Reconstructing the Foundations of Homeownership

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Foundations of Homeownership – Public Policy

- **Inherent Goal**
  - Increase homeownership – benefits, however mixed
  - Reduce minority homeownership gaps
  - Rely on both private market and public enterprise to achieve the goals
- **Inherent Conflict – What to do when things go wrong?**
  - Ration homeownership?
  - Increase public intervention? Hard to stand by…
  - Reduce private market flexibility?
  - Mitigate losses

What Changed?

- **Types of Mortgage Products Originated**
  - Complex risk layering – not just high LTV but high LTV with little/no doc; low FICO scores; no DTI constraint due to no doc of income
- **Institutions Originating Mortgage Products**
  - Share of originations by non-depositories increased –
    - Different regulatory oversight
    - Decreased role of FHA
- **Institutions Securitizing Mortgage Producs**
  - Plain vanilla MBS – GSE products
  - Complex CDOs and ABS – Wall Street products
- **Total Indebtedness of Households**
  - Considerable optimism that credit card debt could always be repaid with home equity loans
  - Considerable optimism that house prices would rise with the guarantee of instant equity

Mortgage Products – What Changed? Lots…

Table 1							
Mortgage Originations							
Year	**FHA/VA**	**Conv/Conf**	**Jumbo**	**Subprime**	**Alt-A**	**HELOC**	**Total**
Direction of Change	↓↓	↓↓	↓↓	↑↑	↑↑	↑↑	↑↑
2001	**8%**	57%	21%	7%	2%	5%	100%
2002	**6%**	59%	**20%**	**7%**	2%	6%	100%
2003	**6%**	**62%**	16%	**8%**	**2%**	**6%**	100%
2004	**4%**	**41%**	**18%**	**18%**	**7%**	**11%**	100%
2005	**3%**	**35%**	**18%**	**20%**	**12%**	**12%**	100%
2006	**3%**	**33%**	**16%**	**20%**	**13%**	**14%**	100%
2007	5%	47%	**14%**	8%	11%	**14%**	100%
2008	20%	62%	**7%**	2%	3%	8%	100%

Source: Inside Mortgage Finance Publications, *The 2009 Mortgage Market Statistical Annual*, Volume 1, p. 4

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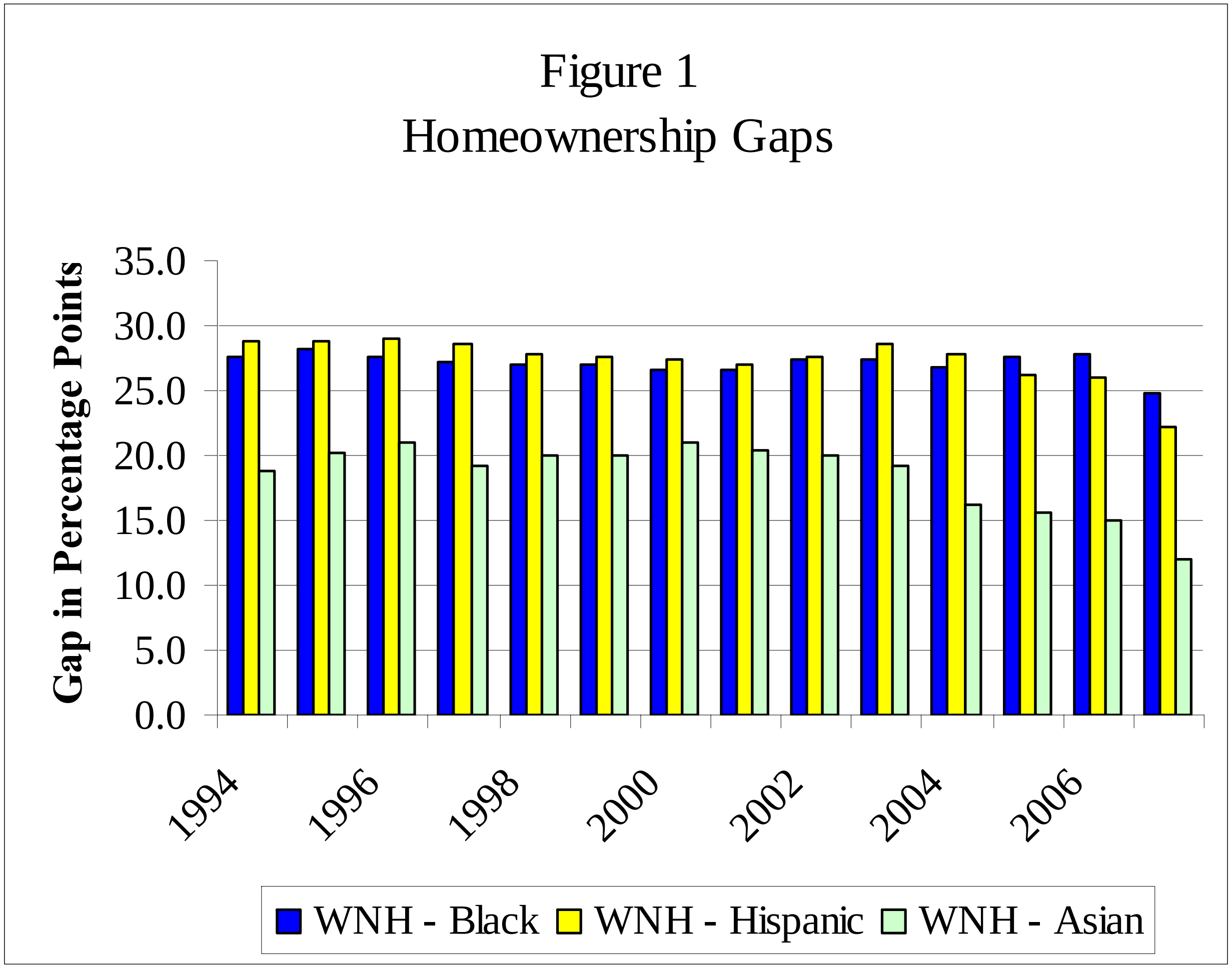
Homeownership Gaps – What Changed? Little…



Tools for Promoting Homeownership

- Community Reinvestment Act
- GSE Act and Affordable Housing Goals
- Targeted mortgages offered by FHA
- Innovative Products offered by Conventional Lenders

What worked and what did not?

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CRA in a Changing Financial Landscape

CRA provides a good example of financial institutions managing simultaneously public policy/affordability requirements and care about shareholder value.

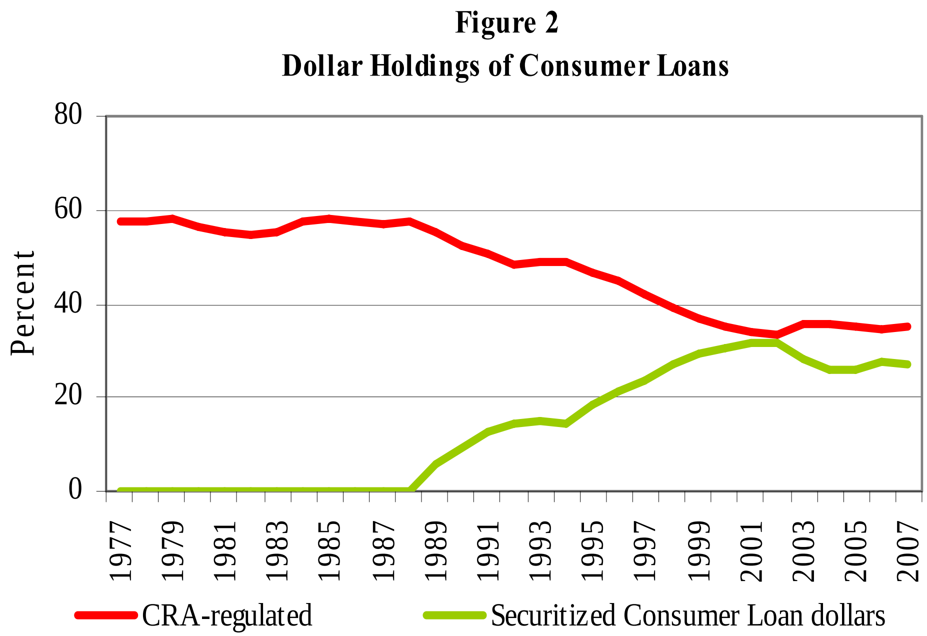
However, CRA's coverage fell over recent years due to:

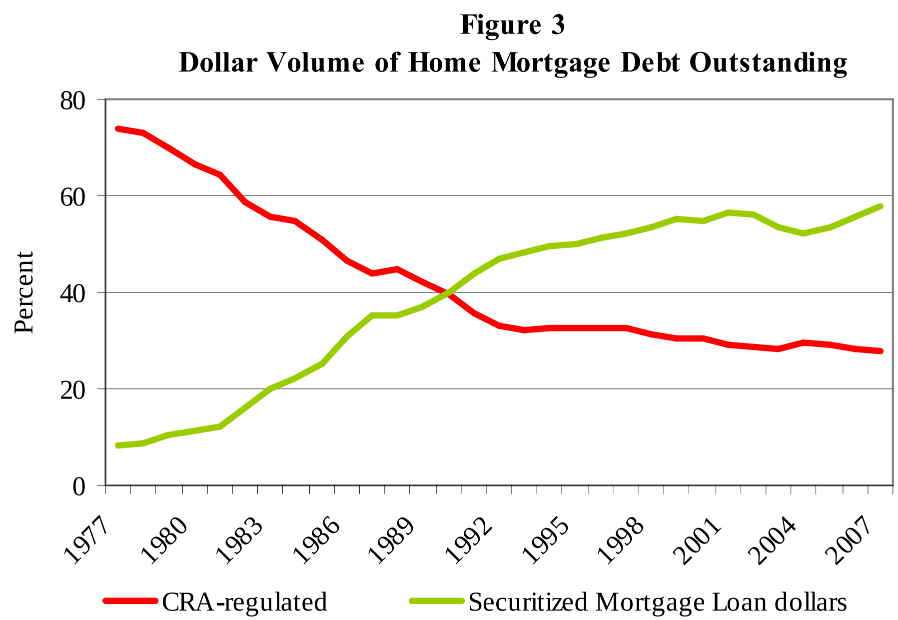
- (1) growth of financial institutions not covered by the CRA, and
- (2) decline in the within-assessment area activity by the larger CRA-regulated institutions -- the footprint of financial institutions has increased dramatically and no longer is financial activity largely locally based. Instead, the institutions that operate across several states or have nationally based operations conduct most financial activity.

[1] Avery, Robert B., Marsha J. Courchane, and Peter M. Zorn, "The CRA Within a Changing Financial Landscape," *in Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, a joint publication of the Federal Reserve Banks of Boston and San Francisco, pp. 30-46, February 2009.

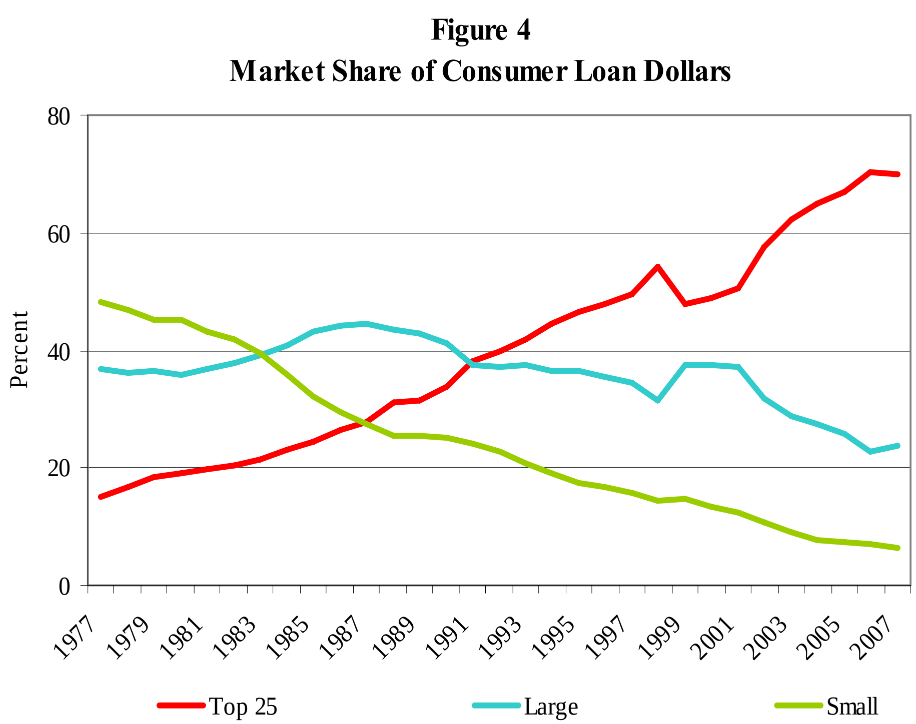
Institutions Originating Mortgage Products – What Changed?

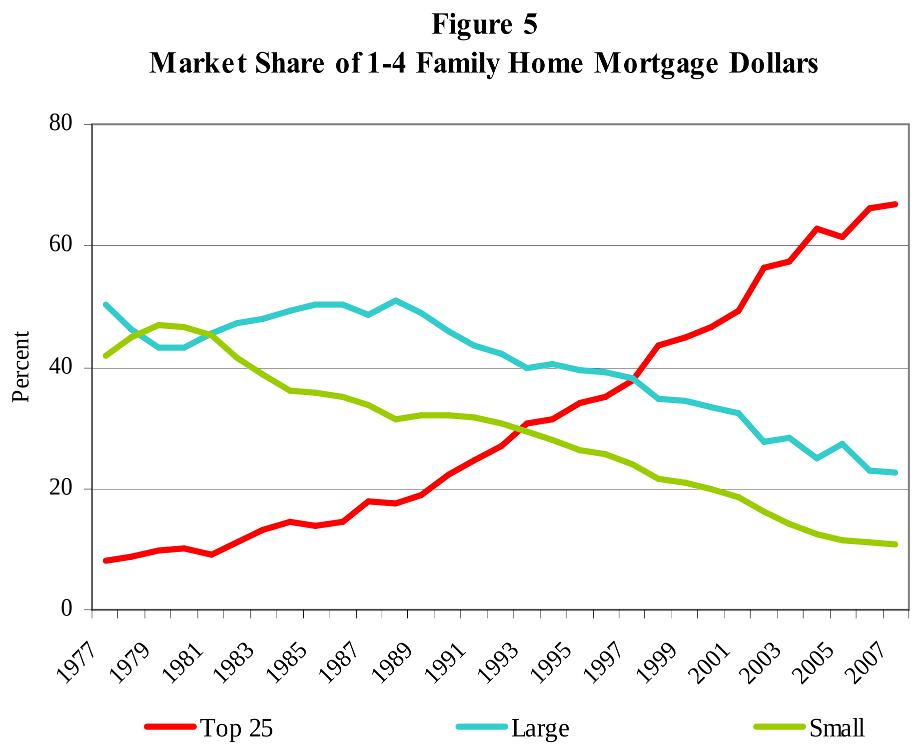
CRA-regulated institutions hold a declining share of loans





Institutions Originating Mortgage Products – What Changed? Larger Depositories





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Institutions Originating Mortgage Products – What Changed?

In-assessment area lending has declined, and less-favors low- and moderate-income households

Figure 6
Share of Mortgages in Assessment Area

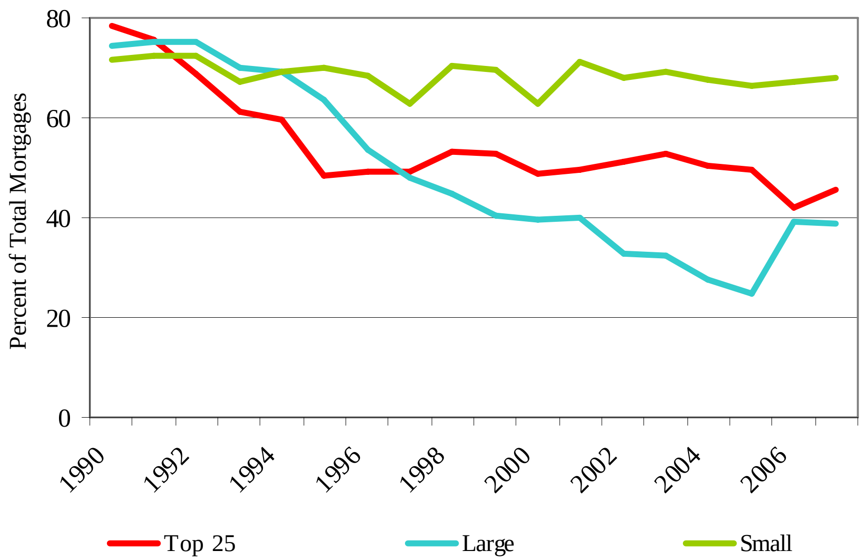
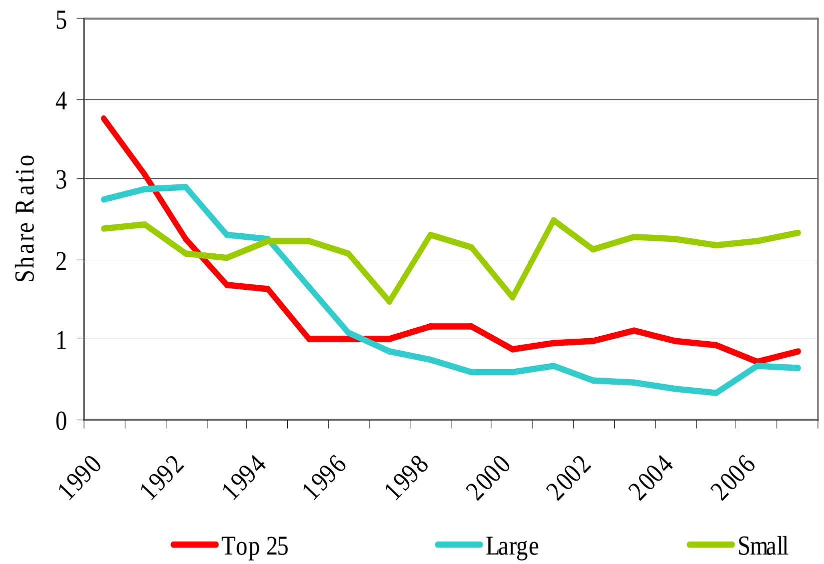


Figure 7
Ratio of Shares of LMI Lending that are in/out of Assessment Area



Impact of GSE Goals

- The effectiveness of CRA is not independent of the GSE's efforts to meet HUD's affordable lending goals as both depend, at least in part, on the mortgage loans originated by CRA-regulated lenders.
- Critics have linked the increased affordable goals to increased subprime lending just as they have linked CRA lending to increased subprime lending. Undoubtedly, the goals for Fannie Mae and Freddie Mac have increased over time. It is also true that the increase has been coincident with the rising share of subprime lending but that does *not* equate the loans meeting affordable lending goals with subprime loans.
- At least as measured by high loan-to-value ("LTV") ratios, disproportionately the goal qualifying affordable loans were not subprime loans.

GSE Affordable Goals

- In 2002, HUD's affordable lending goals were set at 50% (low- and moderate income), 31% (underserved) and 20% (special affordable). By 2007, the low- and moderate income base goal was set at 55%, the underserved areas goal at 38% and the special affordable goal at 25%.[1] Clearly HUD expected the GSEs to meet stiffer goals for targeting home mortgage lending to lower income and underserved populations. It is these same populations, LMI borrowers and neighborhoods, that CRA targets.
- The affordable lending share of GSE mortgage purchases, representing loans to low income borrowers, increased from 27.8% in 2004 to 36.2% by 2007. The total market's comparable share increased from 32.2% in 2004 to 41.8% by 2007 with the FHA share at 56.0%. Similarly, the GSE share of mortgages that were loans for properties in low-income tracts increased from 11.7% in 2004 to 14.6% in 2007 while total market share increased to 17.2%. The GSE minority shares increased from 20.4% in 2004 to 24.1% in 2007, while the entire market minority share barely changed, increasing from 27.2% to 27.6% over the period 2004 – 2007.[2]
- **On balance, the changes observed in GSE performance reflected the changes observed in the market on *these* measures.**

- **[1] HUD also established home purchase subgoals targeted to single family, owner occupied properties that took effect in 2005. These goals were set at 47% (low- and moderate income goal), 33% (underserved) and 18% (special affordable).**
- **[2] U.S. Department of Housing and Urban Development, Office of Policy Development and Research, *Profiles of GSE Mortgage Purchases, 2005 – 2007.***

GSEs did not mirror the market on high LTV

- One of the risks presented by loans originated in the subprime mortgage market was the very high incidence of high LTV loans. The Federal Reserve Board estimated that the share of piggy back loans at the height of the subprime market in 2006 was as high as 22%.[3] T
- SF mortgages that met one or more of the affordable housing goals and were purchased by the GSEs were not predominantly high LTV mortgages.[4] In 2005, 76.8% of the goal qualifying SF mortgages had LTV ratios of less than or equal to 80%. In 2006, that percentage was 75.7 and in 2007 it was 69.5%.
- In fact, only 11.5% of the goal qualifying SF mortgages had LTV ratios above 90% in 2005, although that percent increased to 19.2% by 2007.
- Arguably, the loans with high combined LTV ratios were among the first to become delinquent and default as housing prices fell and the mortgages were higher than the value of the property that secured the mortgage. This may mean that those "affordable goal qualifying" mortgages purchased by the GSEs are less likely to default than others with higher LTV ratios

CRA and GSE Goals

- While both CRA and the GSE affordable goals are meant to target lower income borrowers, the targeted public policy goals are not without some costs. Evidence indicates that the delinquency and default rates for lower income borrowers are generally relatively higher than for households with incomes above the median level. For example, in Freddie Mac's Annual Housing Activities Report for 2007, Exhibit 15 indicates that lower income borrowers have a relative delinquency rate of 1.2 and a relative default rate of 1.1 when compared to higher income borrowers.[5]
- While the GSE affordable goals did target lower income borrowers and neighborhoods in ways similar to CRA, the characteristics of the borrowers and loans purchased by the GSEs or originated under CRA programs did not represent as significant a *layering of risks* as the loans found in the subprime sector.*

- *high LTV, no doc, low FICO, short term ARM combined to layer risks

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Understanding What Happened -- Why Did FHA Decline?

Two competing rationales for the decline – within tract or across tract declines

- **FHA products were not as desirable/attractive across tracts**
  - Products in the non-conforming and subprime markets may have been more appealing; more affordable; more quickly available; easier to obtain?
- **Tracts with high FHA shares may have had slower population growth and declining market share across all products, including FHA**
  - Turns out not to be the case

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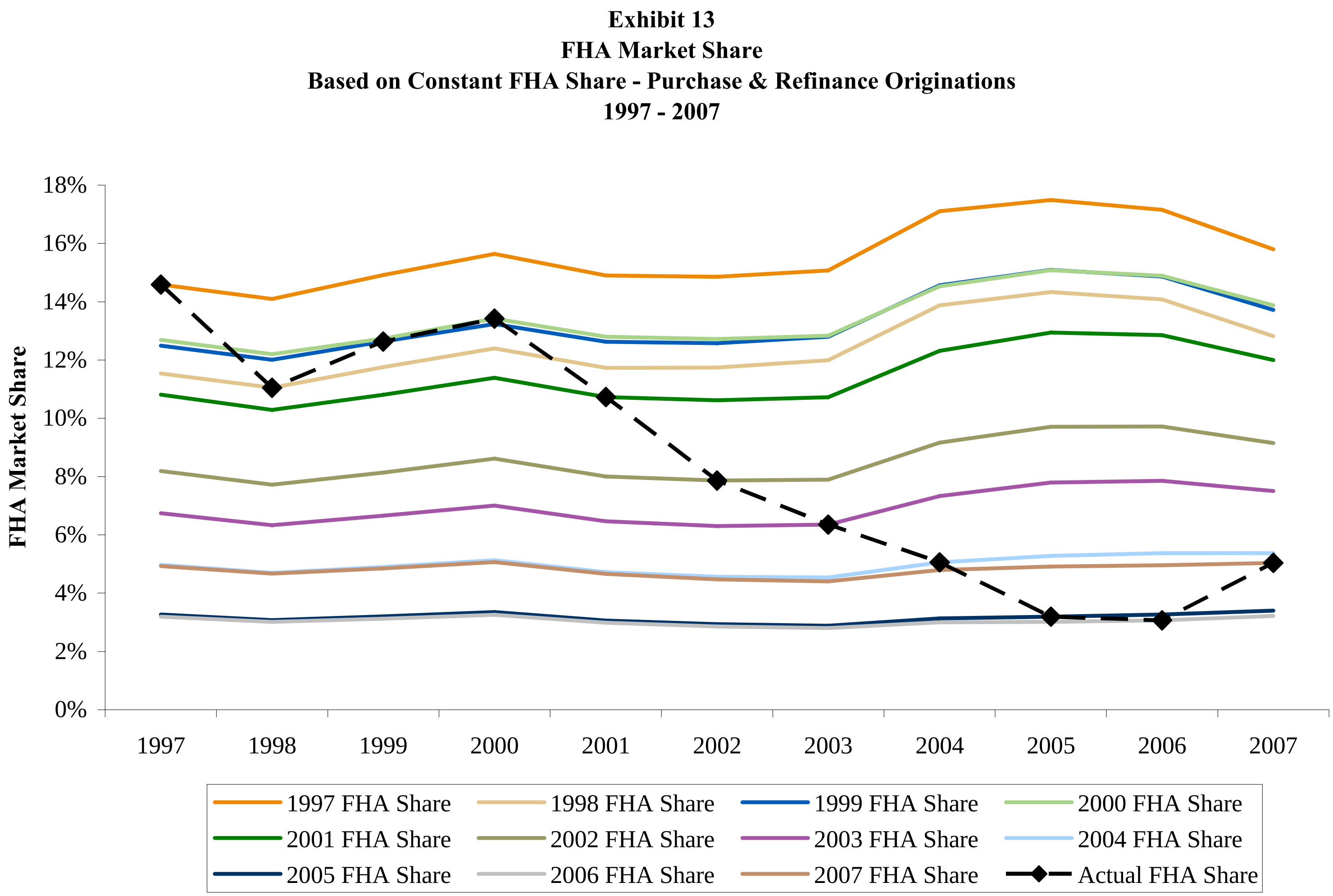
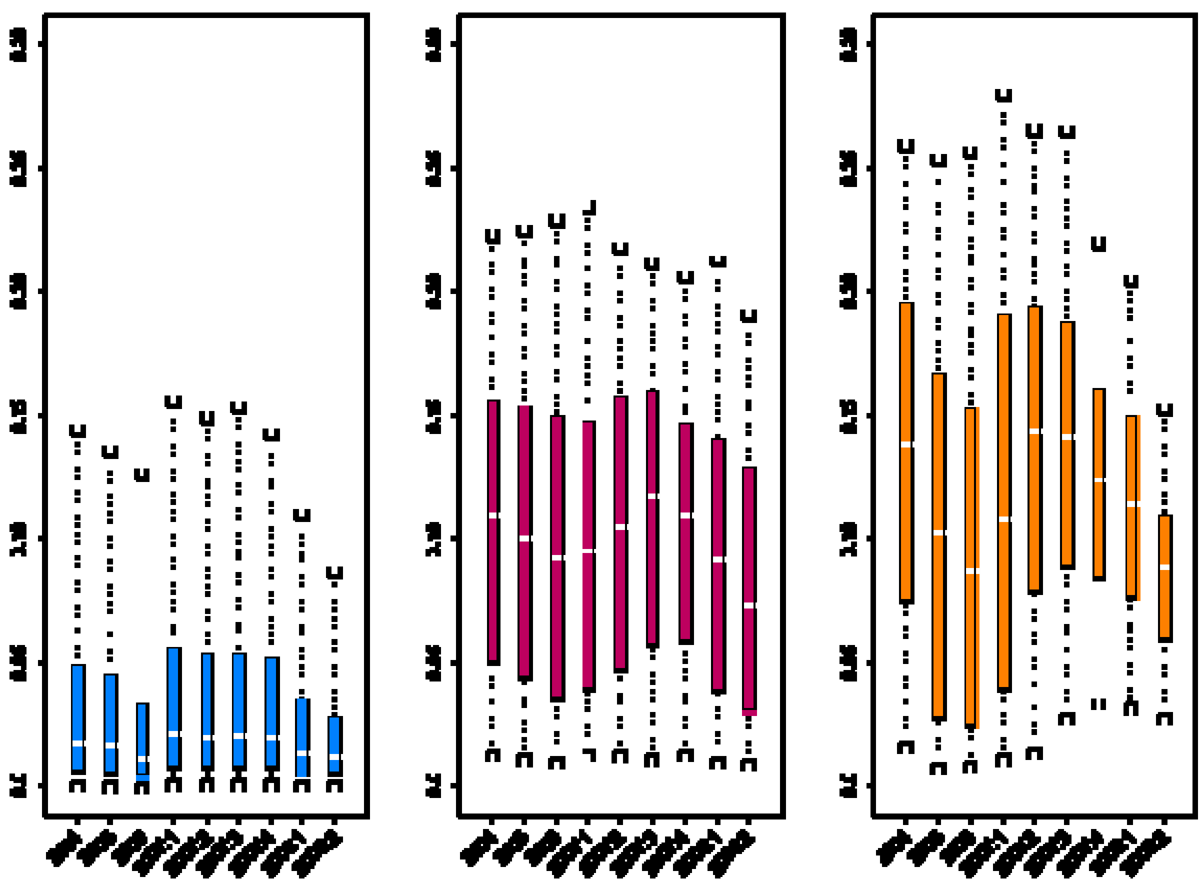
Constant FHA Share in Tracts – FHA Would Have Increased Slightly Over Time



FHA Could Not Compete – Can It Now?
Predicted CDRs: 2004 – 2008Q2

Cumulative Default Rates

PRIME **FHA** **SUBPRIME**



Now What?

- **Need for assessment of what went right – not only what went wrong**
  - GSEs – critical to Obama plan; many critics
  - CRA – much strength; many critics
  - FHA – current important segment; many critics
- **Need to try to provide incentives for stability in the short run and improvement in the long run**
- **Need to balance short run losses against long run gains**

Desired Roles of Financial Institution

- **Setting underwriting standards**
  - Uniformity of application process (e.g. 1003)
  - Uniformity of application standards
    - FICO scores, automated U/W models, known pricing tradeoffs
- **Relaxing constraints – which aspects matter?**
  - Meant to lower constraints to homeownership
    - Low down payments (for low-mod segments)
    - Alternative credit (for young, immigrants)
    - Low doc (for good credit borrowers to speed up process)
    - Longer amortization periods (for low-mod borrowers in early stages of life cycle)
- **Well functioning secondary market**
  - Liquidity provided where needed, efficiently
  - 2008 witnessed sharp drop in sales to non-agency investors

Sustainability

- Both CRA and the GSE Act were meant to encourage participants in the primary and secondary mortgage markets to meet the housing needs of borrowers and neighborhoods in the U.S. *in safe and sound ways without the cost of predatory or discriminatory practices.*
- The current mortgage crisis, has, however, forced a consideration of not just access to credit for homeowners but, rather, access to credit that is compatible with sustainable homeownership – keeping borrowers in the homes they purchase.
- Loss Mitigation efforts improving, but slow progress

Loss Mitigation Efforts – Need to Improve

HOPE NOW					
	Q1 2008	**Q2 2008**	**Q3 2008**	**Q4 2008**	**Q1 2009**
Payment Plans Initiated	314,000	303,000	335,000	350,000	350,000
Loan Modifications Completed	170,000	220,000	256,000	322,000	391,000
All Workouts	484,000	523,000	591,000	672,000	741,000
Foreclosures Completed	203,000	246,000	263,000	205,000	208,000
Workouts/Foreclosures	2.38	2.13	2.25	3.28	3.56

GSEs					
	Q1 2008	**Q2 2008**	**Q3 2008**	**Q4 2008**	**Q1 2009**
Payment Plans Initiated	63,756	66,443	85,771	28,292	
Loan Modifications Completed	15,655	15,387	13,488	23,777	
All Workouts	79,411	81,830	99,259	52,069	
Foreclosures Completed	31,533	38,185	47,497	34,846	
Workouts/Foreclosures	2.52	2.14	2.09	1.49	

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Primary Market

OCC & OTS (from Mortgage Metrics Report)					
	Q1 2008	**Q2 2008**	**Q3 2008**	**Q4 2008**	**Q1 2009**
Payment Plans Initiated	134,624	124,946	154,649	180,152	
Loan Modifications Completed	74,208	134,478	116,483	121,496	
All Workouts	208,832	259,424	271,132	301,648	
Foreclosures Completed	76,548	117,337	126,280	89,634	
Workouts/Foreclosures	2.73	2.21	2.15	3.37	

Sources:

Developed using 2008 data in the Appendix table "Mortgage Metrics Comparison," Federal Housing Finance Agency, Foreclosure Prevention Report, Disclosure and Analysis of

Fannie Mae and Freddie Mac Mortgage Loan Data, Fourth Quarter 2008.

Q1 2009 data from the HopeNow web site.

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Long Run Needs for Achieving Neighborhood Goals

- **Financial Literacy – Must be a Goal of Federal/State and Community Programs**
  - Better management of credit (so qualify for better products)
  - Better understanding of savings (so more down payment)
  - Better understanding of products (so less confusion and less vulnerability)
- **Financial Institution Cooperation**
  - More consistent regulation across agencies is needed – lenders need to work with and not against regulators to help design *safe and sound* products and lending programs
    - Default purchase product? – the 30 year fixed rate mortgage with 20 % down and full documentation of borrower characteristics
    - Default refinance product? – evaluation of income/credit at the time of refinance – no cash out refinances for borrowers that have demonstrated declining credit profiles

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Summary

- **Many contributing factors to collapse of mortgage markets**
  - Products changed; originators changed; secondary markets changed; house prices & equity changed
- **CRA and GSE Affordable Goals did not cause the collapse and may have mitigated the impact**
- **CRA needed for promotion of sustainable lending**
- **GSEs needed for setting standards and loss mitigation efforts**
- **Focus must be on safe, sound, sustainable lending by conventional and govt lenders with the support of a sound secondary market**