1 *Foreclosing on the American Dream*

Millions of families have lost their homes since the start of the Great Recession in 2008. By mid-2010, 4.6 percent of all mortgage loans in the United States were in foreclosure, three times the rate of foreclosure at the height of the Great Depression of the 1930s.[1] Working families were left to pay for the recklessness of a market run amok, and they continue to do so through the loss of their homes, unrelenting unemployment, and stagnant wages. After the failure of more than 150 banks, the loss of over $7 trillion in homeowners' equity, and a global credit freeze, some analysts want to place the blame for these economic crises on policies that promoted homeownership rather than on the wildly irresponsible financial schemes promoted by Wall Street.[2] Is the dream of homeownership lost for America's working families?

No. It doesn't need to be. The current crisis provides an invaluable opportunity to regain the dream by expanding access to sustainable and affordable mortgages for American families. How can affordable lending be resumed without excessive risk taking? The answer lies in the experiences of low-income, low-wealth families who bought homes using traditional, well-underwritten mortgages that they could afford in the decade leading up to the crisis. We document the experiences of 46,000 of these families, who have a median income of $30,000 and most of whom put down less than 5 percent on their home purchase. Despite facing the biggest housing crisis since the Great Depression, these families have experienced low defaults, less than a quarter the level of the subprime market. Given a fair opportunity, the vast majority have successfully maintained and benefited from homeownership.

Before we explain how to regain the dream of homeownership, we step back and recall why national policy has for several decades focused on making homeownership widely accessible.

Homeownership helps families build prosperity. For many Americans, especially less affluent Americans, home equity represents the greater part of their household wealth. For generations, we Americans have viewed homeownership as the cornerstone of the American dream. We value homeownership because it signals economic advancement, promises long-term economic benefits, and represents a tangible piece of the American way of life.

Americans' homes are inviolable: they provide us with stability and security, both financial and psychological. We mark the most important events in our lives by where we lived when they occurred. Our homes also provide shelter, a reliable, long-term savings vehicle, and the chance to pass along wealth to our children. Home equity and the ability to borrow against it allow us to send our children to college, start businesses, and save for retirement. Homeownership also promotes broader economic growth as it fuels a host of construction, real estate, and financial businesses.

For all these reasons, since the 1930s U.S. housing policy has focused on enabling access to mortgage finance. The evolution of this policy is worth reviewing briefly. This history demonstrates that policy drives and shapes what markets do. More important, it shows that when policy promoting homeownership has proven to have shortcomings, it has been modified, not discarded. The effects of housing policy can be profound; thus policymaking must be an incremental process—not always the case in the past. Missteps have only emphasized the importance of getting housing policy right.

Since 1934, when the Federal Housing Administration (FHA) was established to restore confidence in a mortgage market crippled by the Great Depression, U.S. housing policy has sought to promote access to capital in ways that allowed an increasing number of families to build financial security through homeownership. One of the mortgage finance system's most important innovations is the affordable, thirty-year, fixed-rate mortgage. Widely promoted in the 1930s following the creation of FHA insurance, this long-term, low-down-payment, fully amortizing product brought down the cost of homeownership to a point where many Americans could buy into the American dream.

In a world where the adjustable-rate mortgage remains the norm, the United States is one of only three countries where long-term, fixed-rate mortgages are widely available.[3] In the United States, borrowers with fixed-rate mortgages are largely relieved of interest rate risk: interest payments do not go up when rates rise, but if rates fall borrowers can refinance to a lower rate loan. Investors in capital markets, not borrowers, bear the risk of interest rate changes. These investors buy bonds or securities backed by the value of mortgage loans in the so-called secondary mortgage market, accepting risks they can manage in proportion to the return they want.

Because of these innovations, American families can own a home with a manageable financial outlay and predictable monthly payments and, in the process, can build substantial savings. The homeownership rate in America climbed steadily following the creation of the thirty-year fixed-rate mortgage until 2004, by which point two-thirds of American households owned their own homes, compared to just 48 percent of Americans in 1930.[4]

However, the benefits of homeownership, enabled and supported by public policy, are not shared equitably. The American dream has historically been less attainable for minority households and for those with lower incomes, even though access to opportunities for economic mobility is particularly important for those with little wealth. In 2010, 74 percent of white families owned their homes, but only 45 percent of blacks and 47 percent of Latinos enjoyed the same privilege.[5] Homeownership has also been less accessible to those with lower incomes. In 2010 the homeownership rate for those with incomes in the top half was 82 percent, while for those with incomes in the bottom half it hovered at 51 percent.[6]

These disparities are in part the result of policies put in place by the federal government itself as it worked to expand mortgage lending in the 1930s. As the government began to assume much of the risk of lending in U.S. mortgage markets by backing home loans with FHA insurance, it also developed, through the Home Owner's Loan Corporation, appraisal practices and standards that undervalued dense, racially mixed, or aging neighborhoods. By definition, this rating system favored newer suburban developments to the detriment of older central cities.

As new policies favoring suburban real estate markets were created in the 1940s, so were practices determining who would have access to these markets. Now that it was undertaking much of the risk for mortgage lending, the federal government was interested in setting the lending rules. Since those informing federal policy maintained that integrated and mainly minority neighborhoods had unstable property values, the federal government advocated the preservation of mainly white neighborhoods. Toward this end, until the practice was ruled unenforceable in 1948, the FHA required that properties it insured have covenants that maintained divisions by race. Though these guidelines and practices disappeared decades ago, they shaped the form of U.S. cities and their suburbs, and their consequences remain to this day.

By the 1960s the civil rights movement put fair housing issues on the national agenda, and several legislative changes to equalize access to credit and opportunity followed. The 1968 Federal Fair Housing Act and the 1970 Equal Credit Opportunity Act prohibited certain forms of discrimination in housing and lending. In 1975 Congress enacted the Home Mortgage Disclosure Act (HMDA) so that the public might monitor access to the home mortgage market. Data gathered under HMDA confirmed an unequal distribution of credit by banks and thrifts, and in 1977 Congress passed the Community Reinvestment Act (CRA) to address these disparities.

Unlike other pieces of legislation developed during the civil rights era, the CRA did not prohibit discriminatory practices on the part of institutions but rather placed upon banks the obligation that they accommodate creditworthy households that had previously been excluded from conventional home finance. The CRA required financial institutions to meet in a sound manner the credit needs of the communities in which they were chartered. Banks responded by increasing their lending to low- and moderate-income borrowers and communities, particularly as CRA performance measurements became more quantitative in 1995. One common approach was to develop special mortgage lending programs that featured flexible guidelines.

The history of housing policy in the United States demonstrates that—for good or for ill—the government has a hand in determining how markets work to provide credit and opportunity. Following the economic shock of the Great Depression, the government acted boldly to redress a liquidity shortfall. However, the policies established during that era were skewed to help only certain categories of people. With the passage of the CRA, the government stepped in to correct the distortion in the allocation of housing credit that prior housing policies had helped to cause.

The CRA could only go so far in increasing lending to low- and moderate-income people, however, since one of the greatest determinants of which loans were issued was which loans could be sold to Fannie Mae and Freddie Mac. These two government-sponsored enterprises, created in 1938 and 1970 respectively, were designed to provide lenders with an outlet for the loans they originated. By purchasing loans from banks and thrift institutions, Fannie Mae and Freddie Mac increased liquidity in the housing finance market. By their very mission, the two entities had a lot of power in determining which loans got issued in the first place: if Fannie Mae and Freddie Mac weren't willing to buy it, a loan was less likely to be made.

Unfortunately, though the CRA was pushing banks to make loans to a broader spectrum of borrowers, Fannie Mae and Freddie Mac were not keeping pace in terms of the loans they would buy. To conform to efforts in the primary market, Congress in 1992 established goals that required these two entities to serve lower income communities more actively.[7] In the late 1990s Fannie Mae made a trillion-dollar commitment to expanding lending services to underserved communities. By then it was clear not only that these services would make access to credit more equitable but also that investing in lower income home buyers was financially sound.

One of Fannie Mae's partners in learning this lesson was Self-Help Ventures Fund, an affiliate of Self-Help Credit Union, the nonprofit community development financial institution that Martin Eakes and Bonnie Wright founded in North Carolina in 1980. At that time, the median white American household had eleven times the net wealth of the median African American household, and Eakes and Wright had noticed that minorities and other disadvantaged households had unequal access to business loans.[8]

To address this racial wealth gap, they established Self-Help Ventures Fund. Their original intention was to make loans to small businesses and thereby create jobs and economic opportunity. But they soon discovered that one reason minority and lower resource entrepreneurs had less access to capital was that they did not enjoy an advantage that many well-off borrowers did—the ability to borrow against the equity in their homes.

Those involved with Self-Help Ventures Fund recognized that home equity constitutes a large share of household wealth, particularly among lower income households, and that homeowners had significantly more wealth than renters in the same income categories. In the late 1980s the wealth gap between owners and renters was substantial: the median homeowner's net worth was $120,000, while the median renter held just $2,400 in wealth.[9] Though homeownership is an important step in building wealth, at that time many people couldn't qualify for mortgages from mainstream banks.

Self-Help Credit Union (the institution with which Self-Help Ventures Fund is affiliated) began making carefully underwritten home loans directly to low-income and minority borrowers so they could gain the benefits of homeownership. Defaults proved very low, and within a few years the small lender started buying portfolios of community reinvestment mortgages originated under special programs from various North Carolina banks. Several of these banks would later grow through acquisitions and mergers until they stood among the nation's top ten. Because CRA performance factored heavily into regulators' decisions to allow bank mergers, these institutions were notably active in community mortgage lending.

These banks were making more mortgages to lower income communities, and though the loans were performing well, they did not meet the standards then in place for the secondary-market giants, Fannie Mae and Freddie Mac. Borrowers who qualified for community mortgage loans might have high debt-to-income ratios, limited assets, nontraditional employment, or nontraditional proof of creditworthiness. In addition, the loans often didn't require private mortgage insurance. The government-sponsored enterprises were unable to purchase these loans without additional risk assurances.

Though it had only $55 million in total assets at the time, in 1994 Self-Help acquired a $20 million CRA home loan portfolio from a North Carolina bank. In time, the nonprofit lender's track record convinced Fannie Mae, which by then was charged with meeting affordable housing goals, that mortgage loans to low-income borrowers were a good bet. The Self-Help model also highlighted the massive latent potential of private financial institutions to break down barriers to household economic security.

In 1998, with a $50 million grant from the Ford Foundation and institutional capacity provided by Fannie Mae, the Community Advantage Program (CAP) was launched. Under the program, Self-Help purchased community reinvestment loans from lenders and sold them to Fannie Mae, while retaining the associated risk. CAP had two purposes: to increase the flow of efficient, secondary-market capital to low-income and minority borrowers; and to demonstrate that making mortgages to these borrowers could be profitable for the lenders.

Between 1998 and 2009, CAP purchased over 46,000 loans made to low-income households, which were able to achieve homeownership and the benefits that go with it. CAP was one of several innovations being tested by Fannie Mae and Freddie Mac, to safely and sustainably expand homeownership opportunities.[10]

In the early 2000s, though, something else was changing in the mortgage market, and rapidly. People who had traditionally been shut out from financing and were beginning to gain access through innovations such as the CRA and a host of secondary-market innovations, of which CAP was one, were increasingly being offered a new kind of mortgage: subprime loans. These loans were largely unregulated and costly, but they provided people with the ability to buy or to refinance a home. These nontraditional, exotic loans included features that made them more complicated and riskier for borrowers than the traditional thirty-year, fixed-rate mortgage. And as the subsequent skyrocketing default rates of subprime and exotic mortgages demonstrate, these mortgage products did not provide the credit needed for sustained homeownership.

Nontraditional mortgages did not have Fannie Mae, Freddie Mac, or Ginnie Mae/FHA backing, and initially these mortgages represented a small part of the market. The loans were bundled into mortgage-backed securities and sold privately, outside of the traditional government-sponsored enterprises. But fed by a global oversupply of capital, the nontraditional mortgage and mortgage-backed security market grew explosively between 2003 and 2006, pumping out mortgage loans on the assumption that house prices would never stop going up. Easy money helped inflate the property value bubble, and rising home values kept credit readily available.

These unsustainable mortgages had features that would prove problematic: no documentation of income or assets, high upfront fees, risk-based pricing, prepayment penalties, teaser rates, balloon payments, and negative amortization. Borrowers and the investors who bought these mortgages from the initial lenders took on risks that they did not understand and, more perilous for the economy, that they ultimately could not bear. Meanwhile, those who issued the loans made large, short-term profits. Eventually, Fannie Mae and Freddie Mac began to invest in these subprime loans and private label securities, which gave the practices legitimacy and momentum. Though community groups, housing advocates, and regulators in several states called for this unregulated sector to be reined in, federal regulators instead hailed such practices as innovations.

In late 2007 delinquency rates in the subprime and the riskier-than-prime Alternative A (Alt-A) sectors began to skyrocket.[11] Financial institutions failed, leading to a credit freeze. The U.S. mortgage market—once the envy of the world because it made economic opportunity available to so many—was a shambles. The government put the mortgage market on life support in 2008 by taking Fannie Mae and Freddie Mac into conservatorship and turned to the FHA once again to lead the way forward: in 2010, nine out of every ten U.S. mortgages were purchased by the government-sponsored enterprises or insured by the FHA. In contrast, the private sector response to the crisis has been to retrench and tighten underwriting guidelines. In fact, private lending all but shut down.

What should be the long-term response to the mortgage crisis? In July 2010 President Obama signed financial reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The comprehensive legislation is structured to promote a return to safety and soundness in financial markets and to curb those behaviors that led to the crisis. The act promotes financial stability, improves accountability and transparency, discourages corporations from becoming "too big to fail," and protects consumers from abusive financial practices. The ultimate effect of the law will not be known for some time, since the process of rulemaking is far from complete. However, we do know what is not in the act: an explicit overview of how credit for affordable homeownership should become available again. Clearly, policymakers should take the invaluable lessons learned from the mortgage lending debacle and do better. But how?

Our research aims to answer this question. Through exhaustive examination of a Community Reinvestment Act loan portfolio, we set out to discern precisely what has and what hasn't worked in the affordable mortgage lending industry. We do so in order to provide policymakers and legislators with the best possible information as they work to strengthen the financial system without unreasonably restricting access to credit. In this book, we share what we know and make recommendations for an equitable, sustainable homeownership policy.

Until now, policymakers have had little in the way of real-time data with which to chart their course. However, the Center for Community Capital at the University of North Carolina at Chapel Hill has tracked mortgage loans made to lower income borrowers since 1999 to see whether this lending meets sound business criteria. The borrowers the center is following started with low net worth, low incomes, and low credit scores or no credit history at all (as is the case for recent immigrants to this country, for instance). Obviously, borrowers who have fewer resources pose a higher risk than borrowers with greater resources, since a borrower with more resources can tap into those resources in times of crisis. But does the fact of their having limited resources mean borrowers with low incomes are too risky to lend to?

The issue, center researchers discovered, is not whether low-income, low-resource individuals pose a greater risk than those with higher incomes. It is that the nature of the mortgage they receive can either amplify or mitigate that risk. The depth of our data allows us to examine this thoroughly, and we find that the wrong mortgage product exacerbates some risk characteristics. Our unique analysis provides important evidence as to the benefits and pitfalls of homeownership for a population traditionally underserved by the mainstream market. More telling, the timing of our study (with data gathered from 2003 to the present) allows us to examine these benefits and pitfalls in times of both boom and bust. As we detail in the chapters that follow, our analysis demonstrates that correctly structured loans to low-income households perform quite well: it is indeed possible to regain the dream of homeownership while minimizing the risk that doing so will result in another economic nightmare.

In chapter 2 we explore the value of homeownership, illustrate how it has benefited the middle class, and trace how government policy has shaped the housing finance system. We describe more fully how affordable lending programs strive to make these benefits accessible to more working families, and we argue that community reinvestment lending has been consistent with safe and sound financial principles. Where it occurs, this type of lending is doing what it was designed to do: promote fair access, choice, and prosperity in low-income and minority communities while profiting financial institutions.

In chapter 3 we differentiate between community reinvestment lending that increases access to sustainable credit for lower income borrowers and the reckless lending that led to the foreclosure crisis and devastated families and communities. We examine the evolution and the results of the shadow mortgage system, identifying the regulatory failures, speculation, and faulty products that resulted in economic meltdown.

Then in chapter 4 we look at what happens when lending is done right. Community Advantage Program mortgages have significantly lower rates of default and prepayment than subprime loans. To determine why, we examined the performance of more than 46,000 CAP loans and conducted in-depth interviews on the long-term effects of affordable homeownership. We also compared outcomes for CAP borrowers and subprime borrowers in the same communities. Based on our findings, we pinpoint the practices that caused harm and those that created the greatest possible benefits both for the mortgage industry and for low- and moderate-income homeowners.

Chapter 5 distills the lessons we are learning about borrowers and their experiences during the financial crisis. We examine how CAP borrowers are managing during the Great Recession. In particular, we examine the financial and psychological stressors they are facing and how these owners are coping during tumultuous economic times.

In chapter 6 we turn to the question of how we can ensure that lower income individuals who both desire and are willing to work for homeownership can purchase a home and remain in that home as long as they want to. In this chapter, we glean lessons from the analysis presented in chapters 4 and 5, and we suggest changes to lending practices that will enable and extend low-income and minority homeownership moving forward. We concentrate on four areas: product design, underwriting, origination, and servicing.

In chapter 7 we turn to the issue of what factors would be necessary to bring community reinvestment lending to scale nationally. We look at three things in particular: the credit enhancement mechanism that enabled the Community Advantage Program, the functions of the secondary market that allow the program to thrive, and the broader systemic stability required for affordable home lending to take place.

In the book's final chapter, we turn to the core elements of a housing finance policy that will enable all sound mortgage lending going forward. To be effective, we argue, housing finance and regulatory policy must promote well-functioning markets, encourage the appropriate use of technological innovation, align the interests of market participants, minimize potential conflicts of interest, and guarantee the well-being of consumers in the mortgage marketplace. Only with these supports will America's housing finance market be strengthened to fulfill its original purpose—that of giving all Americans who are able and willing to work for homeownership a fair opportunity to have access to sustainable mortgage loans and the foundations of prosperity.

Important as that goal is, homeownership policy that works must do more than expand the universe of people eligible for mortgage products. It must also address the loan products themselves and ensure that they are sound investments for both mortgage lenders and borrowers. The evidence is clear that good lending programs create profit for the loan industry and successfully expand access to credit for underserved communities. Lending that follows the community reinvestment model has proved to be sustainable, and it has had excellent economic and social results.

But those results can be improved. Every market participant, whether private or public, regulator or regulated, shares some culpability for the mortgage finance crisis, and we recommend ways to prevent future missteps. It is not enough to make mortgages. The country must work to enhance the ability of those who take out those mortgages to stay in their homes over the long term.

In responding to the mortgage crisis, it is essential to protect and improve fair access to homeownership opportunities and the social and economic benefits those opportunities provide. The chapters that follow detail our findings on how these goals can be achieved.