal Reserve Chairman Ben S. Bernanke concluded that “unfair or deceptive acts and practices by lenders resulted in the extension of many loans, particularly high-cost loans, that were inappropriate for or misled the borrower” (2008, 1). Unfortunately, these changes came too late: The subprime market peaked in 2006 even as the housing bubble started to deflate in late 2005. If regulators had acted earlier, the current foreclosure crisis could have been prevented.⁵

Regulation might have been delayed in part by the subprime market’s appropriation of the theme of advancing homeownership through innova-

²During testimony before the House Committee on Oversight and Government Reform on October 23, 2008, Alan Greenspan admitted to being at least “partially wrong” in his trust that markets would self-regulate (Andrews 2008).

³The warnings are too numerous to list. We will provide just a few examples from a variety of sources. A *Business Week* article by Berner and Grow (2008) about state regulators’ efforts to persuade federal regulators of the dangers of “irresponsible lending” cites Attorney General Roy Cooper of North Carolina, which in 1999 became the first state to pass anti-predatory lending legislation. The Center for Responsible Lending Web site (n.d.) records numerous instances of testimony before House and Senate committees and regulators as far back as 2000. In a report published in 2000, the U.S. Department of Housing and Urban Development called for “timely and concerted federal action...to protect subprime borrowers from the dangers of predatory lending.” Even a former member of the Board of Governors of the Federal Reserve System—Edward M. Gramlich—expressed concern in 2000 and throughout his tenure on the Board (see Krugman 2007).

⁴The final rule was issued on July 14, 2008. For newly defined “higher-priced mortgage loans” secured by principal residences, the new rule requires verifying income and assets and assessing repayment ability (based on the highest scheduled payment in the first seven years), limits prepayment penalties, and requires tax and insurance escrows. The rule also establishes additional protections for all loans secured by a consumer’s principal dwelling, regardless of whether the loan is higher priced or not (Board of Governors of the Federal Reserve System 2008a).

⁵In October 2008 testimony before a House committee, Alan Greenspan suggested the root problem was the subprime securitization market, specifically excessive and “aggressive” demand for subprime securities, the “collapse” of underwriting standards, and “failure” of risk and pricing models (Greenspan 2008).

tion and the “democratization of credit,” although in fact the majority of subprime loans were made for the purpose of refinancing (Center for Responsible Lending 2007).⁶ Proponents argued that any steps to constrain the supply of increasingly exotic mortgages were detrimental to homeownership.

Paradoxically, as the pendulum swings toward re-regulation, there are those who would pin the crisis on the promotion of homeownership among low-income and minority borrowers. In particular, they assert that the regulatory requirements of the Community Reinvestment Act (CRA) and/or GSEs’ Affordable Housing Goals (AHGs) motivated lenders and the secondary market to make irresponsible lending decisions.

Thus, the current debate, which is likely to intensify, is whether the crisis was caused by a lack of regulation (of consumer protection, industry safety and soundness, or capital requirements) or by CRA requirements and the AHGs adopted by GSEs. The outcome of this debate will have important policy implications. To inform the debate, this article presents and examines evidence on policies that encourage affordable homeownership lending.

Examining the evidence

There is no doubt that increasing the homeownership rate has been a goal of U.S. housing policy for decades. Homeownership has long been recognized as a path to financial security: Even in the face of a \$700 billion drop in the value of households’ real estate holdings from mid-2007 to the present, home equity still accounted for the largest element of household wealth in the second quarter of 2008 (Board of Governors of the Federal Reserve System 2008b). Yet large gaps in homeownership and wealth between non-Hispanic whites and racially and ethnically underrepresented groups have persisted. Therefore, policy makers have paid particular attention over the past three decades to promoting homeownership to low-income and minority households whose homeownership rates lagged behind those of other groups.

Two key policy tools designed to advance this goal are CRA (passed in 1977 and strengthened in 1995) and the AHGs (a similar secondary market device originally established in 1992 and successively augmented over time). In response, banks and thrifts developed CRA Special Lending Programs (Avery, Bostic, and Canner 2000a), and GSEs created “special affordable programs.” Common features included reduced cash-to-close requirements, flexible underwriting of credit and employment history, and higher accepted

⁶According to page 3 of the report, the share for refinances was between 56 percent and 70 percent for the 1998–2006 period.

levels of debt to income (Avery, Bostic, and Canner 2000b; Temkin, Quercia, and Galster 2000).

During the 1990s, the U.S. homeownership rate experienced a substantial rise; between 1995 and 2001, it grew 3.8 percent—from 64.2 to 68 percent (U.S. Bureau of the Census 2008). The minority homeownership rate increased by 5.8 percentage points, but was still only two-thirds of the white homeownership rate (Joint Center for Housing Studies 2008). Although many factors contributed to this increase, research has suggested that both of these policy interventions had their intended effect of increasing homeownership (Ambrose, Thibodeau, and Temkin 2002; Barr 2005). Meanwhile, researchers found that CRA programs, which adhered to the important “safety and soundness” provision, were overwhelmingly profitable (Avery, Bostic, and Canner 2000b). In general, the rise in homeownership rates was not accompanied by a dramatic increase in default rates: Overall, 3.76 percent of conventional loans were past due or in foreclosure by the end of 2001 (Mortgage Bankers Association of America [MBA] 2002). Although CRA delinquencies were not reported separately, institutions that were surveyed reported an estimated average delinquency rate of around 4.4 percent for CRA-related mortgage loans in 1999. This is not a particularly high number, especially given the typical features of such loans.

But times changed. In 2003, the nonprime mortgage market began to heat up, growing from 10 percent to nearly one-third of originations by 2006.⁷ As of June 2008, the Second Quarter National Delinquency Survey put out by MBA indicated that 30 percent of subprime loans were delinquent or in foreclosure. By definition, subprime loans are made to borrowers who do not qualify under prime market guidelines, and ample evidence⁸ shows that these loans also were disproportionately made to low-income and minority borrowers. But this time, CRA was not a major motivator for the institutions that poured capital into the subprime market, because few of these mortgages were made by CRA-covered institutions in their assessment areas (Goldstein and Hall 2008). And at least at the outset, AHGs were not a factor, because most of these loans were originated and securitized outside

⁷See Shiller (2008) for a detailed description of the growth and bust of the subprime market within the context of the broader global financial crisis.

⁸According to Home Mortgage Disclosure Act data, for first-lien, owner-occupied mortgages issued in 2005 and 2006, only 23 percent of white borrowers received subprime loans, in contrast to 48 percent of black borrowers and 38 percent of Hispanic borrowers. Low-income borrowers were 50 percent more likely to get a subprime loan than higher-income borrowers. For a review of studies documenting the geographic concentrations of subprime loans in low-income and minority neighborhoods, see Ding, Ratcliffe et al. 2008.

of Fannie Mae and Freddie Mac. Until 2005, such mortgages constituted only a small proportion of new business for GSEs.⁹ Thus, the timing is not consistent with the contention that GSEs instigated the risky lending and securitization practices that began to implode in 2007.

This discussion should not be taken to imply that GSEs do not need some retrenching along with the rest of the system (Lockhart 2008). Their accounting practices and models have been at issue; GSEs did add liquidity to the subprime and Alt-A markets. In short, GSEs may have “followed the market down in 2006 and 2007” (Lockhart 2008, 2), albeit to a lesser extent,¹⁰ but their current hangover is not due to core affordable housing lending. To wit, as of the second quarter of 2008, Alt-A loans make up just 11 percent and 10 percent of Fannie Mae’s and Freddie Mac’s portfolios, respectively, but account for at least half of second-quarter credit losses at both institutions. The profile of these Alt-A loans is not consistent with an affordable housing focus: The average loan amount is over \$170,000, and their average loan-to-value ratio is below 75 percent (Fannie Mae 2008; Freddie Mac 2008).¹¹

Ongoing research

At the University of North Carolina, we are conducting a multiyear study of a large portfolio of CRA and affordable mortgages made to lower-income borrowers. Our findings portray the stark difference between CRA/AHG lending and the type of lending that was done in the largely unregulated

⁹Subprime and Alt-A purchases constituted about 14 percent of the new business for GSEs in 2005 and about 33 percent in the first half of 2007 (Lockhart 2008). According to Barr (2007), “Subprime mortgages are offered to lower-income borrowers with spotty credit records....Alt-A loans were originally designed for borrowers with clean credit records, but with other issues that often meant they provided fewer documents or even no documents showing what they earned....The popularity of Alt-A mortgages exploded in recent years. A record \$400 billion of these loans were originated in 2006. They accounted for 13.4% of all mortgages offered last year...but as the Alt-A business grew, more of these loans were offered to less creditworthy borrowers.”

¹⁰As Goldstein and Hall (2008) state, “Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48 percent of the subprime loans that were sold into the secondary market to holding about 24 percent, according to data from *Inside Mortgage Finance*, a specialty publication.” It should be noted, moreover, that the majority of the GSE subprime holdings are not in the form of loans but rather in the form of lower-risk tranches of securities. As of the second quarter of 2008, for example, Fannie Mae held \$8 billion in subprime loans and \$28 billion in subprime securities.

¹¹According to these two sources, Fannie Mae quarterly investment reports indicate a serious delinquency rate (the rate for loans 90+ days past due and in foreclosure) of 3.79 percent for Alt-A loans and 9.08 percent for subprime loans. Freddie Mac reports a serious delinquency rate of 3.7 percent for Alt-A loans. LoanPerformance reporting institutions indicated serious delinquency rates of 10 percent for Alt-A loans and 21 percent for subprime loans (LoanPerformance.com 2008).

subprime market. They suggest that greater access to affordable homeownership finance remains a viable and attainable common goal, even among low-income and minority households.

For example, Self-Help is a community development financial institution based in North Carolina and founded in 1980. Its Community Advantage Program (CAP) provides a secondary market outlet for traditional community reinvestment loans. The program was launched in 1998 by a partnership that included the Ford Foundation and Fannie Mae. Mortgages made to low- and moderate-income home buyers under nonconforming guidelines were sold by banks around the country to Fannie Mae, while Self-Help retained full recourse. Thus this program provided liquidity for banks' CRA programs while advancing AHG lending. Between 1998 and this writing, the program funded more than 50,000 mortgages, with a median size of \$84,000, for borrowers earning an average of 64 percent of area median income. Minority and female-headed households make up a disproportionate share of these mortgages.

Comparing the performance of these loans with subprime loans made to similar borrowers over similar time periods clearly confirms that traditional CRA mortgages have performed much better in terms of safety and soundness for borrowers and lenders alike. Using propensity score matching, we estimate that if the borrowers had taken out typical subprime loans instead of CAP loans, their default rate would have been three to five times as high (default is defined as incurring a 90-day delinquency within the first 24 months of origination). In short, borrowers with similar profiles actually do much better in avoiding defaults or foreclosures with CRA-compliant loans (Ding, Quercia et al. 2008). And if borrowers do better, so do lenders and investors.

Many features explain why CAP loans perform so much better. A typical CAP loan is a fully amortizing, 30-year, prime, fixed-rate mortgage with escrows and no prepayment penalties. By contrast, subprime mortgages were more likely to be broker originated, to carry prepayment penalties, and to have adjustable payments that could double overnight. The more these risk features are layered, the greater the likelihood of default.

The study also indicates that we can look to GSEs' traditional affordable housing programs and the CRA programs of banks and thrifts for best practices. The basic purpose of the GSEs—providing long-term affordability and liquidity—continues to be essential to the functioning of U.S. housing markets (Lockhart 2008). With AHGs, GSEs simply sought to extend the same benefits in the form of uniformity of rates, liquidity, and transparency in mortgage finance to more households.

The results of our study indicate that traditional CRA and affordable housing loans are not at the root of this crisis and should not be conflated with the irresponsible practices that were. We posit that a large part of what went wrong lay in the failure of policy makers and regulators to recognize and act on the distinction between mortgage policies aimed at advancing homeownership and the excesses of the subprime and Alt-A markets. Recognizing that difference is essential to understanding the current crisis and to charting a recovery and a new housing policy.

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