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Getting on the Right Track: Improving Low-Income and Minority Access to Mortgage Credit after the Housing Bust

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SECTION I: INTRODUCTION AND SUMMARY

During the past decade, the housing finance system contributed to a boom-and-bust cycle that triggered the greatest economic crisis since the 1930s. A brief but disastrous explosion of nonprime—and often predatory—lending in the early to mid-2000s was followed by a dramatic tightening of underwriting standards and a housing market collapse that rapidly spread to the broader economy. In the words of the President's Working Group on Financial Markets, the boom turned to bust so quickly because the shock of mounting subprime delinquencies uncovered and exacerbated weaknesses in the global financial system. The Great Recession then left millions of homeowners out of jobs and in foreclosure, millions more seriously delinquent on their loans, and the private mortgage and banking sector in shambles.

Lower-income and/or minority communities were among the hardest hit by the mortgage market meltdown. Unfortunately, because policymakers have failed to address longstanding issues—including persistent racial and ethnic discrimination and growing inequality in the distribution of income and wealth—these same households and neighborhoods may not fully benefit from the emerging housing recovery. Although initial efforts to reform the mortgage finance system and enhance consumer protections seem promising, these initiatives are complex and will take years to implement. Moreover, the potential beneficiaries of these reforms may not readily understand the implications of the policies designed to enhance access to affordable and sustainable homeownership opportunities, while the powerful interests that benefited from the very policies that triggered the mortgage market meltdown are fully armed to resist the changes. As a result, the era of toxic mortgage products and abusive lending practices has evolved into an era of toxic public debate.

This paper examines lending patterns during the housing boom and subsequent bust and current efforts to create a new mortgage market. The primary focus is on how all the changes washing over the housing finance system will affect future lending to lower-income and minority borrowers and communities, and what policies and programs will be needed to promote sustainable homeownership opportunities in these areas over time.

Following this brief summary of key findings, the report looks at the events leading up to the mortgage market boom and assesses in some detail the implications of the subsequent bust. While thousands of books, reports, scholarly papers, and opinion pieces have been written on these events, this report seeks to identify what information was known or readily available during the boom-bust period, what information has emerged since the crisis, and what analysis has the benefit of 20-20 hindsight.

The paper also assesses government responses to the mortgage meltdown and presents basic guidelines for building a new mortgage finance system. Recognizing that many of the key decisions and regulations that will shape this new market are just getting underway—including reform of the Community Reinvestment Act (CRA), the Federal Housing Administration (FHA), and the government sponsored enterprises (GSEs), as well as implementation of major provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act—policy development must proceed step by step. This is especially critical in light of the fragile state of the housing and economic recovery.

Summary of Findings: How We Got Into This Mess

Homeownership has long been the cornerstone of U.S. housing finance and housing-related tax policy, as well as numerous direct assistance programs. Supportive public policy, a booming economy, and easier financing helped lift the national homeownership rate sharply after World War II. The rate continued to drift upward in the 1990s, aided by government efforts to expand access to mortgage capital for lower-income households and racial/ethnic minorities. Based on the limited data available, minority homeownership gains over that decade were in fact significant. From 1993 to 2001, home purchase lending to Hispanic borrowers increased by 159 percent and to African-American borrowers by 93 percent, while lending to whites grew just 29 percent. This surge in lending activity pushed the national homeownership rate to a then record high of 66.2 percent in 2002.

Many viewed the expansion of homeownership opportunities as an important step in reducing inequality in the distribution of income and wealth, which in combination traps millions of minority households in poor neighborhoods with limited economic and social opportunities. While income transfer programs can help families meet day-to-day needs, homeownership can be a vehicle for lower-income households to build assets and, in doing so, create a sustainable foundation for upward mobility.

But what actually fueled the growth of lower-income and minority lending was a dual mortgage delivery system. These borrowers were targeted by different types of lenders and steered to a different mix of products than commonly found in higher-income markets. The mortgage products given to lower-income and credit-impaired borrowers typically had higher interest rates and less favorable terms than the conventional prime loans available in the mainstream market.

The new nonprime and nontraditional loans were highly profitable for both primary and secondary market participants, prompting a surge in private label asset-backed securities (PLS). Issued by large banks and Wall Street institutions that bought and securitized receivables from a wide variety of debt-related assets, PLS opened the door to mass securitization of nontraditional mortgage products. Particularly in the case of nonprime residential mortgages, the PLS market suffered from weaker lending standards and more limited counterparty controls. In addition, PLS involved issuing and selling securities to investors that, unless they had capital requirements, did not have to hold any particular funds to cover losses.

When house price appreciation slowed and mortgage delinquencies and foreclosures began to mount, the collapse of the PLS market triggered a mortgage market meltdown that rocked the world. The severe tightening of mortgage underwriting standards that ensued, combined with the sharp downturn in the economy, and the mounting wave of foreclosures quickly eliminated the homeownership gains achieved earlier in the decade. This collapse also brought widespread devastation to the many lower-income and minority communities where subprime lending had been concentrated.

The excessive risk taking badly depleted public and private mortgage insurers’ reserves. When Fannie Mae and Freddie Mac were wiped out, heavy taxpayer infusions were necessary to staunch their losses and raise capital. Meanwhile, the U.S. Treasury and Federal Reserve helped to prop up the market with massive purchases of mortgage backed securities (MBS). Government-backed entities—the FHA and the GSEs –GSEs—emerged as the dominant providers of mortgage credit, while private capital fled the market. Amid this turmoil, policy analysts, elected and appointed officials, and media pundits sought to find someone or something to blame.

Looking Ahead: Creating a Fair and Sustainable Mortgage Market

Beginning in 2008 and continuing today, the government has introduced numerous initiatives to stabilize the housing and financial markets and to help those hardest hit by the crisis. But analysis of the events that helped to trigger the collapse, as well as assessment of these new programs, has been hampered by lack of detailed data. As the contentious debate continued, discussion often returned to the proper role of government in the mortgage market. Some attributed the collapse to past interventions, placing the blame on Community Redevelopment Act (CRA) requirements, GSE affordable housing goals, or FHA low-downpayment lending programs. While the CRA, the GSEs, and the FHA are sorely in need of reform, they are hardly to blame for the crisis. In addition, these claims did little to advance the transition to a more sustainable and cost-effective mortgage market.

Yet the financial and economic trauma is not easily overcome, and dramatic changes are underway. The Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 mandated the development of regulations to define ability to repay and to combine that concept with other sound underwriting criteria to set the criteria for a qualified mortgage (QM), often referred to as a “good” mortgage. Dodd-Frank also sought to align lender and investor incentives by mandating rulemaking about what constituted a qualified residential mortgage (QRM)—i.e., the rules governing when the securitizer had to retain at least 5 percent of the credit risk.

These reforms have come along so fast and furiously that their impacts are difficult to divine. Indeed, many rules and regulations will only be finalized in the coming year. Meanwhile, left undecided are the fates of Fannie Mae and Freddie Mac, the broader government role in insuring loans or guaranteeing timely payment of principal and interest of MBS, and, importantly, the responsibility of private firms to serve the mortgage credit needs of historically underserved borrowers and communities.

Creating a responsible mortgage market must start by developing liquidity that provides broad access to mortgage credit that borrowers understand and have the ability to repay. This means reducing the government’s outsized presence and encouraging the return of private mortgage capital. To insure access to mortgage capital for low-wealth and low-income borrowers and communities, efforts must continue to eliminate any vestiges of the discriminatory lending practices that played such a prominent role in the buildup to the recent crisis. Moreover, it will be important to reaffirm the obligation of mortgage market participants to help expand access to affordable mortgage capital for all creditworthy borrowers, and to deploy scarce federal resources in an explicit and targeted manner that focuses on those low-income and low-wealth families and individuals unable to qualify for conventional loans.

Accomplishing these goals will not be easy or quick. Recognizing the importance of attracting private capital back into the mortgage market, FHA reforms must be closely coordinated with GSE reforms. Without this alignment, government-insured FHA lending, not private capital, will fill the void left by the winding down of Freddie Mac and Fannie Mae.

Moving forward, trial and error will be necessary in designing the new products, new organizational structures, and new oversight mechanisms that will define tomorrow's mortgage market. Reform must proceed step by step and adapt as information accumulates and events warrant. Even though it is tempting to act quickly to decide the fates of the FHA, the GSEs, and the CRA, their reform must await completion of key elements of the Dodd-Frank Act, including final rules about what constitutes a qualified mortgage (QM) and a qualified residential mortgage (QRM). Rebuilding the mortgage market will take time and it may be years before it is clear that the country has gotten on the right track.

SECTION II: LOOKING BACK, OR HOW DID WE GET INTO THIS MESS?

The homeownership boom that began in the mid-1990s was remarkable for its depth and breadth, outlasting an international finance crisis in 1998, an economic recession in 2001, and job losses in 2002–3. Low interest rates kept housing markets thriving, while rising home values generated wealth effects that helped to sustain consumer spending and job growth in the broader economy. Favorable demographic factors also contributed to the boom, particularly the movement of the younger baby boomers into their peak homebuying years and growth in the number of affluent older boomers purchasing second homes. Adding to the demand mix, foreign-born and minority households continued to be the fastest-growing demographic segments of the population. By 2004, the national homeownership rate topped 69 percent—an increase of nearly 5 percentage points in a decade.[1]

But these gains were not evenly shared. Even in the mid-1990s, there was growing concern about the significant gaps between the homeownership rates of racial/ethnic minorities and non-Hispanic whites. Census Bureau figures for 1995 indicated that the homeownership rate was only 42.9 percent among African-American households and 42.0 percent among Hispanic households, nearly 30 percentage points lower than the rate for non-Hispanic whites.[2] The housing boom did little to close this disparity, given that policymakers failed to confront the underlying structural factors—growing income inequality and the vestiges of housing market discrimination—fueling the homeownership gap.

RETHINKING THE DREAM OF HOMEOWNERSHIP

For decades homeownership has been hailed as the American Dream. Indeed, Nobel Prize-winning economist Robert Shiller (2010) once opined that the pursuit of homeownership was as American as “Mom and apple pie.” And in many important ways, efforts to expand access to homeownership have contributed both to individual and societal well-being. Advocates for affordable homeownership point to an extensive body of literature demonstrating that homeowning contributes directly or indirectly to numerous positive outcomes and is therefore worthy of public support. Among other things, studies have found that homeowners save more, invest more in their children, properties, and neighborhoods, and accumulate more wealth than their counterparts living in rental housing.[3]

By the 1990s, after more than three decades of focusing on income support, some poverty analysts began to espouse strategies designed to help low-income households build wealth as a complement to efforts to expand income through education and job training (Blank 2000). Housing figured prominently in such strategies because home equity is the cornerstone of household wealth for most Americans. Although the value of stocks and mutual funds now rivals the amount of housing wealth that households hold, home equity is much more broadly

[1] For further discussion, see E. Belsky and N. Richardson, *Understanding Boom and Bust*, 2010.
[2] Joint Center for Housing Studies, *The State of the Nation’s Housing: 2007*.
[3] See R. Dietz and D. Haurin, “The Social and Private Micro-Economic Consequences of Homeownership,” 2003.

distributed. In fact, the Survey of Consumer Finances shows that fully half of U.S. households in the bottom income quintile owned homes in 2007, while less than 5 percent held stocks or mutual funds. In addition, the median net wealth of lower-income homeowners (with less than $20,000 in income) in that year was more than 70 times greater than that of their renter counterparts. While this dramatic difference reflects to some degree the concentration of income-poor but housing-rich elderly among the ranks of homeowners, the gap between owners and renters under age 65 is also striking (Wolff 1995).

Moreover, purchasing a home enables a household to secure decent housing for relatively low monthly payments. Prior to the Great Recession, lower-income families with limited cash to invest could obtain a home mortgage with as little as 3 percent down. In addition, homeownership promotes systematic savings since part of each monthly mortgage payment typically goes to paying down the principal. Individuals who remain in their homes for a long time may eventually own their properties free and clear, while also benefiting from price appreciation.

At the same time, though, homeownership is not necessarily the best choice for all families and individuals at all times. Rather than assess whether buying a home makes financial sense, many households fail to weigh the benefits and costs of ownership. As Shiller (2010) noted, the often mindless pursuit of homeownership had a "great deal to do with culture, and little to do with financial wisdom." As he and others have pointed out, homeownership poses risks. A basic tenet of financial management is that families should diversify their assets—exactly the opposite of what many buyers did during the housing boom when they put all available assets into purchasing homes. In addition, families of all income levels assumed a highly leveraged position in the housing market, which can magnify risk because home prices can and do decline—as so many learned so painfully in recent years.[4]

An extensive literature also highlights how the rapid expansion of homeownership imposed numerous costs on society in general and high costs on racial and ethnic minorities in particular. As American families pursued the dream of homeownership, they tended to move away from higher-density central city locations to newly growing suburbs, or what Kenneth T. Jackson (1995) labeled "the crabgrass frontier." Increasing suburbanization, in turn, prompted a range of fiscal zoning actions that added to the upward pressure on housing and land costs.[5]

While many land use regulations address important public policy concerns such as environmental protection and public health, they nevertheless make housing more expensive. In a paper prepared for the What Works Collaborative, Vicki Been and colleagues (2010) noted that since World War II, a wide range of fiscal, housing, land use, and transportation policies have contributed to environmentally unsustainable growth patterns.

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[4] For an excellent summary of the risks associated with homeownership, see Chapter 4 of E. Gramlich, *Subprime Mortgages*: *America's Latest Boom and Bust*, 2007.

[5] Fiscal zoning techniques increase the costs of home construction through large minimum lot size requirements, restrictions on the land available for residential development, impact fees linked to project-related infrastructure and public services, and lengthy approval processes that add costs, uncertainty, and delays to building schedules.

When combined with historically low mortgage interest rates, these forces sparked a record jump in home prices in the late 1990s and early 2000s. With prices in the most desirable areas soaring, buyers in hot markets scrambled to purchase homes. In the spring of 2006, the Joint Center reported that the median house price in an increasing number of metropolitan areas exceeded median household income by a factor of four or more. In these rapidly appreciating markets, the interest rate declines in the early part of the decade were insufficient to offset the impact of skyrocketing prices, sending the homeownership rate downward by mid-decade.

The Boom Did Little to Close the Racial/Ethnic Homeownership Gap

While analysts continue to debate its social and economic costs and benefits, the housing boom clearly did not help to narrow the longstanding racial/ethnic homeownership gap. The homeownership rate for African-American households reached 49.8 percent in 2005, an improvement of 7 percentage points from 1995 but still some 27 percentage points below the rate for non-Hispanic whites. Hispanics made similar progress over the decade, leaving the homeownership gap with non-Hispanic whites at 26 percentage points (Joint Center for Housing Studies 2007).

These statistics attest to the failure of public policy at all levels of government to ensure that whatever success was achieved in expanding homebuying opportunities during this period was widely shared. To gain access to decent housing, good jobs, schools, and other public amenities, many lower-income and/or minority households were forced to move to the suburbs or the urban fringe where only limited supplies of affordable housing were available. Evidence suggests that the lack of available affordable housing in both the owner and rental markets encouraged many families to buy homes despite exposure to substantial levels of risk.[6] Compounding the problem, unscrupulous mortgage brokers, lenders, and real estate agents preyed upon many low-income, low-wealth borrowers by offering to put them in homes that they could not afford under terms they did not understand. The persistent evidence of racial and ethnic "steering" and mortgage lending discrimination during the boom underscores that much work remains to ensure that fair and equal access to affordable housing for all families.[7]

THE REVOLUTION IN MORTGAGE FINANCE

While widely hailed as a revolution in mortgage finance, the market forces propelling the great housing boom of 1995–2005 were in fact sowing the seeds of the subsequent bust. During this period, changing demographic patterns sparked new demand for homeownership, while sluggish income growth added to the affordability challenges for a growing number of low- and moderate-income households. With the emergence of new products and new industry players, however, the changes in mortgage finance held out promise of overcoming these constraints. They instead set off a homebuying frenzy and excessive risk taking that would eventually lead to the collapse

[6] Several studies have looked at the geographical dispersion of subprime originations during the late 1990s and early 2000s. See, for example, Scheessele 2002 and Calem, Gillen, and Wachter 2004.
[7] For further discussion of redlining, see Turner and Skidmore 1999. See also U.S. Department of Housing and Urban Development 2000; Fishbein and Bunce 2000; Bradford 2002; Temkin, Johnson, and Levy 2002.

of the housing and mortgage markets in 2007 and then to the Great Recession in 2008—much to the detriment of lower-income and minority borrowers and communities.

Technology Transformed Mortgage Markets

Beginning in the mid-1980s and gaining momentum in the 1990s, advances in computing and telecommunication technology, along with the rise of credit scoring and automated underwriting, reshaped the mortgage market. But the new automated systems required substantial upfront investment, leaving many traditional lenders such as smaller banks and thrifts unable to compete. At the same time, because these technologies operate at low marginal or incremental cost, the remaining firms had to differentiate their products by offering a wider range of loan features and approaches to marketing and sales.

An important element of the new mortgage market was the decoupling of origination activities (including product marketing and sales) from lending activities (relating to the funding of loans), as well as from servicing and securitization. These changes not only increased the presence of the government sponsored enterprises (GSEs) in the market, but also promoted greater specialization to support scale economies. While lowering costs, this shift gave rise to several new public policy challenges. Among the most critical issues were the growing concentration of mortgage lending activities in the hands of a few entities; the proliferation of new mortgage products that were poorly understood by regulators and consumers alike; a lack of alignment of incentives among key players; and the growth of abusive practices and outright fraud in the marketplace.

New Industry Giants Dominated the Landscape

Banks and thrifts were once leaders in mortgage lending. These institutions took an "originate-to-hold" approach, issuing loans that they held in portfolio. The new technology fostered development of the potentially more efficient "originate-to distribute" model.[8] This was executed through two distinct channels. In the retail channel, commercial banks and newly emergent nonbank lenders underwrote, originated, and funded loans that they either sold to other lenders or securitized in the secondary market. In the correspondent channel, brokers, thrifts, and community banks acted on behalf of other lenders, originating the loans but immediately selling them to wholesalers on previously agreed-to terms. The wholesalers typically retained servicing rights on the pools of loans before selling the pools into the secondary market. These changes not only reduced the cost of originating mortgages, but also opened the mortgage market to an increasing range of capital sources from within the United States and abroad.

By 2006, the top 25 firms accounted for almost 90 percent of lending—more than double their share a decade earlier (Figure 1). Moreover, the top 10 originated some 70 percent of loans. Although the larger entities achieved substantial scale economies that reduced costs, there was growing concern that this consolidation was undermining important goals of expanding access and affordability. In particular, efforts to serve lower-income, higher-risk borrowers often

[8] Although the originate-to-distribute model traces its origins to the 1970s when banks first began to sell bundles of loans to life insurance companies, it was not until the mid-1990s that this approach became commonplace. See Foote, Gerardi, and Willen 2012.

required more personal attention than automated processes could deliver. In addition, while the market as a whole included a sufficient number of lenders to remain highly competitive, fewer institutions were operating in traditionally underserved markets. Indeed, the evidence suggests that smaller lenders in both urban core neighborhoods and selected nonmetropolitan and rural areas could not compete with the more efficient mortgage giants. As recently as 2003, more than 14,000 entities originated home purchase or refinance loans. The smallest 10,000 of these participants, however, collectively accounted for only a 5 percent market share.[9]

Figure 1. Market Share among the Nation's Top Mortgage Originators More than Doubled Between 1996 and 2006

Similar consolidation occurred in the servicing industry, with the top 20 firms capturing 68 percent of the market (Figure 2). Many large-scale servicers were affiliated with same financial services giants that dominated mortgage originations. But because these firms operated as distinct business units, they did not necessarily service all of the loans originated by their corporate parent or affiliate. Instead, servicing rights were bought and sold depending on the going price, the relative efficiency of alternative servicing entities, and the business strategies of the companies involved.

Figure 2. The Servicing Industry Also Consolidated Over this Period

New Products and Sales Techniques Posed Added Risk

The complex and highly automated financial services environment drove the introduction of innovative products and sales approaches. Under the new system, mortgage brokers and bank loan officers played an important role in consumer outreach. Mortgage brokers are independent third-party agents that receive fees for taking loan applications and processing paperwork. When the borrower is ready to lock in loan terms, brokers typically choose a lending institution to fund the mortgage. Loan officers perform similar functions, although they are usually employees of a lending institution.

During the homebuying boom, mortgage brokers were not only compensated in part by borrowers, but often received fees (tied to the coupon rate, product type, and loan size) from the wholesale lenders. Banks and thrifts also offered additional compensation to their loan officers for placing specific products and/or larger loans. The fee structures thus rewarded lending agents differently depending on the nature of the product. Rather than motivating agents to search for the best loan for the customer, these variable fees encouraged brokers and loan officers to "push market" particular products to the extent that competitive market pressures would bear and regulatory or lender oversight would allow.

While many households benefited from the new mortgage products, they posed serious challenges for some borrowers. High-cost lenders disproportionately targeted minority (particularly African-American) borrowers and communities, resulting in a notable lack of prime

[9] In their annual review of HMDA data, FRB researchers tracked this growing concentration. See, for example, Avery, Brevoort, and Canner 2006; Apgar, Calder, and Fauth 2004.

loans among even the highest-income minority borrowers. Joint Center researchers found that in 2001, only 70.8 percent of refinancings for African-Americans with incomes above 120 percent of area median, living in predominantly high-income African-American neighborhoods, were prime loans. In contrast, the share for lower-income white borrowers living in predominantly white lower-income communities was 83.1 percent. This disparity, in part, reflects the fact that minorities have lower credit scores on average than whites. But Joint Center researchers raised concerns that some high-cost lenders were actively targeting minority applicants who were vulnerable to deceptive, high-pressure marketing tactics because of their limited understanding of the product options and the mortgage system (Apgar, Calder, and Fauth 2004).

Private Label Asset-Backed Securities Tapped New Capital Sources for Subprime Mortgages

Asset-backed securities (ABS) are created by combining tangible or financial assets that collect receivables over time and then pooling those receivables to form a security that is sold to investors. During the 1990s, relatively large shares of affordable low-downpayment prime loans were funded by ABS that included mortgages insured by the Federal Housing Administration (FHA) or guaranteed by Ginnie Mae, Freddie Mac, Fannie Mae, or other government-backed entities. Though oversight of the entities issuing these securities was far from perfect, the so-called agency MBS market offered investors some semblance of standards in terms of lender partners, underwriting guidelines, and mortgage insurance requirements.

The development and expansion of the non-agency MBS or private-label asset backed securities (PLS) market opened the door to mass securitization of subprime mortgages and other nontraditional home loan products. Fueling the growth of the PLS market were private conduits, including large Wall Street institutions that bought and securitized receivables from a wide variety of debt-related assets. While agency MBS issuance rose more than 70 percent in real terms in 1995–2000, PLS issuance increased even faster, lifting the private-label share from 15 percent to 22 percent of the market (Inside Mortgage Finance 2009).

The PLS market suffered from weaker lending standards (especially for nonprime residential loans), more limited counterparty controls, and lower reserve requirements. In fact, unless investors had capital requirements, they did not have to hold any particular sum to cover losses. By contrast, Fannie Mae and Freddie Mac charged a guarantee fee, some of which was held in reserve to cover expected losses. Similarly, if loan-to-value (LTV) ratios exceeded 80 percent, mortgage insurers (including the FHA) charged an additional premium to guard against the known and heightened risk.

Although marketed as offering relatively low-risk tranches, PLS did not eliminate the risk inherent in the pools containing the riskiest nonprime mortgages. Instead, most junior tranches were left without protection. Moreover, the safety and soundness of any given pool depended on the ability of rating agencies to assess whether the mortgages in that pool conformed to published standards. As a result, once market conditions deteriorated, investors quickly discovered that even pools rated AAA did not perform as advertised.[10]

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[10] See Belsky and Richardson 2010. See also Ernst, Bocian, and Li 2008; Green 2008.

Nonprime Lending Extended the Boom

While the ability of the new mortgage market to extend credit to higher-risk borrowers was well established by 2000, tracking exactly who this expanded lending served was difficult. Lacking a clear definition, HUD issued periodic reports on what it labeled "loans by subprime specialists" (Scheessele 2002). Many in the industry relied on data from Inside Mortgage Finance that used its own definition.[11] Yet by 2006, there could be no doubt that nonprime lending was central to the mortgage market boom. Indeed, Inside Mortgage Finance reported that subprime, Alt-A, and near-prime loans accounted for approximately 40 percent of originations in that year (Figure 3).

Figure 3. High-Cost Lending Continued to Rise

The rapid growth of piggyback lending (the simultaneous origination of a first and second lien secured by the same property) also added to the increasing risk in selected submarkets—in particular, the lowest-income and/or minority neighborhoods located in the most expensive metropolitan areas.[12] While typically involving a prime first-lien component, piggyback loans raised overall mortgage risk by enabling borrowers to have combined loan-to-value ratios of 100 percent or higher. Moreover, since first and second liens are often held in different security structures, piggyback loans increased the cost and complexity of loan workouts in situations of delinquency or foreclosure.[13]

Also adding to market risk was the rapid growth in loans to purchasers of second homes and to highly leveraged investors. Under the belief that home prices would continue to appreciate steadily, households with a wide range of incomes rushed to buy vacation homes and retirement properties before prices rose further. The plentiful supply of mortgage capital also fed a substantial rise in high-risk lending to investors in one- to four-unit rental properties. By 2006, nearly 20 percent of foreclosures involved absentee owners of these smaller rental properties.[14]

EMERGENCE OF A DUAL MARKET

With nonprime lending on the rise, housing policy analysts and fair lending advocates scrambled to obtain the data needed to determine whether the loans were free from the discriminatory practices common in the late 1970s and 1980s when redlining (denial of mortgage loans based solely on the applicant's location) was at its height (Turner and Skidmore 1999). Using its lists of subprime specialists, HUD (2000) studied lending patterns in five metropolitan areas in 1999 and found that subprime loans were in fact disproportionately found in lower-income and/or minority communities.

[11] Following common industry practice, Inside Mortgage Finance classified loans by credit quality ranging from A or prime credit, to Alt A or near-prime credit, to subprime or credit quality of B or lower.
[12] See Avery, Brevoort, and Canner 2006.
[13] See Been et al. 2012.
[14] Joint Center, *State of the Nation's Housing: 2008*.

Building on these studies, the Joint Center for Housing Studies combined HUD data on subprime specialists with Home Mortgage Disclosure Act (HMDA) and census data to examine the spatial distribution of loans made between 1993 and 2001 (Apgar and Calder 2004). This analysis also concluded that subprime lending was more concentrated in low-income minority neighborhoods than in higher-income neighborhoods. In addition, the results indicated that the higher the share of minority residents in a neighborhood, the greater the odds that *any* borrower in that neighborhood would receive a loan made by a subprime specialist. Although controlling for a wide range of neighborhood and borrower characteristics reduced its effect on the probability of receiving a subprime loan, race remained a significant factor.

HMDA-based studies were widely challenged because, among other issues, the early data lacked detailed information on mortgage characteristics including pricing. Industry players and others argued that most observed differences in mortgage lending outcomes across racial/ethnic lines simply reflected systematic differences in borrower risk and other objective factors that should legitimately influence mortgage pricing and terms. They also asserted that any discriminatory behavior was limited to the illegal actions of only a few and should be addressed by more vigorous enforcement of existing laws and regulations.

Pricing Data Sparked Renewed Debate on Fair Access

To settle the "risk or race" debate, HMDA regulations required lenders to disclose pricing information for the first time in 2003.[15]Although fair lending issues had received attention in public policy arenas and the popular press for decades, release of the more detailed HMDA data the following year stirred renewed interest in the topic. With this new evidence, numerous housing policy analysts, advocates, and public officials pointed to what they viewed as disparate treatment in mortgage pricing and terms with respect to race and/or ethnicity, or situations where individuals with different racial or ethnic characteristics but otherwise similar economic, demographic, and risk characteristics did not obtain mortgages at the same price and terms.

While nonprime lending did extend homeownership opportunities to households and families underserved by the traditional mortgage market, the concern was that aggressive marketing and sales techniques were being used to convince consumers to select specific, often higher-priced products that they neither understood nor could afford. In addition, the uptick in subprime mortgage delinquencies was already beginning to take its toll on selected regional markets as well as on mortgage lenders with significant exposure. Particularly worrisome were the soaring delinquency rates on so-called "affordability products," namely interest-only, payment-option loans. While some adjustable-rate mortgage (ARM) products were carefully underwritten, clearly explained, and offered significant benefits for some borrowers, a new variety of "hybrid" ARMs—featuring low teaser rates for up to two years, but substantially higher rates thereafter—were often sold to borrowers with limited ability to absorb the interest-rate shock. These products

[15] HMDA regulations mandated disclosure of pricing information on first-lien mortgages with an annual percentage rate (APR) that is 3.0 percentage points above a typical prime loan. These higher-priced mortgages were roughly equivalent to what other data sources at the time termed nonprime or subprime loans.

encouraged borrowers to take on higher debt burdens, exposing them to even higher levels of risk and setting the stage for the subsequent bust.[16]

Channel Specialization Promoted Market Segmentation

As noted earlier, the new mortgage market had distinct delivery channels, involving three sets of players: (1) individuals (mortgage brokers, correspondent lenders and loan officers) that conducted the initial marketing and sales efforts to generate loan applications; (2) organizations (bank and nonbank entities) that evaluated the applications and underwrote as well as funded the loans; and (3) entities that purchased loans (GSEs and other mortgage conduits) either to hold as investments or securitize and sell on national and international capital markets.

While specialization within a channel could enhance market efficacy, it also generated practices and outcomes that were neither efficient nor fair. Using the newly released HMDA data, the Joint Center found that a segmented or dual market had developed in which funding for higher-priced mortgages flowed in distinct channels from investors to borrowers.[17] This structure, along with the complex regulatory systems overseeing different channels, contributed to disparate and potentially illegal lending outcomes across racial and ethnic lines. Moreover, such outcomes implied that the mortgage market of the mid-2000s allocated capital in an inefficient manner in that borrowers with similar economic, demographic, and risk characteristics did not obtain loans at the same price or on similar terms. Even after controlling for a relatively detailed list of borrower characteristics, race—and to a somewhat lesser extent, ethnicity—remained a significant factor in determining the chances that an individual borrower received a higher-priced home purchase or refinance loan.[18]

Regulatory Oversight of the Mortgage Market Lagged

The various components of this complex dual-market mortgage delivery system were governed by an equally complex set of laws and regulations. This regulatory structure was slow to adapt to the dramatic changes in the mortgage finance system. For example, even as the share of mortgage capital flowing through nonbank channels continued to grow, the most significant elements of the mortgage market regulations were promulgated when traditional banks and thrifts dominated the market. Regulators struggled to adapt these antiquated regulations to the new corporate structures with their increasingly complex relationships between and among banks and with their mortgage banking and servicing affiliates. Even so, federal regulatory

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[16] The most popular of these loans were the "hybrid" ARMs, followed by interest-only loans, with payment-option loans a distant third. Payment-option loans allowed borrowers to make minimum payments that are even lower than the interest due on the loan and roll over the balance into the amount owed. In 2007, the Joint Center reported that serious delinquency rates for new subprime and nontraditional loan products were two to three times higher than for prime loans. See Joint Center, *State of the Nation's Housing: 2007*.

[17] Immergluck and Wiles 1999 first characterized the tendency for conventional lenders to serve higher-income white areas while other lenders served lower-income and minority communities as a "dual mortgage market." See also, Apgar, Bendimerad, and Essene 2007.

[18] For example, African-Americans were 5 percentage points more likely than whites to receive a higher-priced home purchase loan and 2.6 percentage points more likely to receive a higher-priced refinance loan. For Hispanics, the corresponding differences were 3.4 percentage points and 1.0 percentage point. (Apgar, Bendimerad, and Essene 2007)

agencies vigorously defended their “turf” and frequently challenged efforts by individual states to expand oversight of abusive lending practices, arguing that federal rules preempted local authority.

As a result, many basic consumer protections available in the prime segment of the market were absent or less diligently enforced in the subprime or high-cost segment. According to the Joint Center report (Apgar, Bendimerad, and Essene, 2007), whites were 50 percent more likely than black borrowers (28.5 percent versus 17.4 percent) to obtain a loan originated by a federally regulated bank or thrift operating in their assessment area. Whites were also more likely than blacks to obtain a loan that was sold to a GSE (29.7 percent versus 17.1 percent). The differential for Hispanics was only slightly smaller.

CONCLUSION

Over the past 15 years, the Joint Center for Housing Studies and numerous other research and advocacy organizations have documented the fact that low-income and minority borrowers were likely to pay more to attain the American dream of homeownership. Early HMDA-based studies conducted during the housing boom consistently showed that lower-income and minority communities were disproportionately targeted for abusive subprime and nontraditional loans. Later studies, while focusing on the impact of the financial crisis and subsequent retrenchment of mortgage lending, indicate that redlining also persisted. As one study noted (Engel and McCoy, 2011), these patterns are a manifestation of stark inequities in mortgage lending that continued to deny low-income and minority people and communities access to mortgage capital on a fair and equal basis.

The lack of uniform regulations and the unwillingness of regulators to adapt to changing market circumstances left many of the most vulnerable borrowers in the rapidly growing higher-priced market, with less than equal access to consumer protections commonly available in the lower-priced prime market. To address these concerns, the Joint Center and others proposed a series of actions to expand consumers’ ability to assess loan characteristics, emphasizing the importance of developing a uniform set of rules and regulations to govern mortgage lending across distinct channels. Unfortunately, these and similar calls for action gained little traction as new and untested products, along with antiquated regulatory structures, planted the seeds of disaster. As increasing numbers of borrowers struggled to make payments on loans they neither understood nor could afford, what started out as a cyclical uptick in delinquencies and defaults soon morphed into a full-fledged mortgage market meltdown.

SECTION III: ASSESSING THE DAMAGE

After benefiting little from the homeownership boom, low-income and minority households and communities were especially hard hit during the ensuing bust. When the problems of nonprime lending on Main Street spread to Wall Street, analysts had to take a closer look at the situation. What they discovered was that the cresting of the housing boom in 2005 and 2006—soon accompanied by record numbers of subprime delinquencies and foreclosures, the failure of several large subprime hedge funds, and increasing volatility in the capital markets—marked the beginning of a downward spiral in housing and economic activity that would rock the world.

THE BOOM TURNS TO BUST

In many ways, the superheated housing market masked the structural problems in the U.S. capital markets that would lead to the Great Recession of 2008–9. In the words of the President's Working Group on Financial Markets (2008, p. 1), the boom turned to bust so quickly because the shock of mounting subprime delinquencies "uncovered and exacerbated other weaknesses in the global financial system."

Depending on the extent of home price appreciation and the concentration of nonprime loans, delinquencies across states had begun to diverge earlier in the decade. In rapidly appreciating markets, delinquency rates actually declined from 2002 to 2006 because homeowners could use accumulated equity to refinance and/or pay off any mortgage arrearages and otherwise extinguish debt obligations. As house price appreciation slowed, however, these outlets were closed off and a growing number of homeowners were unable to avoid foreclosure.[19]

Particularly for households with subprime and/or adjustable-rate mortgages, a modest uptick in interest rates could quickly strain budgets. Many nonprime borrowers took on second jobs and drained savings, but were still unable to withstand the payment shock when teaser rates on hybrid ARMs expired. Others fell under the weight of loans that should never have been made, including those underwritten without a clear measure of borrowers' ability to repay.[20] Serious delinquencies and foreclosures in the subprime sector continued to edge up in 2006, before climbing sharply (Figure 4). While most troubled subprime loans involved owner-occupants, housing speculators also defaulted—encouraged by the eroding mortgage market to walk away from their investment properties. Indeed, the Mortgage Bankers Association reported that absentee owners accounted for almost one in five loans entering foreclosure in the third quarter of 2007.[21]

[19] See Edmiston and Zalneraitis 2007 for discussion of how expectations of rapid housing price appreciation encouraged borrowers to take on higher-cost mortgage debt in the hope of refinancing into lower-cost loans once their home values had risen sufficiently or interest rates had dropped.

[20] For further discussion of how expansion of the subprime mortgage market and declines in bank underwriting standards made mortgages accessible to many borrowers with weak credit histories and insufficient (or unverified) income and assets, see Engel and McCoy 2011. In contrast, Bhardwaj and Sengupta 2008 claim that there was no dramatic weakening of underwriting standards within the subprime mortgage market.

[21] Cited in Joint Center, *America's Rental Housing,* 2008, p. 2. See also, Avery, Brevoort, and Canner 2007.

Figure 4. Subprime Delinquencies Climbed Sharply After 2006 and Remain High Today

Mortgage Companies Imploded as Delinquencies Rose

Households were the not the only early casualties of the mortgage bust. Eventually even creative finance could not overcome rising interest rates and decreasing affordability. The swift deterioration, especially in subprime loan performance, caught many mortgage lenders and MBS and PLS investors unaware.

But two indicators charted the implosion of the subprime market: the sharp rise of early payment defaults and the ABX index, designed to enable investors to trade exposure to the subprime market without holding the actual asset-backed securities. Early payment defaults shot up in 2006 as more and more borrowers became delinquent within the first six months of their mortgages—a clear sign of lax underwriting or poor fraud detection on the part of originators and securitizers.[22] The decline in the ABX in 2007 indicated substantially lower investor appetite for securities backed by subprime loans.[23]

The deterioration in both indicators triggered a dramatic loss of confidence in subprime securities. Investors demanded that originating lenders buy back millions of dollars of subprime loans, leading to the unprecedented failure of more than 100 institutions. The price of subprime MBS plunged as well. Investment banks holding large amounts of subprime MBS, such as Bear Stearns and Lehman Brothers, were crushed by overwhelming losses and the unwillingness of capital providers to offer credit. Banks began to doubt each other's viability. The commercial paper market—the $28 trillion credit market used by banks and corporations to meet short-term obligations like payroll—froze up, prompting the most extensive federal government intervention in financial markets since the Great Depression.

In this environment, the national mortgage market was transformed. Many of the largest and best known industry leaders went bankrupt or disappeared as they were split into pieces and sold off. Household names in 2006—including major originators such as Countrywide, Washington Mutual (owner of Long Beach Mortgage), Wachovia, and IndyMac—were out of business in 2010 (Figure 5). RESCAP was severely weakened and began a downward spiral that eventually ended in bankruptcy. Issuers of PLS underwent a similar transformation, with Lehman and New Century entering bankruptcy and Bear Stearns sold to JP Morgan Chase at a rock-bottom price. Meanwhile, survivors like Bank of America and Wells Fargo gobbled up whole Wall Street institutions or bought pieces of other distressed companies (Figure 6).

Figure 5. Five of the Largest Loan Originators Were Out of Business by 2010…
Figure 6. …Along with Six of the Ten Top Private MBS Issuers

[22] See, for example, Fitch Ratings, *Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance*, 2007.
[23] For an early account of how Wall Street traders sunk the subprime ABX market, see Paul Muolo and Matthew Padilla, *Chain of Blame: How Wall Street Caused the Mortgage and Credit Crisis*, 2010.

The meltdown also hit several hundred regional and smaller community banks. FDIC closed 25 insured depositories including three large institutions that were prominently linked to the subprime lending crisis: Washington Mutual Savings Bank, Indy Mac FSB, and Downey Savings and Loan. The number of bank failures climbed from 140 in 2009 to 157 in 2010, before easing back to 92 in 2011. While each closing involved unique elements, they did offer federal regulators an opportunity to better assess what went wrong. Perhaps more significantly, the FDIC—under the leadership of Sheila Bair—gained valuable knowledge from the failure of Indy Mac about using principal write downs to restructure delinquent mortgages and avoid needless foreclosures.

FHA Fared Relatively Well but GSEs Were Caught in a Race to the Bottom

FHA traditionally played a large role in insuring loans for minority first-time homebuyers. During the boom, however, FHA's loan volume fell off sharply in the face of aggressive and often predatory competition from nonprime lenders. Even as aggregate loan volumes soared elsewhere in the market, the number of FHA-insured single-family loans dropped from about 1.3 million in 2002 to 426,000 in 2006. Indeed, FHA's market share dipped below 5 percent, down from the 10–12 percent range common prior to the boom.[24]

In hindsight, this was fortunate. First, FHA resisted the temptation to participate in the "race to the bottom" but rather sought to maintain sound underwriting standards during a period of reckless lending. This decision helped FHA avoid even larger capital losses in that it insured relatively small shares of loans made during the years when house prices peaked and abusive market practices were most widespread. Like other mortgage insurers, however, FHA suffered losses linked to outright fraud of brokers and lenders who "push marketed" FHA products to many households ill-equipped to take on the responsibility of homeownership. Indeed, as a market leader in minority lending, FHA arguably failed to take a sufficiently aggressive stance against lender partners engaged in the abusive practices that were ravaging low-income and minority communities.

A major source of these losses involved the so-called Seller-Funded Down-Payment Assistance program. While FHA traditionally allowed borrowers to receive downpayment assistance from friends and other third-party sources, an increasing number of nonprofit organizations also began to offer such assistance in the late 1990s. The abuse occurred when the assistance provider colluded with the home seller to raise the sales price of the unit and then used the additional proceeds from the FHA-insured loan to give kickbacks to the nonprofit. The program started slowly at first, but loans with nonprofit seller-funded downpayments accounted for nearly a third of all FHA lending by 2006.[25]

[24] For more complete discussion, see *FHA Actuarial Review*, 2010.

[25] See GAO, *Seller-Funded Down-Payment Assistance Changes the Structure of the Purchase Transaction and Negatively Affects Loan Performance*, GAO-07-1033T, 2007. See also, GAO, *Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance*, GAO-06-24, 2005.

FHA officials were keenly aware that these loans were not performing as well as similar loans without downpayment assistance and proposed a regulation to end the practice in 2007.[26] This met with fierce opposition. Program advocates obtained a court order forcing FHA to pull the rule, arguing that it exceeded FHA's statutory authority. When FHA submitted legislation to provide clearer statutory authority, opponents gathered significant congressional support to continue the practice. FHA eventually prevailed when the 2008 Housing and Economic Recovery Act (HERA) provided the needed legislative fix.

The challenges of managing risks to the FHA insurance fund highlight a major flaw in FHA's enabling legislation. FHA is a federal entity created to serve a public function but initially chartered "to work more like a business." Yet over the years, FHA has become weighted down with numerous and often conflicting legislative mandates. As a result, even in the face of clear evidence concerning the need for congressional action, it took the near-collapse of the FHA fund to achieve approval for limited reform.

Fannie Mae and Freddie Mac also suffered from structural flaws. While steering clear of the worst excesses permeating less-regulated sectors of the economy, these entities joined the race to the bottom by expanding their investment portfolios, relaxing their underwriting and purchase criteria, and generally taking on greater risk to regain market share lost to the private securities market. The perception in the marketplace that the GSEs had government backing lowered the cost of these activities and provided investors confidence that Fannie and Freddie were too big to fail.

When the bubble burst and losses soared, it became clear that the two companies could not stand on their own. Using new legislative authority created by HERA and working in close coordination with the U.S. Treasury Department, the Federal Housing Finance Agency (FHFA) made the difficult but necessary decision to place Fannie Mae and Freddie Mac into conservatorship. While representing a major expansion of the government's role in the housing market, the move served—at least temporarily—to calm the mortgage markets. Treasury's clear and continued commitment to supporting the GSEs, along with FHA's survival of the crisis, proved to be key ingredients in efforts to restore stability to the marketplace and maintain the flow of mortgage credit.

MORTGAGE MARKET TURMOIL SPREAD TO THE BROADER ECONOMY

What started out as a softening of home prices soon became a full retreat. According to the S&P/Case-Shiller National Home Price Index (HPI), home prices were down 30 percent from their peak by the first quarter of 2009.[27] The FHFA National Home Purchase Price Index measured the

[26] Though estimates vary, *FHA Actuarial Review* estimated in 2010 that the Seller-Funded Down-Payment Program generated upwards of $15 billion in losses over and above what FHA would have incurred if it had not permitted this form of assistance in the first place.
[27] The Case-Shiller HPI is one of several repeat-sales indices with sufficient historical data to track price dynamics during the boom and bust. Case-Shiller HPIs are available for 150 metropolitan areas and composite indices for the

decline at 20 percent. The S&P/Case-Shiller index was more volatile during this period, largely because it captures price trends for subprime loans as well as for FHA and other government-backed loans that the FHFA National Home Purchase Price Index does not.

Even steeper price declines were recorded in areas with the highest foreclosure rates. Depending on the index used, home prices in metropolitan areas of California, Arizona, Nevada, and Florida were off 50 percent or more from peaks. The most precipitous drops were at the lower end of the market. In the 17 metro areas where the S&P/Case-Shiller reports information by price tier, bottom-tier home prices were down from peaks by an average of 53 percent in the first quarter of 2009, or 1.25 times the average decline in middle-tier prices and 1.4 times the average decline in top-tier prices. In most instances, these were the same market segments that had seen the sharpest run up in home prices during the boom.

Numbers of Underwater Borrowers Soared

The drop in home prices destroyed home equity for millions of American households and left millions of others underwater on their mortgages (owing more than their homes were worth) and unable to meet their loan obligations.

Before the mortgage market meltdown, the vast majority of U.S. households had substantial equity cushions. According to American Housing Survey (AHS) data, fewer than 20 percent of all homeowners with mortgage debt had less than 20 percent equity in 2003, while only 3–5 percent were underwater.[28] Based on estimates provided by CoreLogic, the Joint Center found that approximately 15 percent (5.5 million) of all homeowners with mortgage debt were underwater by the end of 2008, along with nearly 20 percent (1.6 million) of borrowers with investor or second-home loans.[29]

As should be expected, households that purchased their homes in the years near the price peak, along with those who bought or refinanced with nonprime products, were most likely to be underwater. While based on limited data, a U.S. Government Accountability Office (2009) report estimated that 37 percent of subprime borrowers who purchased homes in 2007 were in a negative equity position by mid-2009. Half of these households were underwater by more than 50 percent, while only a third were underwater by less than 20 percent.

top 20 and top 10 metro areas, as well as nationwide. FHFA also prepares home purchase indices for 250 metro areas and publishes composite indices for nine regions and the nation as a whole.

[28] AHS estimates of home equity are derived from respondents' estimates of both the value of homes and the amount of mortgage debt outstanding. While less accurate than estimates based on actual transactions data, the AHS offers additional details on borrower characteristics (place of residence, race/ethnicity, family status, and income) that provide insights about the impact of the home price collapse on the well-being of low- and moderate-income families and communities.

[29] Unpublished Joint Center estimates based on data developed by Core Logic. By the end of 2010, the number of underwater mortgages reached 11 million, including 9.1 million owner loans and 2.0 million investor and second home loans.

Early on, few studies looked systematically at the proportion of underwater homeowners in default, but the evidence suggests a strong relationship—especially among borrowers who were significantly underwater. One widely referenced analysis by CoreLogic (2010) found that homeowners defaulted on their primary residential mortgages at the same rate as investors in rental properties, i.e., once they were underwater by at least 25 percent or when the mortgage balance exceeded the property value by $70,000.

Owners with subprime mortgages were also more likely to be delinquent than borrowers with prime mortgages. As recently as the fourth quarter of 2011, the Mortgage Bankers Association (2012) estimated that the delinquency rate for fixed-rate subprime mortgages was 21.4 percent—nearly five times higher than that for fixed-rate prime mortgages. While many factors (including lower borrower income and credit quality) contributed to this disparity, at least some of the difference relates to appraisal fraud. Inflated appraisals saddled borrowers with mortgages that exceeded the market value of their homes as soon as the purchase or refinance was completed. In fact, several subprime lenders, including Countrywide, have now settled claims that, as recently as 2008, they were instructing appraisers to provide inflated appraisals to allow sales or refinances in distressed markets to go forward. Such actions not only violated various federal and state laws, but they also added to the number of underwater subprime borrowers.[30]

Housing Woes Undermined Economic Growth

With house prices plummeting and mortgage interest rates rising, home sales across the country fell sharply as potential buyers remained uncertain whether it was a good time to purchase or invest in housing. Nationwide, sales of newly built homes plunged by two-thirds from 2006 to 2009 while sales of existing homes dropped by more than 30 percent. In high-foreclosure areas, sales came to a virtual halt, dealing a devastating blow to households trying to sell their homes and triggering massive layoffs in the local housing sector.

New construction crashed, along with activity in the home repair, remodeling, building material supply, and other housing-related sectors. The weakness in the housing market soon spread to other sectors of the economy as consumers pulled back from purchasing automobiles, consumer durables, and other big-ticket items. With nearly 2 million workers off the job, the unemployment rate in the fourth quarter of 2008 stood at 7.8 percent—the highest rate in a generation.

Rising unemployment and underemployment not only reduced the ability of families to meet their mortgage obligations, but also forced many to relocate to find suitable work. But underwater borrowers cannot sell their homes and move without incurring significant losses. This fact has raised concerns that the surge in underwater homeowners prolonged the recession by limiting the ability of the labor market to adjust to the economic dislocations of the housing bust.

Delinquency- or default-induced moves are typically the first mobility-related impact observed during a downturn. As a result, increases in unemployment tend to raise household mobility. At

[30] See for example the recent Country Financial Corporation settlement resolving a range of fraud and discrimination allegations (U.S. Department of Justice, 2011.)

the same time, however, the housing finance literature generally focuses on the transaction costs of moving and the difficulty that families at risk of foreclosure may have finding buyers in depressed markets. Growth in the number of underwater borrowers thus served to reduce labor market mobility.

The tension between labor market-induced mobility and constraints on housing market mobility is not new, and has been analyzed in the context of economic adjustments made during severe regional recessions or when a major employer leaves a community.[31] Decidedly less is known about the post-foreclosure experience of former mortgage borrowers because most datasets are not designed to study this issue. For example, loan-level data from CoreLogic and Lender Processing Services are well suited to examine trends in delinquencies and foreclosures, but do not contain any information on terminated loans. In addition, panel studies of individuals and households usually do not collect data on foreclosures and are frequently too small to study geography in detail.[32]

Using AHS data from 1985 to 2007, Ferreira, Gyourko, and Tracy (2010) estimated that negative equity reduced household mobility by 30 percent. Schulhofer-Wohl (2011), however, argued that those results were biased by the fact that they conflated permanent and temporary moves and therefore substantially overstated the “lock-in” effects. While acknowledging the limitations of AHS data (particularly the relatively high nonresponse rate for critical variables needed to analyze mobility patterns), Ferreira, Gyourko, and Tracy (2011) extended their research to include the 2009 AHS panel. After conducting exhaustive edit checks to identify any remaining inconsistencies in household responses to AHS questions, they again found that negative equity reduced household mobility by 30 percent.

In a recent paper, Donovan and Schnure (2011) noted that mobility trends for moves within the same county appear to differ from interstate migration trends. Based on American Community Survey (ACS) data for 2007, 2008, and 2009, they found that the lock-in effects resulted almost entirely from lower mobility within the same geographic job market, while interstate moves tended to be higher in counties with larger house price declines. Their analysis suggests that while the lock-in effect may force underwater borrowers to commute longer distances within a job market in search of work, it does not appear to degrade the efficiency of the labor market or contribute to higher aggregate unemployment rates.

The combination of rising unemployment and falling house prices closed off many pathways to recovery, leaving the downward spiral of the housing sector unchecked. Households with more mortgage debt than their homes were worth or their budgets could accommodate were unable to sell, refinance their way out of high-cost loans, or otherwise avoid foreclosure. Foreclosure-related blight then spread to nearby properties, widening the sphere of disinvestment and neighborhood decline. Even those without mortgages or immediate plans of moving suffered the

[31] See M. Greenstone and A. Looney, “An Economic Strategy to Renew American Communities,” 2010.

[32] Research by Aaronson and Davis 2011 provides a prominent exception in the use of Survey of Income and Program Participation (SIPP) data.

psychological damage of knowing that their home equity—one of the principal ways that households accumulate wealth for their retirement years—was wiped out.

In the Hardest-Hit Communities, Risky Products Turned Toxic

While communities across the country were caught in the downturn, areas where high-risk lending was concentrated became ground zero for the crisis. Using an enhanced HMDA database, the Joint Center compared the neighborhood composition of subprime lending in 2006 with an index that ranks neighborhoods by the extent to which they experienced high foreclosure and mortgage delinquency rates in 2010.[33] By this ranking, "low distress" neighborhoods are the 60 percent of tracts with the lowest scores, while "intense distress" neighborhoods are the 10 percent with the highest scores. The analysis found that home purchase loan borrowers living in what would become the nation's most distressed neighborhoods in 2010 were 2.5 times more likely to have high-cost loans, and nearly twice as likely to have piggyback loans, as their counterparts living in neighborhoods largely unscathed by the mortgage bust (Figure 7). The patterns are similar for borrowers who refinanced and for those who purchased or refinanced second homes or investment properties.

Figure 7. Neighborhoods with Higher Shares of Risky Loans Faced Higher Foreclosures by the End of the Decade

Federal Reserve Board researchers used HMDA data to document that these same intense distress areas also experienced the sharpest declines in home purchase lending, a trend that magnified the downward spiral in these neighborhoods.[34] Over the 2005–10 period, home purchase lending volumes fell 75 percent in those areas, compared with 35 percent in all other neighborhoods. As a result, many of the same low-income and minority communities that paid the highest prices for mortgage credit during the boom years bore a disproportionate share of the aftershock.

Despite Falling Interest Rates, Refinance Rates Remained Low

As the economy weakened, the Federal Reserve Board and Treasury Department worked to push down interest rates. Mortgage rates plunged at the end of 2008 and declined steadily through 2010. Even so, refinancing activity increased only modestly. By comparison, when interest rates fell just as sharply in the 2000s, refinance volumes peaked in 2003 at over 15 million loans—more than refinance volumes in 2009 and 2010 combined.

The sluggishness of refinancing activity undoubtedly reflects the continued tightening of credit standards, driven by perceptions that borrowers with the same nominal characteristics (such as credit scores) posed more risk than previously because of substantially weaker and more uncertain conditions in the housing and labor markets. In addition, lenders appeared to price risk more stringently because they were passing through loan-level pricing adjustments (LLPAs) from

[33] The analysis expanded the JCHS Enhanced HMDA database to incorporate HUD tract-level measures of neighborhood distress.

[34] Avery et al., *HMDA Highlights for 2010*, 2011, pp. 47–9.

the GSEs on mortgages to borrowers in credit score and LTV ranges for which they had not previously charged fees. Subdued refinancing activity also reflected the operational difficulties associated with resolving piggyback and other junior liens, especially in Arizona, California, Florida, Michigan, and Nevada where home prices fell so sharply.

Even so, refinance loans continued be readily available to households living in higher-income communities. Joint Center tabulations of HMDA data indicate that refinance lending in 2010 was off about 66 percent relative to 2004 in neighborhoods with incomes averaging less than 80 percent of area median, but only 8 percent in neighborhoods with incomes averaging in excess of 120 percent of area median.[35]

To examine this phenomenon in more detail, Robert Avery and his colleagues at the Federal Reserve Board drew on the FRBNY Consumer Credit Panel/Equifax[36] for three key pieces of information: (1) details on each mortgage outstanding for a given consumer, including year of origination and current balance; (2) each consumer's credit score as of the end of 2009; and (3) each consumer's geographic location at the level of the census block. As might be expected, refinance rates were found to be generally lower for borrowers in the five states where house prices dropped the most (California, Arizona, Nevada, Florida and Michigan) than in states where price declines were more modest. The difference was especially pronounced for borrowers who had purchased homes without substantial downpayments or had cashed out their equity in a previous refinancing.

In contrast, refinance rates in 2010 were highest among consumers with pristine credit scores (720 or higher) and among those with loans originated between 2006 and 2008 when interest rates were relatively high. Within these origination years, the refinance rates for borrowers with credit scores of 680–719 were less than half the rates for borrowers with the highest scores. The fall-off in refinances appears to be just as dramatic in states that did not experience severe home price declines as those that did.

This pattern is without historical precedent. For example, in 2001–3 when interest rates dropped sharply and refinance volumes peaked, refinance rates did not vary systematically across state groups or fall with credit scores until scores dropped below 680. Avery and his colleagues concluded that if overall refinance rates in 2010 had been similar to those in 2003, some 2.3 million (50 percent) more first-lien owner-occupant refinance loans would have been made. These findings support the view that losses of home equity, weak economic conditions, and tighter underwriting (due to diminished appetite for risk) limited the ability of low interest rates to relieve homeowner financial distress. These same factors also dampened normal cyclical

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[35] Unpublished tabulations of JCHS enhanced HMDA database.

[36] See Avery and others 2011, *HMDA Highlights for 2010*, pp. 27–49. Note the Equifax panel is a nationally representative longitudinal database of individuals with detailed information on consumer and mortgage debt, as well as loan performance drawn from credit records collected and maintained by Equifax, one of the three national credit bureaus. Note also that refinance mortgage loans are not explicitly identified in the credit bureau data, but by following a given borrower over time, it is possible to infer whether refinancing occurred during any particular period.

recovery mechanisms and thus contributed to the persistent weakness of the economy after the housing bubble burst.

MORTGAGE FRAUD FLOURISHED IN THE ERA OF LAX REGULATION

In the superheated atmosphere of the housing boom, all too many market participants used questionable practices to gain competitive advantage. Unfortunately, regulatory systems had failed to keep pace with the fast-changing world of mortgage finance. As new Alt-A, subprime, and other nontraditional products flooded the market, regulators were slow to adapt rules written when 30-year fixed rate prime loans dominated the mortgage lending landscape. They also failed to respond to claims that creditworthy borrowers were being steered toward these alternative high-cost products, not because they were better suited to the borrower's situation but because they offered greater profit potential for the originator, lender, and/or investor.

Moreover, much of the regulatory framework had been built around the definitions of traditional banks and thrifts, and regulators claimed they had no authority to examine lending patterns in these newly dominant mortgage channels. At the same time, calls to expand federal oversight to the nonbank sector were resisted fiercely as an inappropriate intrusion into private mortgage markets. Indeed, the rise of nonbank originators and new approaches to funding mortgages opened what one former Federal Reserve Board governor described as a "hole in the supervisory safety net."[37] Because bank and nonbank lenders were not subject to the same rules, variations in state-level regulation added to the patchwork of mortgage market regulation. As a result, mortgages made in a given metropolitan area, and even a particular neighborhood, were subject to different degrees of regulatory oversight.

While the causes are still under debate, mortgage fraud rose sharply during the boom. In their annual Mortgage Fraud Update, FinCEN reported that Suspicious Activity Report (SAR) filings increased fivefold from 2002 to 2008 and continued to rise thereafter (Figure 8). Many current mortgage fraud filings relate to events that occurred between 2006 and 2008, indicating improved detection on the part of lenders. Continued media coverage has also led many unsuspecting borrowers to discover, long after the fact, that they, too, were victims of mortgage origination fraud.

Figure 8. Mortgage Loan Fraud Suspicious Activity Reports Have Increased Dramatically

Minority groups and communities were disproportionately targeted for aggressive and misleading push-marketing of risky loan products. Once foreclosures began to rise, a wide range of foreclosure rescue scams also appeared on the scene. While the types of fraud were basically similar, they took on different forms as perpetrators adapted to changing market conditions. For example, fraud related to loan applications remains the number-one abuse (although its share of total fraud cases has decreased in recent years). During the boom years, rising house prices motivated some borrowers to misrepresent their incomes or employment to qualify for bigger

[37] Gramlich, *Subprime Lending*, p. 91.

loans or better loan terms. Illegal property flipping, sometimes accompanied by inflated appraisals, was also prevalent during the years when house prices rose rapidly.

CONCLUSION

By 2008, American households had lost $7 trillion in real estate wealth and millions were underwater or delinquent on their mortgages (or both). Without the ability to sell their properties or refinance into less expensive loans, many households were stuck in homes they could not afford. The mortgage market woes spilled over to labor markets as many unemployed workers were forced to limit their job search to areas within easy commuting distance rather than seek better-paying jobs in other regions of the country. By that point, it was abundantly clear that the U.S. mortgage market was in serious need of top-to-bottom reform. The key question was whether this reform would come soon enough to prevent further damage to the overall economy.

SECTION IV: RESPONDING TO THE CRISIS

With more and more toxic securities blowing up around the world, the U.S. financial system teetered on the brink of collapse and the economy headed into a recession of unknown proportions. Working cooperatively in the fall 2008, Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson took actions to calm the waters. Despite these initial efforts, the financial system remained paralyzed through the end of the year and the economic contraction accelerated. Businesses were unable to raise capital to conduct daily operations or fund expansion plans, while families could not obtain credit to buy homes, automobiles, or other big-ticket consumer durables.

Against this backdrop, the Obama Administration worked alongside the Fed early in 2009 to put a broad strategy in place that would shore up the economy, unfreeze credit, and return private capital to the financial system. While these actions served to pull the nation and the world back from the brink, they did not completely stem the downward drift of the U.S. economy. They also spurred vigorous debate about the proper role of government in private markets and the limits of government spending to stimulate growth.

COORDINATED EFFORTS TO HALT THE SLIDE

When credit markets began to freeze up in the fall 2008, the U.S. economy was close to collapse.[38] An unprecedented number of households were on the verge of losing their jobs to employment cutbacks and their homes to foreclosure. On September 7, 2008, in consultation with the FRB and the U.S. Treasury, FHFA placed the GSEs into conservatorship. At the same time, Treasury announced a $220 million set of financing arrangements (Treasury MBS Purchase Program) to ensure the GSEs were able to meet their obligations to the holders of bonds that they issued or guaranteed. The FRB later announced its own $1.25 trillion MBS Purchase Program, bringing the combined Treasury-FRB purchases to $1.4 trillion. Together these programs were designed to push down mortgage interest rates to support housing markets and generally bolster the financial markets.[39]

As the downward spiral progressed in late September 2008, Treasury drafted what would become the 2008 Emergency Economic Stabilization Act (EESA). Among other things, EESA provided the FRB and Treasury additional broad authority to address the crisis and authorized a $700 billion Troubled Asset Relief Program (TARP) to begin to buy up the stock of distressed financial institutions in a move to stabilize the banking sector.

[38] Decision makers scrambled to obtain accurate estimates of the magnitude of potential losses. According to the International Monetary Fund's October 2009 *Global Financial Stability Report*, potential global writedowns on credit over 2007–10 could exceed $3 trillion, including nearly $500 billion in bank writedowns of residential loans and securities.
[39] T. Geithner, "An Assessment of the Foreclosure Mitigation Efforts After Six Months," 2009.

The Obama Administration Builds on Previous Initiatives
The Federal Reserve and Treasury actions helped to stem the panic and slow the momentum of the financial crisis. The Obama Administration's strategy combined a broad economic stimulus package (the American Recovery and Reinvestment Act, ARRA) with comprehensive efforts to repair the financial system (the Financial Stability Plan, FSP). The FSP shifted the focus away from supporting individual institutions to rejuvenating the capital and credit markets, which was critical for restoring economic growth. The plan was intended to engage private sector entities in public sector problem solving, as well as support the housing market in general and troubled homeowners in particular (Figure 9).

Figure 9. The Government Launched Multiple Efforts to Stabilize the Housing Market

To recapitalize the financial system, the FSP required the nation's 19 largest bank holding companies to participate in stress tests as a condition for receiving government assistance, which forced institutions to disclose information about the risks they faced. This not only enabled regulators to provide more effective oversight, but it also allowed private investors to assess the underlying financial strength of each institution. Banks had to raise enough capital from private markets to meet the exacting requirements of the stress test, with the knowledge that inability to do so would mean taking additional capital from the government—capital that would come with tough conditions. The test itself provided the impetus for banks to once again raise private capital and to repay TARP investments, thus lowering the cost of the program to the taxpayer.[40]

Other key elements of the Financial Stability Plan were meant to restart the flow of credit. The Term Asset-Backed Securities Loan Facility (TALF) sought to revive the asset-backed securitization markets that provide credit to consumers and small businesses, while the Making Home Affordable (MHA) program involved a series of initiatives designed to give financially strapped borrowers who could afford to stay in their homes a chance to do so. In particular, the Home Affordable Modification Program (HAMP) reduced monthly payments for households delinquent on their mortgages, while the Home Affordable Rehabilitation Program (HARP) provided incentives to lenders to refinance loans in imminent danger of foreclosure at historically low, guaranteed rates. Rounding out this portion of the plan were programs intended to help households unable to meet their mortgage obligations find ways to vacate their homes without incurring the substantial costs of foreclosure.

Early Program Evaluations Prove Difficult
A broad consensus has emerged that the actions taken in fall 2008 and spring 2009 pulled the U.S. economy back from the brink and bought time to work through some of the other tough issues facing mortgage markets and the economy. But analyzing the effectiveness of various components of the initial crisis response has proven difficult. Indeed, some observers concluded

[40] Originally authorized at $700 billion, the 2010 Dodd–Frank Wall Street Reform Act reduced the TARP authorization to $475 billion. By March 2012, the Congressional Budget Office estimated the total cost to taxpayers net of recoveries would be $32 billion.

that part or all of the positive outcomes flowing from the various interventions could be attributed simply to announcement of the program. For example, Hancock and Passmore (2011) asserted that announcement of the MBS purchase program in and of itself reduced mortgage rates by about 85 basis points over the ensuing month, and that it lowered risk premiums by another 50 basis points once the program started.

In addition to the technical challenges of program evaluation, the "bailouts" of banks, the GSEs, and other large financial institutions in the fall of 2008 and spring of 2009 were highly controversial. Representatives of every segment of the mortgage industry and many consumer groups put forth opinions about the events leading up to the crisis and/or argued that various components of the early interventions were illegal, ineffective, or unfair. In the meantime, implementation of the Financial Stability Plan moved forward, along with numerous initiatives to address consumer protections and the structural weaknesses in the global financial system exposed by the crisis.

MAKING HOME AFFORDABLE UNDERPERFORMS EXPECTATIONS

Announced in February 2009, Making Home Affordable was intended to prevent avoidable foreclosures by providing financial incentives to servicers, investors, and borrowers to undertake loan modifications and refinances in affordable and sustainable ways. In situations where home retention was not possible, the program offered borrowers alternatives to the costly and time-consuming foreclosure process.

The most comprehensive foreclosure avoidance program launched to date, MHA would eventually grow to include two-dozen distinct components. Critics complained that this complexity limited program uptake, as servicers, investors, and borrowers alike struggled to keep up with what seemed to be an ever-changing set of options and requirements. Program advocates argued that the complexity largely reflected two major implementation barriers: (1) capacity constraints present in the nation's mortgage servicing industry, and (2) ongoing debate as to who should bear the cost of loan restructuring—the borrower, the lender, the investor, or the government. In any event, in light of the urgency associated with these initial recovery efforts, instant analyses of what was "wrong" with MHA abounded.

After a Slow Start, MHA Gains Momentum

To provide transparent accounting of program performance, the U.S. Treasury Department began releasing monthly reports on MHA in August 2009. As the program evolved, these reports provided additional detail and were soon joined by the U.S. Department of Housing and Urban Development (HUD) monthly housing scorecard, which attempts to place recovery efforts in the context of key trends in home prices, mortgage market activity, and home construction and sales. Together these reports provided a detailed record of the MHA program that is still being assessed today.

The various components of MHA gradually came on line. Although completed foreclosures are still at near-record levels, the number of foreclosure starts (loans first entering the process) peaked in the spring/summer of 2009 and by March, 2012 had receded by more than 70 percent. Over the same period, HAMP modifications and FHA loss mitigation and early delinquency interventions topped 3.0 million. Including the proprietary modifications offered by lenders participating in the HOPE NOW alliance, the number of families receiving assistance topped 6.0 million—more than twice the number of foreclosure completions recorded over the same period (Figure 10).

Figure 10. New Mortgage Initiatives Helped Millions Delay or Avoid Foreclosure

These statistics do not include the results of the Home Affordable Refinance Program (HARP), which provides streamlined refinancing for low-, no-, or negative-equity mortgages guaranteed by Fannie Mae or Freddie Mac. Once again, after a slow start, nearly a million borrowers have refinanced through HARP. Nevertheless, questions remain why more borrowers have not benefited from the program, especially since the FRB/Equifax panel indicates that 4 million borrowers appear to be making mortgage payments well above current rates and otherwise meet basic eligibility criteria for HARP refinancing (Duke 2011). Of course, some of these borrowers may be uninterested in refinancing. Given the potential savings to homeowners, however, the relatively low uptake on this program warrants another look at the factors that may be impeding participation.

One important friction arises from the inappropriate use of standard risk management tools in situations where the government, as part of GSE conservatorship, already owns the risk. In particular, improved affordability for the first mortgage reduces the government's risk exposure. Some therefore question why the GSEs still add loan level pricing adjustments or upfront fees to the refinancing costs of loans judged to have higher risk characteristics. These fees can increase the cost of refinancing by thousands of dollars and thus discourage borrowers from participating in the HARP program.

Another apparent friction is the so-called "putback" risk. Loan servicers or lenders are reluctant to engage in refinance activity for fear that they will be required to repurchase loans from the GSEs if underwriting of the original loan violated GSE guidelines. Although HARP's recently streamlined guidelines do not require lenders to verify all aspects of a borrower's application, lenders who process HARP loans do face putback risk both from the refinance loan itself and from the original underwriting. This risk may make lenders reluctant to refinance loans originated by other lenders, thereby limiting participation in the program.

Since the GSEs have much to gain by expanding HARP refinancing, FHFA had strong incentives to develop rules that would relieve the liability of the refinancing lender for the mistakes of previous lenders. But with controversy raging around the proposed mortgage market reforms, FHFA continued to resist implementing changes that seemed in the best interest of taxpayers, borrowers, and lenders alike.

Servicing Constraints Prove Problematic

During the boom period, keeping up with the rapidly changing mortgage landscape was extremely challenging. Little wonder, then, that many loan servicers lacked the resources to participate fully in the recovery effort. Historically, servicers were structured and staffed to process mortgage payments and perform loss mitigation for a small number of borrowers. They did not have the systems, staffing, operational capacity, or incentives to engage with homeowners on a large scale or to offer meaningful relief from expensive mortgages.

Before HAMP, there was no industry consensus on what characteristics defined an affordable mortgage product or on other standards important to loan modifications or foreclosure processing. Revelations about the inability of distressed borrowers to reach their servicers, lost applications for mortgage assistance, and the so-called robo-signing of foreclosure documents heightened concerns about the ability of the servicing industry to be productive partners. HAMP therefore worked cooperatively with lenders and servicers to establish the payment standard for an affordable and sustainable loan modification (31 percent of gross monthly income), enumerated a set of document and document handling requirements, and outlined a specific sequence of steps for initiating new loans or modifying existing ones. HAMP also established timelines for completing mortgage modifications or conducting foreclosure or foreclosure avoidance activities.

To meet these higher standards, some servicers had to ramp up capacity and make significant business changes to implement the program. Today, these companies modify mortgages, offer customer service for delinquent borrowers at an unprecedented scale, and routinely consider alternative approaches to keep borrowers out of foreclosure. Throughout this process, Treasury has issued guidance and clarifications to streamline the loan modification process and to provide a more flexible set of documentation requirements that vary by transaction type. Although challenges remain, these efforts have helped to bring greater efficiency and transparency to the loan modification and foreclosure avoidance portion of the recovery effort.

Deeper Modifications, While More Costly, Generate Better Results

The benefits of participating in HAMP and HARP are significant. HUD housing scorecard statistics indicate that the median reduction in mortgage payments for HAMP participants is 36 percent or more than $500 per month—translating to total savings for homeowners of nearly $3.7 billion annually. Early indications suggest that the re-default rates for permanent HAMP modifications are significantly lower than for historical private-sector modifications, reflecting the program's focus on aligning incentives and achieving greater affordability. For example, among HAMP modifications made in the fourth quarter of 2009, less than 10 percent of borrowers with permanent modifications re-defaulted (were at least 60 days delinquent) six months after modification. According to the OCC's Mortgage Metrics Report (2011), the re-default rate for non-HAMP modifications made in the same quarter was more than twice as high.

HAMP data also indicate that the greater the payment reduction included in the modification plan, the greater the success in limiting re-defaults (Figure 11). For example, more than 40 percent of HAMP borrowers whose mortgage payments were reduced by less than 20 percent re-defaulted after 18 months. In contrast, only 16 percent of those with payment reductions of 50 percent or more did so.

Figure 11. Deeper HAMP Modifications Can Help Borrowers Stay Current on Their Mortgage Payments Longer

Given the FDIC's apparent success in using principal write downs to restructure delinquent mortgages seized when it closed Indy Mac Bank, some viewed HAMP as just "kicking the can down the road." HAMP modifications only reduce the amount of borrower payments for up to five years, with the government and the servicer splitting the cost of the reductions. In contrast, a principal write down discharges part of a debt repayment obligation that, depending on the details (including whether the government bears the cost), the lender may never recover. Principal reduction payments may also encourage underwater homeowners to continue to meet their mortgage obligations by restoring confidence that they will eventually be able to rebuild equity.

The extent to which loan servicers, as agents of the lender/investor, can engage in either loan modification or principal reduction programs depends on rules specified in pooling and servicing (P&S) agreements. HAMP officials quickly discovered that these agreements—especially the ones covering nonprime products—were often loosely drafted and generally offered limited guidance about when a loan modification or principal reduction was allowable.

Moreover, as HUD, Treasury, and other administration officials explored various principal reduction options, they quickly encountered strong opposition from many in the lender/investor community who were reluctant to bear a significant share of the cost of the mortgage market meltdown. In some instances, this reluctance reflected the investor's interest in retaining the right to benefit from any future gains when home prices rebound. In others, lenders or investors were concerned that writing down principal for financially distressed borrowers on a large scale would encourage "strategic default" among borrowers who could make mortgage payments but simply chose not to. In the opinion of many, this shift would undermine the legal and moral foundation upon which mortgage lending rests.

LEGISLATIVE ACTION INTENSIFIES DEBATE OVER CAUSES

With efforts to stabilize the mortgage market moving forward, Congress began the lengthy process of crafting a set of legislative proposals that by July 2010 would emerge as the Dodd-Frank Wall Street Reform and Consumer Protection Act. Dodd-Frank established a Consumer Financial Protection Bureau (CFPB) to consolidate rulemaking, supervision, and enforcement of regulations governing consumer protection issues. It also created a Financial Stability Oversight Council (FSOC) with the authority to require FRB to supervise any financial institution whose distress could pose a threat to the country's economic stability.

Moreover, the Dodd–Frank Act created comprehensive federal oversight of the derivatives market and imposed safeguards and transparency on the process of securitizing pools of loans for investors. To protect taxpayers, the legislation restricted commercial banking firms from engaging in proprietary trading or investing in or sponsoring private equity or hedge funds (the Volcker Rule). To limit the phenomenon of "too big to fail," Dodd–Frank also required certain large nonbank financial companies and bank holding companies with assets of $50 billion or more to reduce their size or divest business lines if the company poses a grave threat to the financial stability of the United States. In the event a major financial firm does fail, the legislation provides the federal government authority to wind the business down in an orderly fashion that protects the economy and does not impose the cost on taxpayers.

Representing perhaps the biggest overhaul of the nation's housing finance system in five decades, the Dodd-Frank legislative process triggered wide-ranging debate over the proper role of the government in the mortgage marketplace. In advocating against a broader role for government as envisioned in Dodd-Frank, some argued that the mortgage boom and bust was itself attributable to regulatory over-reach in private markets. Some pointed in particular to Community Reinvestment Act (CRA) lending requirements and GSE affordable housing goals. Others claimed that FHA's focus on expanding credit access for underserved people and communities contributed to the dual market structure that allowed abusive lending to thrive.[41] Although many factors contributed to the crisis, CRA, the GSE goals, or FHA lending to low-income and low-wealth borrowers do not appear to be among them. Studies that claim otherwise are generally built on weak methodological foundations. For example, regression studies compare aggregated time series of loan volumes and pricing, while other analyses rely heavily on theoretical models of market behavior. But because of the compounding effects of changes in the macro economy, the spatial variation in supply and demand conditions across housing markets, and the complexity of the loan products being assessed, these studies fail to "prove" a causal link between the government programs and the mortgage market meltdown.

CRA Regulations Had No Influence on the Emergence of Subprime Lending

Congress passed the Community Reinvestment Act in 1977 to encourage banks to meet the credit needs of communities where they had branches in a manner consistent with safe and sound operations. Since the mid-1990s, federal regulators have evaluated compliance with CRA obligations by measuring the share of loans originated (or purchased from other lenders) in lower- and moderate-income communities and/or made to lower- and moderate-income borrowers.[42] After the financial crisis, some critics have claimed that the wave of risky lending stemmed from the fact that CRA pushed banks into making loans to these borrowers and communities that failed to meet sound underwriting criteria.

A variety of empirical evidence, however, supports the view that CRA's requirements played little or no role in the foreclosure crisis. To begin with, CRA lending requirements had been in force for more than three decades. In addition, the crisis emerged after a sustained decline in the share of mortgage lending activity covered under CRA. As discussed earlier, the growing share of loans

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[41] See also P. Wallison, "Dissenting Comment," 2011, for a review of the literature that argues that FHA mortgage insurance programs, CRA, and GSE goals were key contributors to the financial crisis. See also Liebowitz, 2008.

[42] For a brief history of CRA, see Essene and Apgar 2009.

made by mortgage banking subsidiaries or affiliates of bank holding companies, as well as by independent mortgage companies, led to a corresponding decline in the share of loan originations by deposit-taking institutions (Figure 12). Between 1993 and 2006, the share of home purchase loans made by CRA-regulated institutions in their assessment areas fell from 36 percent to 26 percent, while the share of refinance loans dropped from 45 percent to 25 percent (Essene and Apgar 2009). As a HUD report to Congress noted, “It is hard to argue that CRA produced the foreclosure crisis even as its influence was waning.”[43]

Figure 12. CRA Assessment Area Lending Accounted for Only a Small Share of Risky Lending

The evidence also suggests that only a small share of high-priced subprime loans can be linked to efforts to meet CRA’s lending requirements. While estimates vary depending on the precise definition of a subprime loan, the share appears to be in the 5–10 percent range.[44] Finally, there is some indication that loans made to low- and moderate-income homebuyers as part of banks’ efforts to meet their CRA obligations actually performed better than subprime loans originated by lenders not subject to CRA requirements. In an analysis of CRA-motivated loans sold to a community development financial institution, Ding, Quercia, and Ratcliffe (2008) found that the default risk of these loans was much lower than for subprime loans made to borrowers with comparable incomes and credit risk profiles. Similarly, Laderman and Reid (2008) analyzed the foreclosure risk of home purchase loans made in California in 2004 and 2006 by CRA-covered institutions in their assessment areas, and concluded that such loans were less likely to be foreclosed than those made by independent mortgage companies in the same neighborhoods.

The GSEs’ Affordable Housing Goals Did Not Increase Market Risk

For 20 years, Fannie Mae and Freddie Mac played an important role in creating an efficient marketplace for the purchase and sale of mortgage backed securities, providing a stable source of mortgage capital during periods of market stress. Unfortunately, there was little clarity in the marketplace about the extent of government backing of GSE debt. Despite repeated statements that the GSE guarantees were only as strong as their capital base and their ability to enter into risk-sharing arrangements with mortgage insurers and other third-party parties, their status as government sponsored enterprises fostered the perception that their MBS were backed by the full faith and credit of the federal government. This implicit government guarantee reinforced investors’ belief that Fannie and Freddie were “too big” and “too important” to be allowed to fail. This assumption proved to be incorrect and stockholders lost all their equity in the companies. But ambiguity about the nature of their guarantees did allow the GSEs to take on excessive leverage and in fact was a key factor in their failure.

[43] HUD, “Root Causes,” 2010, p. 41.
[44] Governor Randall S. Kroszner (2008) of the Federal Reserve System used HMDA data to document the fact that only 6 percent of higher-priced loans were originated by CRA-covered institutions in their assessment areas. The Joint Center (2007) estimated the share to be 9 percent.

In addition to other claims, some have contended that the GSEs failed not because of structural design flaws around the guarantees, but because the institutions were required to meet a series of housing goals. In 1992, Congress imposed goals to ensure that Fannie Mae and Freddie Mac “led the market” in providing affordable mortgage loans to low- and moderate-income borrowers and communities. In response, the GSEs set up community lending programs that eased downpayment and underwriting requirements on a very limited basis. HUD then ratcheted up the goals in 2000 and again in 2004, increasing the focus on expanding access to affordable lending and meeting the mortgage needs of historically underserved areas. Nevertheless, little evidence suggests that these elevated housing goals drove the GSEs to purchase the riskier subprime and Alt-A loans that led to substantial losses during the mortgage bust.

In weighing the arguments, Jaffee (2010) concluded that market pressures probably played a large role—including the fact that the GSEs yielded to originators’ demands to purchase riskier products as well as to stockholders’ concerns about losing market share and profits to new competitors. The Financial Crisis Inquiry Commission (FCIC) reached a similar conclusion.[45] These and other observers note that given their size, the GSEs could easily meet their housing goals. Moreover, purchases of Alt-A and interest-only loans offered little help in meeting those goals.

The available evidence also indicates that the GSEs played an even smaller role in supporting the purchase of high-cost loans. Using 2005 HMDA data, the Joint Center (2007) found that loan sales to Fannie Mae and Freddie Mac accounted for a tiny 3 percent of all higher-priced home purchase loans, while private securitizations and other conduits accounted for as much as 48 percent. Avery and Brevoort (2011) took this analysis one step further by matching loan-level HMDA data to measures of loan performance provided by Equifax. Their analysis started with the observation that GSE neighborhood goals relied on clearly defined geographic areas to determine which loans received goal credit and which did not. This could create the anomaly that one loan was “goal eligible” if made in a specific census tract, while another loan (with identical borrower or loan characteristics) made in a different census tract was not. Using a regression discontinuity approach, the researchers compared the performance of loans purchased in census tracts with characteristics just above and just below the thresholds defining eligibility for the GSE neighborhood goal (areas where any effect of the GSE goals should be clearest). Like other analysts, Avery and Brevoort concluded that the GSE goals did not have a significantly negative effect on outcomes.

This is not to say that eliminating or privatizing the GSEs would have no impact on housing markets. As a result of the implicit government subsidy, the GSEs enjoyed a 25–50 basis point funding advantage over other highly rated financial securities.[46] Nevertheless, it is clear that only about a half or a third of whatever financial advantage existed was passed through to borrowers. Studies from the late 1990s and early 2000s suggest that the GSE impact on lowering mortgage

[45] See FCIC, especially pp. 184–7.

[46] These estimates are based on a detailed literature review presented in Jaffee 2010. The author notes, however, that they are only rough estimates given that the benchmark for comparison is controversial and individual studies have produced a range of results. See also, D. Jaffee and J. Quigley 2011.

rates was in the 20–25 basis point range. Indeed, Passmore recently estimated that the effect could have been as small as 16 basis points. The rest of the initial funding advantage provided by the government subsidy was paid out to shareholders of Fannie Mae and Freddie Mac, or captured by their private sector partners in the secondary market.

By relaxing their underwriting standards in search of greater MBS market share, the GSEs contributed greatly to the boom in mortgage lending, but their housing goals had little to do with the rampant growth in subprime lending that lies at the root of the crisis. Of course, when large shares of the mortgages held in their portfolios failed to perform as expected, the GSEs' substantial losses became central to the mortgage bust.

FHA Mortgage Insurance Did Not Contribute to the Mortgage Market Bust
Advocates for a smaller government role in mortgage markets have also targeted FHA. They argue that FHA, along with its secondary mortgage market partner Ginnie Mae, crowd out private sector lenders and securitizers. Several legislative proposals have been introduced over the years to privatize FHA and Ginnie Mae and eliminate all federal support for these agencies. Supporters counter that FHA has played an important countercyclical role by being a lender of last resort with a presence in all markets at all times ramping up during periods of market weakness and backing away during housing booms (Figure 13).

Figure 13. Government-Backed Lending Played Its Traditional Countercyclical Role

Working in tandem with Ginnie Mae, FHA has also expanded access to affordable mortgage capital, especially in lower-income and/or minority borrowers and communities.[47] Indeed, according to the 2010 HMDA data, FHA continued to lead the market in support for minority homeownership**.** While insuring 37 percent of all home purchase loans to owner-occupants, FHA covered about 60 percent of loans to both African-American and Hispanic/Latino borrowers in that year.

FHA did suffer severe losses when home prices fell sharply, as did lenders that originated CRA eligible loans, as did the GSEs that securitized goal-eligible loans. These programs are not perfect and would benefit from reform. At the same time, though, it is important to avoid drawing the wrong conclusion about the role of government in the mortgage market and sacrifice an important goal of the current system: broadening access to mortgage credit to a wide range of creditworthy low-income and low-wealth borrowers. The continuous presence of FHA as a lender of last resort and the affordable housing mandates of the CRA and the GSEs did not cause the housing crisis, but reform of CRA, FHA, and the GSEs are essential to expanding access to affordable mortgage credit in a sustainable way in the decades ahead.

[47] FHA also plays a key role in multifamily finance. For details, see Herbert, Belsky, and Apgar (2012) on federal involvement in the rental market.

CONCLUSION

Moving from crisis response to long-term mortgage market reforms will not be easy or happen quickly. In addition, families that lost their homes to foreclosure were rightfully angry when the government moved to pump billions of dollars to keep the nation's largest banks and financial institutions including Fannie Mae and Freddie Mac afloat. Both political and technical obstacles stand in the way of implementing key elements of the Dodd-Frank Act and of extending the agenda to CRA, FHA, and GSE reform. Indeed, ongoing efforts to stop implementation—including the work of the CFPB before it has established the mechanisms to enhance access to mortgage credit on fair and equal terms—are ample reminder that there is little consensus on how best to move forward. What is needed now is to work toward structural reforms that will reduce the presence of the government in the mortgage market while also creating more sustainable mortgage products and delivery systems.

SECTION V: MOVING FROM RECOVERY TO REFORM

Now that banks and other financial institutions have begun to restore their balance sheets, it is time for the government to gradually step away from the mortgage market and allow private sector entities and private sector capital to return. To ensure that expanded lending is done responsibly, policymakers must perform a careful balancing act as they implement key provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. On the one hand, over-reaching regulations may discourage private lending and thereby hurt the very borrowers the regulations were designed to protect. On the other, consumers must be discouraged from taking on mortgages that they cannot afford in the long term.

A responsible plan of reform should encourage the revitalization of a robust and fair private mortgage market. Over the next several years, this will involve ensuring that lower-income and minority communities hardest hit by the Great Recession benefit from the emerging recovery in housing and mortgage markets. To be successful, this effort must expand the reach of FHA and build on CFPB's initial efforts to establish key parameters relating to the ability to repay a loan (ATR) and underwriting criteria defining what constitutes a "good" mortgage. In addition, it will be important to expand enforcement of fair lending laws to ensure access by all creditworthy borrowers to affordable and fairly priced home purchase and refinance loans on terms that they understand and are able to repay.

FHA IS KEY TO EXPANDING ACCESS AND AFFORDABILITY

As lender of last resort with a presence in all markets at all times, FHA stepped in to play its traditional countercyclical role during the mortgage bust, particularly in neighborhoods not well served by the private sector or the GSEs. According to 2010 HMDA data, FHA as well as other government-backed lenders (including the Department of Veterans Affairs, the Farm Services Agency, and the Rural Housing Service) served the vast majority of African-American (82.9 percent) and Hispanic (76.3 percent) home purchase borrowers (Figure 14). Similarly, in low-income and/or minority neighborhoods—the areas hardest hit by the mortgage bust—government-backed loans for home purchase (including purchases by nonresident owners) increased more than threefold between 2007 and 2008, and doubled again by 2010 (Figure 15). Even in low-income white neighborhoods and high-income minority neighborhoods, government-backed lending picked up quickly in response to the crisis.

Figure 14. Most Home Purchase Loans to Minorities Are Now Government-Backed

Figure 15. Government-Backed Lending Has Played a Vital Role in Restoring Mortgage Activity in a Wide Range of Neighborhoods

With the housing recovery and mortgage recovery well underway, now is the time for FHA to take a back seat and encourage private sector lending to come back into these lower-income and minority neighborhoods as well. Many borrowers now receiving government-backed loans are creditworthy and could qualify for and afford to pay conventional loans. For example, more than half of all FHA borrowers in 2010 had credit scores above 680 and sufficient income to afford stable homeownership. The challenge will be to encourage private lenders to originate new loans in what they perceive to be still-risky neighborhoods rather than channel borrowers into FHA-insured loans.

For its part, FHA should focus on extending access to mortgage credit to those lower-income and lower-wealth borrowers with less than less-than-pristine credit records—borrowers traditionally not well served by the GSEs and the private sector even in the best of times. Failure to reposition FHA in the post-crisis era would result in a new form of disparate treatment in which minorities were unable to obtain a conventional loan on the same terms and pricing as otherwise similar white households. Such an outcome is not only unfair to qualified borrowers, but it would also divert resources from FHA's primary social mission: broadening access to those low-income and low-wealth borrowers who have not yet benefited from the revolution in mortgage finance.

FHA Suffered Near Fatal Losses During the Bust

Although FHA did not participate in the race to the bottom during the lending boom, the FHA Mutual Mortgage Insurance (MMI) fund, which supports its core single-family insurance product, suffered severe losses when house prices collapsed. With lenders and investors unwilling to put uninsured private capital at risk amid the growing uncertainty, originators started to turn to FHA in 2006 to sustain their volume. Indeed, according to FHA's annual actuarial review, more than one in four FHA mortgages originated in 2007 will result in an insurance claim, with even larger shares among loans made to borrowers with the lowest credit scores and highest loan-to-value ratios.

Although backed by the "full faith and credit" of the U.S. Government, FHA's insurance fund has yet to require a "bailout" or cash infusion to cover losses. Instead, FHA has drawn down reserves accumulated over the years from the payment of insurance premiums. For budgeting purposes, FHA maintains separate accounts for financing and capital reserves. The financing account holds reserves equal to the present value of net losses projected over the next 30 years. To the extent the reserves exceed the net present value cost of the loan guarantees, these excess funds are paid into the capital reserve account. If the present value estimated net losses exceed the reserves, funds are paid from the capital reserve account to make up the difference.[48] As of the end of fiscal 2011, FHA's reserves (the combination of the financing and capital reserve accounts) totaled $33.7 billion—an increase of $400 million from 2010, but uncomfortably low relative to the nearly $1 trillion of FHA insurance in force.

By law, if its capital reserves fall below 2 percent of unamortized insurance in force, FHA is required to present a plan to Congress of actions it will take to replenish its funds. The fiscal 2008

[48] This is somewhat analogous to a checking and savings account. The financing account holds reserves, pays default claims or other losses, and receives any payments received from the public; the capital reserve account holds surplus cash

actuarial review revealed that the capital reserves ratio was just 3 percent, and FHA insurance in force was growing rapidly. In early 2009, FHA therefore launched a comprehensive review of credit policies, risk management, lender monitoring, and consumer protections.

As part of this effort, HUD hired the first-ever FHA Chief Risk Officer and expanded the agency's capacity to assess financial, operational, and counterparty risk, perform more sophisticated data analysis, and respond more rapidly to market developments. HUD quickly established tougher credit score and downpayment minimums to balance risk management with providing broad access to housing credit for borrowers who historically met FHA credit quality standards. Although FHA continues to offer loans to creditworthy borrowers with downpayments of less than 5 percent, borrowers with credit scores below 580 must now make downpayments of 10 percent, and applicants with credit scores below 500 are no longer eligible for FHA insurance.

To help replenish its reserves, FHA also launched a series of pricing increases designed to encourage households with sufficient resources to obtain conventional mortgages. In February 2012, FHA announced that it would increase its annual mortgage insurance premium (MIP) on loans under $625,500 from 1.15 percent to 1.25 percent. For larger loans, the annual premiums were raised to 1.5 percent. The agency also increased the upfront mortgage insurance premium (UFMIP) from 1.0 percent to 1.75 percent of the loan amount. Since these upfront fees can be rolled into the mortgage, they serve to immediately raise revenues for FHA but do not limit access for borrowers facing severe downpayment constraints.

In addition, HUD moved aggressively to limit losses linked to the moral hazard associated with fact that FHA insures lenders for 100 percent of losses if borrowers default on their mortgage obligations. Underwriting guidelines alone give lenders little financial incentive to accurately evaluate risk. In addition to increasing enforcement actions against FHA lenders caught committing fraud, HUD shifted responsibility for proper marketing and placement of FHA insurance to lenders. For example, FHA no longer allows loan correspondents to directly submit FHA loans for endorsement, and has increased the net worth requirements for lenders/originators underwriting FHA loans. Needless to say, these actions were highly controversial in that thousands of individual firms could no longer partner with FHA. Even so, these changes were important to restore the MMI fund and to allow FHA to expand targeted access and affordable mortgage credit over the long haul.

HUD also announced new mortgage products to allow creditworthy lower-income borrowers to take advantage of historically low interest rates. FHA estimated that as many as 3.4 million families paid more than a 5.0 percent annual interest rate on their FHA-insured mortgages. Beginning in June 2012, FHA's new Streamlined Finance Program dramatically reduced the insurance premiums on loans it insured without requiring additional underwriting.[49] Because FHA already holds the insurance risk for these loans, the program poses no additional risk to the MMI

[49] The program lowers the UFMIP to just 0.01 percent and reduces the annual premium to 0.55 percent, saving a typical FHA borrower up to $250 per month in mortgage payments.

Fund. And to the extent that the program enables borrowers to better meet their payments, FHA will avoid the substantial costs associated with foreclosure.

Together, these recent changes illustrate the complexity of expanding access to affordable homeownership while restoring FHA's solvency for the long term. In an era of scarce government resources, FHA should focus its programs where they are most urgently needed. At the same time, though, families must be discouraged from taking on debt that they cannot afford to repay. Going forward, FHA must develop new approaches to utilizing downpayment assistance for low-wealth but creditworthy borrowers with limited ability to meet even modest downpayment requirements. Moreover, all levels of government must work to encourage private capital to serve all those with the resources to secure conventional loans and not hide behind exaggerated fears about the risk of lending in lower-income and minority communities.

CFPB TAKES INITIAL STEPS TO LAUNCH THE NEW MORTGAGE MARKET

The new Consumer Financial Protection Bureau has rulemaking, enforcement, and supervisory authority over a variety of consumer financial products and services, including many previously enacted consumer protection laws such as the Real Estate Settlement Practices Act (RESPA) and the Truth in Lending Act (TILA). Although placed within the Federal Reserve Board for budgeting purposes, it is independent of the Fed in all other ways. According to the CFPB's webpage, its mission is "to make markets for consumer financial products and services work for Americans—whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products."

CFPB and FSOC Assume Important New Rulemaking Responsibilities

One of the important consumer protection elements of the Dodd-Frank Act is to reduce the number of borrowers who obtain mortgage loans they cannot afford to pay back. The act mandates that the CFPB develop regulations to define ability to repay and to combine that concept with other sound underwriting criteria to set the criteria for a qualified mortgage (QM), often referred to as a "good" mortgage.[50] Dodd-Frank also mandated a risk retention requirement to align lender and investor incentives, forcing lenders to have "skin in the game," i.e., suffer losses if a loan goes to delinquency or foreclosure. Toward this end Dodd-Frank introduced the concept of a qualified residential mortgage (QRM) that would be the only mortgages exempt from the "skin in the game" requirements and charged the newly created Financial Stability Oversight Council (FSOC) with rulemaking regarding this issue. The FSOC includes representatives of six federal agencies (SEC, HUD, OCC, FRB, FDIC, FHFA), but not the CFPB—a structure that clearly requires cross-agency cooperation.

Defining a Good Mortgage Proves Elusive

In defining a good mortgage, it is important to strike a balance between loans that borrowers have the ability to repay with those that allow broad access to affordable mortgage credit.

[50] ATR and QM rulemaking authority was originally assigned to the Federal Reserve Board, but was transferred to the CFPB when it commenced operations on July 21, 2011.

Starting from first principles, ability to repay should not be confused with propensity to repay. The ATR depends on the amount of the mortgage, other debt, and housing-related payments relative to income known at the time the loan is originated. The propensity or willingness to repay depends on how the borrower reacts to future changes in income and other factors.

To predict and manage their risk exposure, mortgage lenders employ a credit box (a combination of historical credit behavior and other factors) to estimate the likelihood of repayment and to adjust the terms and prices of their mortgage offerings accordingly. Of course, the trick is to limit lending to those unable or unwilling to repay, but to do so in a way that treats equally situated applicants similarly.

The CFPB initially proposed rules specifying that a mortgage would comply with QM regulations if it met certain criteria, including no negative amortization, no balloon or interest-only payments, and no terms exceeding 30 years. During the boom-and-bust period, balloon payment and interest-only loans were among the products that borrowers had the greatest difficulty understanding and were associated with the highest delinquency rates. Loans for more than 30 years offer little advantage to consumers and complicate the pricing of risk. In addition, the CFPB solicited input on two alternative approaches to enable borrowers to seek redress for perceived illegal behavior on the part of lenders: safe harbor and rebuttable presumption of compliance.

Meanwhile, the FSOC moved along with rulemaking about what constituted a qualified residential mortgage (QRM)—i.e., the rules governing when the securitizer has to retain 5 percent of the credit risk. . Under Dodd-Frank, a QRM must meet all the requirements that define a qualified mortgage (QM) as established by the TILA, plus other underwriting criteria that include consideration of the borrower's debt repayment history, current and anticipated capacity to make debt payments, and the quality and the value of the collateral securing repayment. The proposed rule, issued in March 2011, proved to be highly controversial. Among other things the QRM rule specified that to be exempt from the risk retention requirements, a mortgage would not only have to meet the requirements for a QM, but also have less than an 80 percent loan-to-value ratio.

Taken as a package, the proposed QM and QRM rules pleased almost no one. A wide range of mortgage analysts argued that requiring a 20-percent downpayment went well beyond what is needed for prudent risk management. Lenders and others claimed that the relatively high downpayment requirement and a tightly defined QM would make it more costly, if not impossible, to raise capital to fund their lending operations since these tight boundaries would mean that a large share of lending would require capital retention. At the same time, affordable housing advocates complained that, with their limited ability to save, lower-income and/or and low-wealth households would not qualify for these good mortgages.

The litigation rules raised another set of contentious issues. Under the proposed safe harbor option, lenders would be presumed to be in compliance with regulations if the loan met the features defining a QM. Consumer advocates expressed concern that this formulation would allow unscrupulous lenders to find ways to circumvent the QM requirements, and they remained reluctant to abandon ready access to the courts to adjudicate grievances.

Under the rebuttable presumption of compliance approach, lenders/originators would have to meet the guidelines specified in the safe harbor option and could be challenged for not making a reasonable and good faith determination of a borrower's ability to repay. Lenders/originators argued that this approach would vastly increase the number of wrongful foreclosure cases that would go to court—an often lengthy, cumbersome, and expensive process. They also asserted that foreclosure defense attorneys would be able to challenge whether the loan was in fact QM-compliant. If the loan was not compliant, they claimed, judges could award significant damages to the borrower under certain TILA provisions. In their view, the costs of potential litigation would be unpredictable, especially in the so-called judicial states where foreclosure cases have relatively easy access to the courts. Moreover, lenders/originators contended that this would actually harm consumers in that the expected costs of this uncertainty would be passed along to borrowers, dampening demand.

Consumer advocates acknowledged the importance of incentives for borrowers to meet their mortgage obligations, but argued that few borrowers have the resources to bring mortgage or foreclosure disputes to court. Even so, many advocates believe that the prospect of litigation, associated fines, and reputational damage are needed to deter the lender abuses witnessed during the housing boom. In their view, more clearly defined rules (a "bright blue line") or alternative dispute resolution procedures could help weed out frivolous claims and reduce the impacts on the cost of credit.

Balancing Safety and Soundness with Access and Affordability

The responses to the proposed QM and QRM rules included a range of empirical assessments of likely loan performance under differing mortgage terms, borrower attributes, and legal frameworks. By necessity, these assessments are backward-looking, i.e., rely on historical data and experience. Though informative in many ways, historical data may offer a skewed picture of the relationships among borrowers, neighborhoods, loan terms, and the drivers of default and foreclosure. In addition, it is empirically challenging to tease out how standard variables used in underwriting (LTV, CLTV, front- and back-end DTI, or FICO scores) affect loan performance. Moreover, given the dynamic nature of housing and mortgage markets, it is difficult to predict with any degree of precision what would happen under various alternative QM and QRM scenarios.

Further complicating evaluation of these analyses is the lack of good data covering the entire mortgage market. As noted in Sections II and III, nonprime loan-level data that include borrower characteristics, property characteristics, and loan prices and terms are difficult to assemble. As a result, the comments and empirical results submitted in response to the CFPB's initial QM rule were often based on statistical models covering different market segments and/or different variables. This left the CFPB with the unenviable task of sorting out the competing claims and deciding how to move forward.

On May 31, 2012, the CFPB requested that the lending community submit additional comments on evaluating the data in hand, and provide information on nonprime and non-GSE loans that might help clarify the relationship between borrower and loan characteristics and loan performance. It also asked for additional comments and available data on borrower cash reserves, income stability, and timely housing payments used in loan underwriting. Finally, CFPB requested additional data and comments on the potential litigation risks and costs of the safe harbor and rebuttable presumption options. The CFPB will use this new information, along with the data in hand, to develop the final QM rule. Again recognizing that defining a QM is the first step in determining what constitutes a QRM and eventually reform of the GSEs and other secondary market activities, the CFPB is under considerable pressure to complete its work.

The CFPB must also be mindful about getting implementation of Dodd-Frank off to a good start. Public discussion is often framed as a choice between the "invisible hand of the free market" and the "heavy hand of government intervention," or between "borrower interests" or "lender interests." The reality of the rulemaking process is much more complex. For example, some consumer protection advocates emphasize legal rights, while others believe that properly crafted market incentives are the best approach. Within the lending community, rifts have emerged between the so-called big banks and the smaller regional and community banks, since big banks arguably have more resources and capacity to implement any mandated changes or contest any litigation that may come out of the regulations.

Assembling the detailed loan performance data needed to properly assess the impact of various approaches could take years. Yet the CFPB must move forward, since the failure to craft a "bright blue line" of what constitutes a QM could be used as an excuse for the private market to abandon low-income/low-wealth borrowers and simply steer them to FHA products.

CONCLUSION

Many decisions about FHA reform are best made in the context of broader mortgage market reforms. In particular, efforts by the Financial Stability Oversight Council to specify appropriate risk retention standards and by the Consumer Financial Protection Bureau to define a "good" mortgage product that a borrower has the ability to repay will affect FHA's position in the market. Among other things, the outcome of FSOC's and CFPB's actions will influence private sector originations of specific products, including low-downpayment, 30-year fixed-rate mortgages. Moreover, recognizing the importance of attracting private capital back into the mortgage market, FHA reforms must also be closely coordinated with GSE reforms. Without this alignment, government-insured FHA lending, not private capital, will fill the void left by the winding down of Freddie Mac and Fannie Mae.

SECTION VI: THE FUTURE OF THE HOUSING FINANCE SYSTEM

The Dodd-Frank Act of 2010 set about building a fairer and more responsible mortgage finance system from the ground up. Now just two years later, implementation of more than 200 mandated rulemakings is well underway. Over the next three to five years, policymakers must complete key structural reforms to ensure that the events of the past five years are not repeated. The focus of these reforms includes eliminating the distorting influence of financial institutions that are "too big to fail," bolstering the traditional role of FHA as provider of mortgage credit access for low- and moderate-income households and first-time homebuyers, and, at minimum, reducing the presence of Fannie Mae and Freddie Mac in the secondary market. These shifts should be implemented with a sense of urgency that pushes against the inertia of federal regulatory agencies, but slowly enough to allow all participants to adjust to the new market environment and to preserve widespread access to good mortgages.

ENDING THE RISK OF TOO BIG TO FAIL

Before the lending boom, mortgage market participants seem to have assumed that major financial companies (including the GSEs) would receive government assistance if they became troubled. And in fact, the initial actions taken in response to the crisis solidified that view. But the belief that some companies are too big to fail represents a form of moral hazard or misaligned incentives that could encourage some institutions to relax underwriting and purchase criteria in search of greater profitability and market share. The perception that a company is too big to fail also reduces the incentives of the shareholders, creditors, and counterparties of these companies to avoid excessive risk-taking. Moreover, companies perceived as too big to fail can often fund themselves at lower cost than other companies. This distortion is unfair to smaller companies, damaging to competition, and encourages further consolidation and concentration within the financial system.

By bringing the problem of "too big to fail" to the forefront, the financial crisis revealed serious shortcomings in the U.S. regulatory system including: (1) the inadequacy of stress tests and the failure to conduct those tests consistently across all segments of the market; (2) the lack of adequate procedures to resolve or, if necessary, wind down failed institutions; and (3) the failure to define and monitor problems associated with an interconnected financial system, especially counterparty risk.

Implementing a Regulator-Defined Stress Test Regime

The demise or near-collapse of seemingly well-run financial institutions during the crisis prompted renewed attention to risk management. Stress tests, a specific tool of risk management, are forward-looking assessments of whether a financial institution can withstand certain adverse conditions, including higher costs of capital, weaker demand for its products, and the negative impacts of falling home prices on capital reserves.

Even before enactment of the Dodd-Frank Act, the Federal Reserve Board had begun to overhaul the supervision of the most systemically important financial institutions. Through its Large

Institution Supervision Coordinating Committee, the Fed supplemented its traditional, firm-by-firm approach with routine horizontal or cross-firm reviews to monitor industry practices, common trading and funding strategies, balance sheet developments, interconnectedness, and other factors. As part of this effort, the Fed implemented a new stress test regime to assess the internal capital planning processes of the 19 largest bank holding companies and evaluate their capital adequacy under a hypothetical scenario consisting of a peak unemployment rate of 13 percent, a 50-percent drop in equity prices, and a further 21-percent decline in housing prices. The simultaneous review, using traditional methods, of the nation's largest banking firms also helped the Fed to evaluate the resilience of the system as a whole, including its capacity to make credit available to households and businesses if the economy were to perform very poorly.

The Dodd-Frank Act required regulators to conduct such tests for U.S. banks with more than $10 billion in assets. Roughly 190 banks now have to submit reports to regulators on the stress tests and publish a summary of results. But stress tests are no cure-all. Although intended to be forward-looking, such tests must rely on statistical assessment of historical data. Analysts attempting to draw on information from the past decade have to sort out the confounding effects of the boom and bust, including the unprecedented collapse of home prices, home sales, and the general economy.

Moreover, recent events have left an indelible mark in the minds of decision makers that will inevitably affect how they respond to the next crisis. For example, regulators may overcorrect for past failures and spend too little time trying to identify potential new threats. As Nassim Taleb (2007) opined, all disasters are black swans—always new and unthinkable. Enhanced stress testing may, however, help to reveal issues that require corrective action and improve understanding of how losses in one segment of a bank or corporation spill over to another segment or are influenced by dependency on an outside counterparty.

Preparation of Living Wills Can Smooth the Resolution Process

Resolution plans, or so-called "living wills," are mandated by the Dodd-Frank Act to help regulators understand the structure of complex financial firms whose failures could wreak havoc on the system, and wind them down if necessary. In the fall of 2011, the FRB and the Federal Deposit Insurance Corporation (FDIC) issued regulations requiring that banks and bank holding companies with $50 billion or more in worldwide assets file resolution plans that they update regularly.

In total, 124 banks—nearly 100 of which are foreign institutions with U.S. affiliates—are subject to the living will requirements. A handful of the largest bank holding companies doing business in the United States (with $250 billion in assets) submitted their required plans before July 1, 2012. This list includes Bank of America, J.P. Morgan Chase, Citi Group, and at least two foreign banks (Deutsche Bank AG and Barclays). Smaller companies will have until the end of 2013 to craft their plans. If regulators deem any nonbank financial firm to be a potential threat to the U.S. financial system, that firm will also have to submit a plan. (Regulators have yet to determine which nonbanks fall into that category.)

Banks face increasingly severe consequences—culminating in forced divestitures—if regulators do not find their living wills credible. Plans must highlight an institution's risk areas, and this information will be available to investors to help them make decisions about investments and acquisitions. This increased transparency will hopefully promote enhanced risk management and better corporate governance at the banks. Plans must also include a strategic analysis of the procedures required for orderly resolution, as well as information on corporate governance related to resolution planning, organizational structure, management information systems, interconnections and interdependencies among various subsidiaries and lines of business, and supervision and regulation of the organization.

To help insure that plan preparation does not devolve into a make-work exercise, a company's board of directors must approve the initial resolution plan and identify a senior official to be responsible for overseeing the development, maintenance, implementation, and filing of future updates. The FDIC and FRB note that the requirements set a floor, but corporate governance structures are likely to vary according to the size and complexity of the company. Smaller companies are permitted to submit plans consistent with the scale and scope of their operations.

Focused Efforts Are Required to Monitor and Manage Counterparty Risk

In the legislative maneuvering that led up to enactment, Dodd-Frank stopped short of providing regulators with general authority to break up financial conglomerates as some advocated, but it did provide the FRB limited authority to break up systemically important financial institutions if they posed "grave threat" to U.S. financial stability.[51]

The Dodd-Frank Act also calls for new rules governing counterparty risk exposure. While the idea is simple, the execution is complex and controversial. Policymakers want to prevent an ailing institution from infecting the entire system by limiting exposure to any single counterparty (including those that are part of the same corporate structure) to no more than 25 percent of their capital. In proposed rules issued on January 5, 2012, the FRB set even tighter standards, i.e., that entities judged to be systemically important financial institutions should have no more than 10-percent exposure to any single counterparty. The proposed rule also mandates that lenders provide the FRB with ongoing credit-exposure reports, configured to a mandated methodology.

The comment period, which ended on April 30, 2012, produced a deluge of responses. Wells Fargo objected to the way the creditworthiness of the counterparty would be measured, suggesting that "the proposed calculation methodology (for risk) will require costly system enhancements but will not accurately measure credit risk" (Wells Fargo, 2012). Goldman Sachs presented a quantitative analysis indicating that the proposed counterparty requirements would reduce GDP growth by 15–40 basis points and eliminate 150,000–300,000 jobs (Goldman Sachs,

[51] Dodd-Frank also included the so-called Volcker Rule prohibiting proprietary trading by commercial banks (using deposits to trade on the bank's own accounts). Arguably, such trading was a key factor in the excessive risk-taking that precipitated the crisis.

2012). Others generally argued that the proposal would destabilize markets in the short term and make them less efficient and resilient in the long term.

How the FRB and FDIC respond to this latest chapter in the too-big-to-fail saga remains to be seen. Proponents of limiting the size and complexity of banks and bank holding companies argue that these giants have more than exhausted any potential for scale economies and that their demise would allow for development of smaller, more specialized financial institutions. Opponents of such limits stress that matters of individual financial institutions are best left to market forces and corporate governance.

By requiring living wills and enhanced measures for assessing counterparty risk, these reforms in theory should enable regulators to better monitor the risk-taking behavior of major institutions before any new crisis emerges, and to achieve an orderly resolution if they fail. The hope is that these efforts will help the United States avoid another crisis on the scale of 2008. Moreover, without some resolution of these macro issues, it is difficult to see how Congress can make much progress on meaningful reform of FHA and the GSEs or on other legislative matters that are central to the mortgage access issue.

FHA NEEDS ADDITIONAL FLEXIBILITY TO EXPAND MORTGAGE ACCESS

Founded in 1937, FHA once represented an innovative public-private partnership combining government backing with business expertise to offer insurance products and services that competed in the marketplace. Since then, FHA has lost much of its operational flexibility. A 1995 GAO report noted that despite its classification as a "government corporation" designed to operate in the private marketplace, FHA had become subject to numerous statutes and regulations relating to public disclosure, personnel, procurement, financial reporting, and oversight that impinge on its ability to adapt its product line quickly to an ever-changing market.

There have been several previous bipartisan calls to restore FHA's ability to operate more like a business. For example, in 2002 the Millennial Housing Commission recommended that Congress restructure FHA as a wholly owned government corporation within HUD. This and other legislative proposals[52] share many common themes: namely, the importance of allowing FHA to manage its own budget, set hiring and procurement processes, and adapt its programs to evolving markets without Congress legislating each change or mandating numerous complex or inconsistent rules and regulations.

To ensure that the agency does not itself become "too-big-to-fail," the new FHA Corp. should be subject to regular financial and other reporting requirements, including an independent actuarial review each year and stress tests similar to those for other systemically important financial

[52] For example, in 1995 Representative Jerry Weller (R-Illinois) proposed a new FHA Corp. with significant flexibility. Legislation submitted by Representative Bruce Vento (D-Minnesota) in 1997 presented a similar proposal. More recent attempts to privatize FHA also emphasize the importance of acting in a more business-like manner, but generally back away from its social mission.

institutions. In addition, the new FHA Corp should remain affiliated with HUD. As part of HUD, FHA would still be able to collaborate closely with other department offices on production and preservation of affordable homeownership and rental opportunities.

At the same time, to ensure political accountability and adherence to its public mission, goals, and objectives, the new FHA could be led by a CEO who is nominated by the President, confirmed by the Senate, and is answerable to Congress. This process mirrors selection of a new cabinet secretary or senior administration official. The key difference would be that the CEO of FHA Corp. could have a term that overlapped administrations (like the terms of most banking regulators and the president of Ginnie Mae), and would be supported by an advisory board appointed by key congressional leaders.

To be more effective in its role as lender of last resort, FHA needs to be retooled as more than a first responder in a financial market emergency. As such, it should have the flexibility and capacity to experiment with mortgage features and adjust pricing as conditions warrant, including altering product features without having to wait for the next legislative appropriation and authorization cycle.

Even without another crisis, some form of federal intervention into housing and residential mortgage markets is still needed, especially on behalf of lower-income and low-wealth families who have yet to benefit fully from the revolution in mortgage finance. One important task for the new FHA Corp. should be to identify workable and cost-effective alternatives to today's widely used prepayable, 30-year, fixed-rate loans.[53] This product allows households to lock in an interest rate and stabilize their mortgage payments for the foreseeable future. If a borrower needs to relocate from one state to another for work, for example, paying off the mortgage without fees reduces the cost of such a move. But along with the borrower's underlying credit risk, investors need to be compensated for assuming both interest rate and prepayment risk. A prepayable 30-year mortgage is therefore typically more expensive than a shorter-term product or one with prepayment penalties.

A reformed FHA would offer solutions for lower-income borrowers facing intense affordability pressures even in the best of times. For example, FHA might expand the downpayment assistance programs now run by state and municipal housing finance agencies (HFAs) to other, carefully monitored private and nonprofit entities. Mindful of the heavy losses it suffered as a result of the abuse of seller-funded downpayment assistance activities, it is essential that going forward FHA have both the internal capacity and legal authority to quickly alter or terminate any new program if it appeared unsound.

Next, HUD could provide counseling to help potential homebuyers manage their resources better in order to save more toward a downpayment. Qualified counselors could help low-income and low-wealth borrowers scale their expectations appropriately so that they look for homes that

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[53] For a statement discussing the risks of FHA lending see E. Pinto, "The Government Must Jettison the 30-Year Mortgage," 2011.

they can afford. By offering a range of both online and face-to-face budgeting workshops, even borrowers with relatively affordable mortgage payments would benefit from this service.

RESTRUCTURING THE GSEs—MOVING INTO A NEW ERA

Few decisions are more important, more complex, and more controversial than determining the future of Fannie Mae and Freddie Mac. After being placed into conservatorship in the fall of 2008, the two GSEs have been operating under government protection—including an explicit 100-percent guarantee on their mortgage-backed securities. Since then, there have been hundreds of assessments of the structural problems in the GSEs' charters, as well as numerous proposals to reduce their market share and/or replace them with new entities with more explicit regulations and robust oversight. Yet as Michael Stegman, counselor to Treasury Secretary Geithner, recently observed, rather than offer clarity, the best proposals based on the best available research instead provide further evidence of the challenges and complexities of GSE reform.[54]

As noted earlier, GSE reform is intricately entwined with current rulemaking about a borrower's ability to repay and what constitutes a good mortgage product, as well as with risk retention rules and FHA reform. Also implicit in the discussion of GSE reform are questions about whether taxpayers are willing to pay for expanded access to good-quality mortgages and affordable housing options for low-income, low-wealth households. Given its complex and controversial nature, GSE reform legislation is unlikely to be completed until 2013 at the earliest. But now is still a good time to suggest some broad principles that should underpin reform and in doing so continue the dialogue concerning the rationale for government intervention into secondary markets.

Secondary Market Reform Should Focus on Efficiency, Access and Affordability

Federal intervention in secondary markets has had two main goals: (1) to help promote market efficiency and ensure a stable supply of financing for residential mortgages nationwide, and (2) to increase the affordability of these mortgages and extend homeownership opportunities to a wide range of households. Given that liquidity is a key component of these efforts, the government established the legal and regulatory framework to allow securitization of residential mortgages and development of Ginnie Mae, Fannie Mae, and Freddie Mac as an efficient marketplace for purchasing and selling mortgage backed securities.

There is undoubtedly less benefit from a federal presence in the secondary mortgage market today than when the three institutions were chartered.[55] Among other factors, standardization has increased in both the primary and secondary mortgage markets. Automated systems have also enabled investors to better assess the risk present in a wide range of mortgage types and

[54] M. Stegman, remarks to the American Urban Economics and Real Estate Association (AUEREA) annual research conference, June 1, 2012.

[55] Ginnie Mae was established in 1938 as a government corporation. Fannie Mae separated from Ginnie Mae and was converted to a private corporation in 1968. Freddie Mac was established in 1978.

security structures. Indeed, a number of financial institutions are willing and able to securitize mortgages.

This paper has argued that by relaxing their underwriting standards in search of greater market share, the GSEs contributed greatly to mortgage market instability but had little to do with the rampant growth in subprime lending that lies at the root of the crisis. This is not to say that eliminating and/or privatizing the GSEs would have no impact on housing markets. Because of their implicit government guarantee, the GSEs did enjoy a funding advantage over other highly rated financial securities. Even so, the impact is likely to be minimal. Studies from the late 1990s and early 2000s suggest that the GSEs' impact on lowering mortgage rates was in the 20–25 basis point range. More recent estimates suggest that the effect could have been as small as 16 basis points.[56] The rest of the initial funding advantage provided by the government subsidy did not go to borrowers but rather was paid out to shareholders of Fannie Mae and Freddie Mac or captured by their private sector partners in the secondary market.

Proposals for GSE Reform Abound

On February 11, 2011, HUD and Treasury released a white paper summarizing proposals for reforming America's housing finance system.[57] The report rejected proposals to completely privatize mortgage markets, noting that the initiatives often confused the role of the private sector in the primary market as opposed to secondary markets. First, with few exceptions, the private sector has always originated all mortgages, and, when guided by an effective set of consumer protections, has done so effectively. And except for its failure to extend mortgage credit to low-income, low-wealth borrowers and communities without explicit government guarantees, private sector originations have proven to be fairly innovative and cost-effective. There is little doubt, however, that without a government-backed secondary market, private capital would not be widely available in difficult-to-serve markets. It is also questionable whether, in a world with more limited government guarantees, the private sector would even serve the broader market for longer-term fixed-rate mortgage products.

Emphasizing the importance of ensuring mortgage access and affordability for lower-income, low-wealth households, the HUD/Treasury white paper presented three options for GSE reform that build on the foundation of a financially strong and mission-driven FHA. The first would limit government support to a narrowly targeted group of people covered by FHA and other federal agency guarantee programs.[58] This roughly accords with proposals to reform FHA insurance programs to focus on a targeted set of credit-impaired borrowers and, in doing so, encourage the return of private capital to the broad conforming market.

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[56] These estimates are based on a detailed literature review presented in Jaffee 2010. He notes, however, that the estimates lack precision given that the benchmark for comparison is controversial and individual studies have produced a range of results. See also, D. Jaffee and J. Quigley, 2012 and Passmore, 2005.

[57] HUD and Treasury, *Reforming America's Housing Finance Market: A Report to Congress*, 2011. For a review of this white paper, see P. Swagel, "Reform of the GSEs and Housing Finance," 2011.

[58] These would primarily be programs administered by the Department of Veterans Affairs and USDA.

The second option would include a guarantee mechanism covering a larger slice of the secondary market, offering a backstop to ensure access to credit during a housing crisis. This mechanism would have a minimal presence in the market during normal times, but would be ready to scale up when private capital withdraws in times of financial stress. One approach would be to price the secondary market guarantee fee at a sufficiently high level that it would only be competitive during crises and available only when needed. Alternatively, the guarantees could be rationed by restricting the amount sold to the private market in normal times, but allowed to ramp up during a crisis.

This approach, of course, presents the operational challenge of designing and pricing a steady flow of guarantees in normal times, yet can anticipate and take on much more business quickly in stressful times. Moreover, recognizing that the federal presence in mortgage markets is still near crisis-induced highs, moving to this option would likely reduce access and raise the cost of credit at least in the short run, particularly for prepayable, fixed-rate conforming mortgages.

Starting once again from the foundation of a targeted role for FHA and other federal agency guarantee programs, the third HUD/Treasury option would be a catastrophic reinsurance program to stand behind private mortgage capital. A number of well-capitalized and well-run financial institutions would be able to guarantee securities backed by mortgages that meet strict underwriting standards. A government entity (to be determined) would, for a fee, provide reinsurance for the holders of these securities in catastrophic situations, but only when losses would exceed the capital reserves and shareholder equity of the private guarantor. This option would likely attract a pool of investors to the mortgage market and arguably increase the availability of capital to support the prepayable 30-year fixed-rate conforming mortgage for a broad range of homebuyers and owners.

In combination, the capital requirements, oversight of private mortgage guarantors, and premiums collected to cover future losses would help to reduce risks to taxpayers. By its nature, however, reinsurance of private lending activity exposes the government to risk and moral hazard. In particular, if oversight of private mortgage guarantors was inadequate or reinsurance pricing was too low, taxpayers could once again be left to absorb much of the cost of another mortgage market crisis.

Determining the Best Way to Provide Targeted Subsidies

In addition to encouraging a stable supply of mortgage financing, federal housing policy focuses on making homes—owned and rented—more affordable for low- and moderate-income households. The government subsidizes the cost of housing for those groups through its support of the secondary mortgage market, through several types of rental assistance, and through various provisions of the tax code.[59]

[59] For an excellent discussion of these issues see I. Ellen and J. Tye, "Improving the U.S. Housing Market Through Reform of Fannie Mae and Freddie Mac," 2010.

When poorly done, federal intervention may weaken the incentives for all mortgage market participants to manage risk, thereby magnifying rather than reducing systemic risk. And as the last several years have demonstrated, a poorly designed system can transfer risk from investors to taxpayers in a less-than-transparent manner. The central question for GSE reform is how best to balance expanded access to mortgage lending for targeted households against the willingness of the government (and hence the taxpayer) to bear the costs and risks of efforts to promote homeownership more broadly.[60]

A key question raised by the recent crisis is whether the housing finance system is the fairest, most cost-effective, and most politically feasible way to deliver targeted assistance. Much of the literature on alternative subsidy approaches relates to rental housing, including the relative merits of supply- and demand-side measures. For example, government support of secondary markets can lower the financing costs for developers of affordable multifamily rental housing, which in turn lowers rents. Other studies point to the efficacy of demand subsidies such as housing vouchers, as opposed to supplying subsidized units in public housing complexes or in privately owned, publicly subsidized developments. Another strand of research stresses the idea that renters face many information barriers, and that housing counseling and relocation assistance programs could help households better understand their homebuying options and whether renting is in fact a better choice.

On the owner side of the market, federal support for the GSEs apparently did lower the cost of home mortgages, if modestly. Even so, there is reason to believe that direct and explicit subsidies are a more efficient method of providing downpayment assistance than embedding the subsidies in complex financing schemes. Of course, the availability of explicit subsidies could undermine the incentives for buyers to save for a downpayment. In addition, by reducing a homebuyer's skin in the game, downpayment assistance programs could encourage owners to spend less time, energy, and money on maintaining their homes.

At the same time, however, the tax code provides the biggest housing subsidy of all in that it supports homeownership through the deductibility of mortgage interest and property taxes, as well as through favorable treatment of capital gains on residential properties. But such benefits may be fairly small for low- and moderate-income families, who often claim the standard deduction on their tax returns and generally face lower marginal income tax rates. Tax incentives may also lead households to change their behavior in socially undesirable ways, such as purchasing very large homes that far exceed their need for shelter.
In this sense, reforming the GSEs or FHA could be considered part of a larger effort that combines tax reform and the best way to use public resources to meet the housing needs of low- and moderate-income households. But providing FHA the flexibility and resources to assist a tightly targeted group of homebuyers, as well as the political will to reform the GSEs, will be challenging enough. Linking these issues to a broader discussion of income redistribution would only delay progress on financial reform, which is now of utmost importance.

[60] For further discussion about balancing these tensions, see Mortgage Finance Working Group, *A Responsible Proposal for Housing Finance*, 2011.

BUILDING A FAIRER AND MORE ACCESSIBLE MORTGAGE FINANCE SYSTEM

At the most basic level, mortgage markets rest on the ability of individual borrowers to repay their loans. This is why GSE and FHA reforms must build upon the foundation created by other elements of financial sector reform. Going forward, it is important to adhere to a set of guiding principles when evaluating alternative approaches. Suggested principles include:

- Private capital should be the primary source of mortgage funding and bear the burden of losses.
- Mortgage markets should be free from the counterparty risks present in large systemically important financial institutions and the problems associated with "too big to fail."
- Government support should be limited, explicit, and transparent.
- Rules and regulations should apply uniformly to financial institutions and entities performing similar functions.
- Good-quality conforming mortgages should be widely available at reasonable rates.
- Government-subsidized home purchase options should be available to a targeted set of low-income and low-wealth borrowers.

Finally, it is important to focus on transition issues. It took years to create today's complex system—both the good components and the bad. It will also take years to build a replacement. Steps along the way should include:

- Carefully winding down Fannie Mae and Freddie Mac to avoid disruption to the extent possible
- Identifying a set of private sector entities that will be capable and willing successors
- Correcting the flaws that caused the old private-label market to collapse and implementing incentives to bring private capital to the new market
- Enhancing the capacity of federal entities to monitor newly created mortgage insurance or guarantee products

While there is no clear agreement on the proper role of government in housing finance, there is remarkable consensus that comprehensive reform of the system is urgent. This will take time, since the task is nothing short of rebuilding a new mortgage finance system from the ground up. If there is a silver lining to the mortgage market boom and bust, it is that the crisis will lead to a fairer, more stable, and more efficient system in the future.

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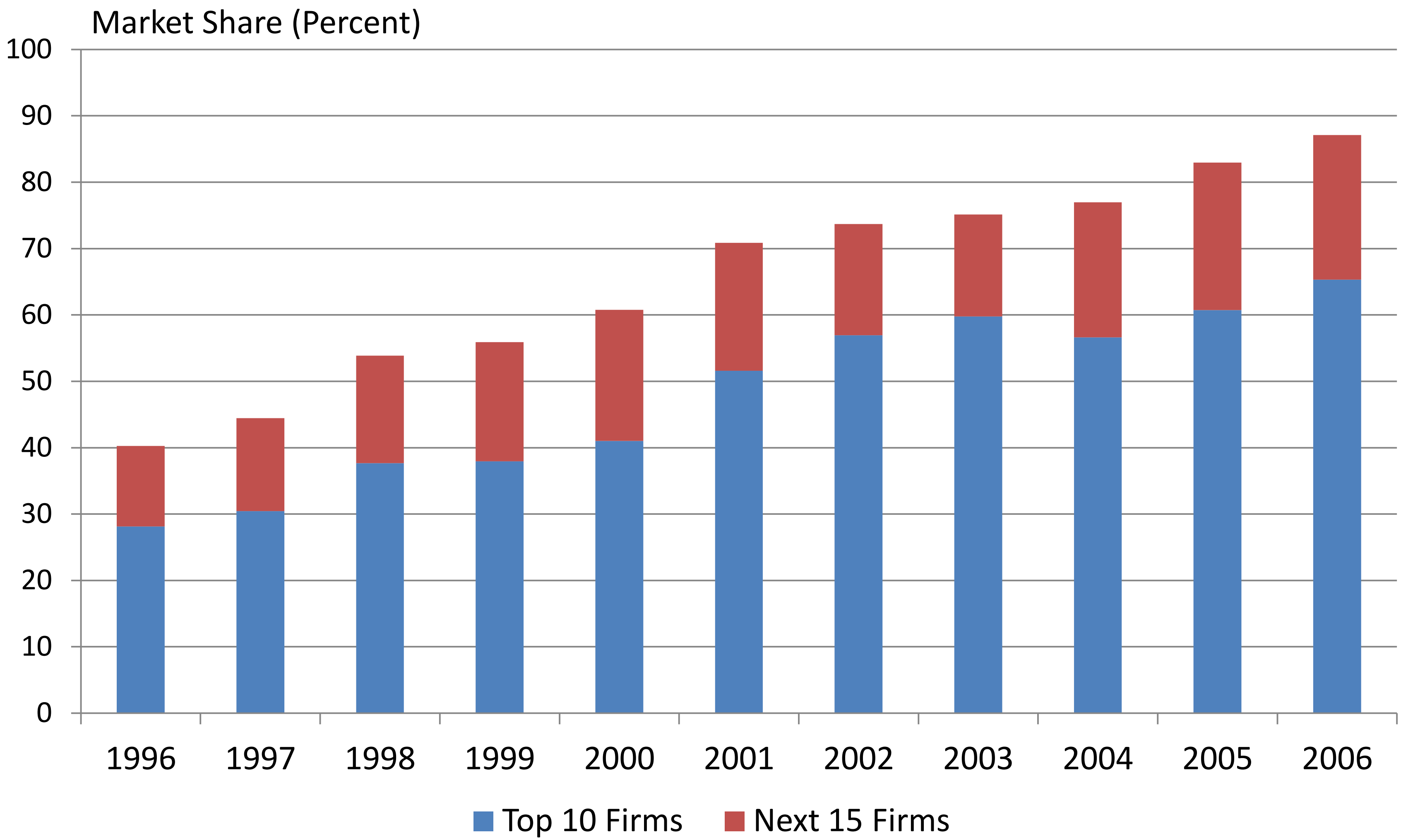
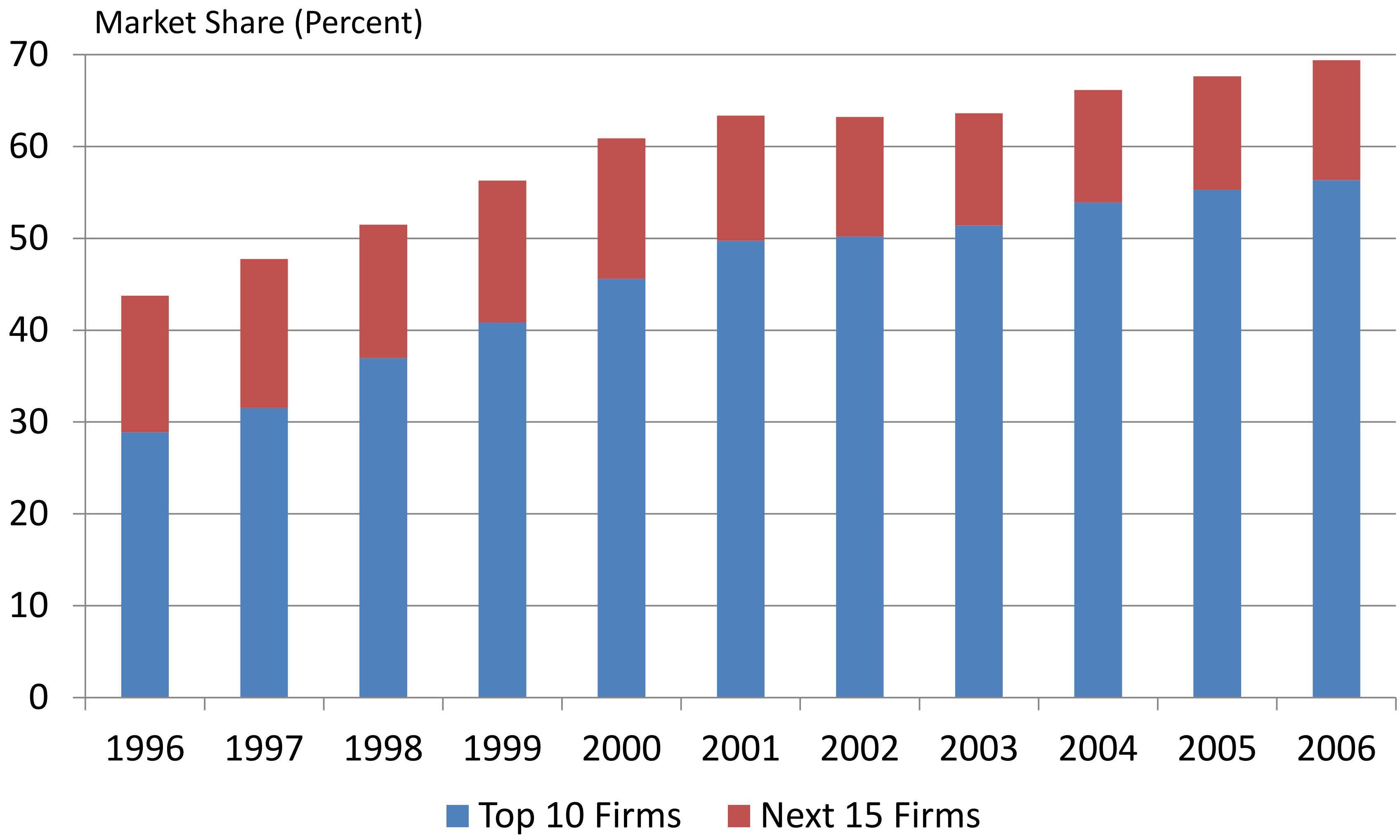
Figure 1: Market Share Among the Nation's Top Mortgage Originators More than Doubled Between 1996 and 2006



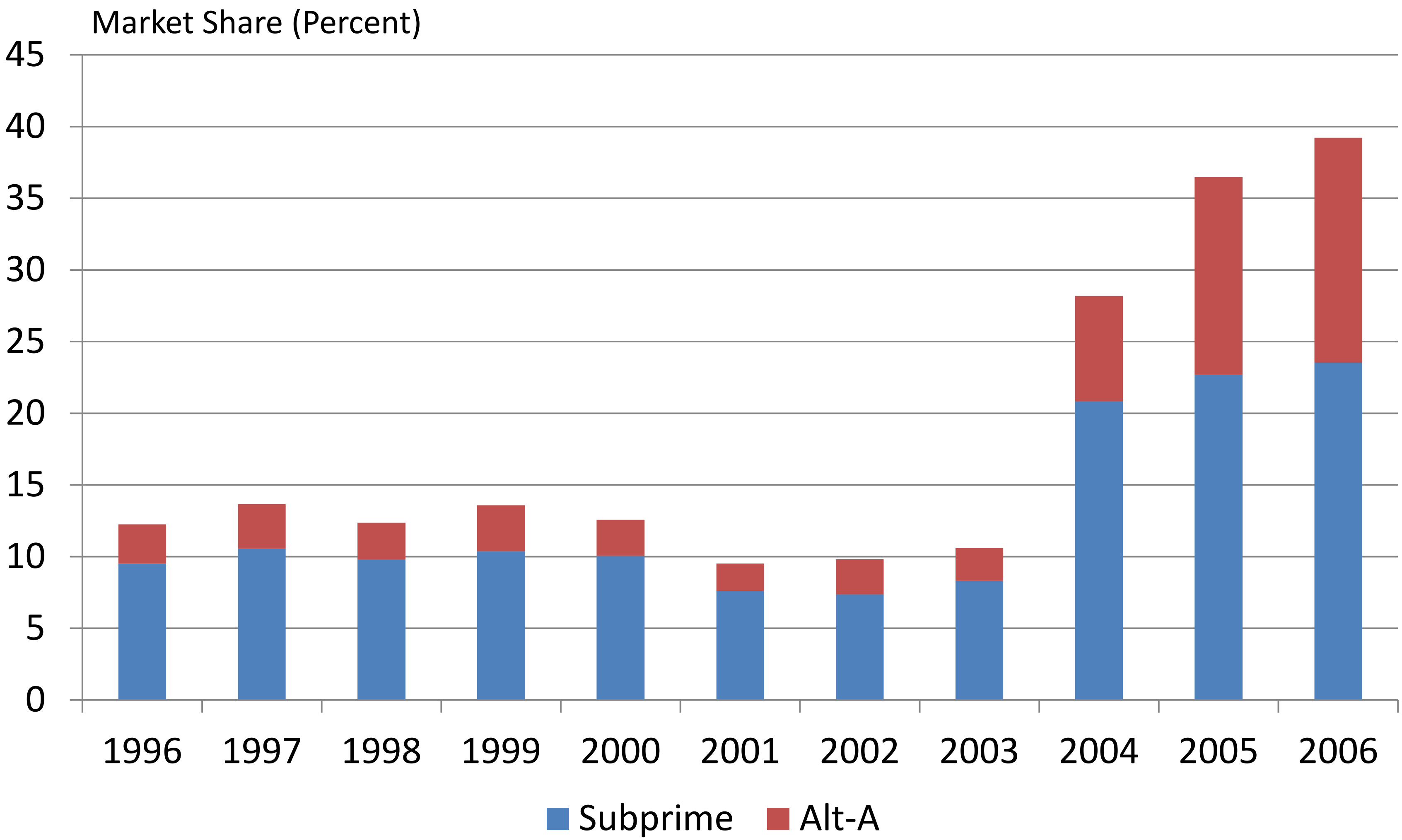
Note: Market share is measured by dollar volume of loans.
Source: Inside Mortgage Finance, *2011 Mortgage Market Statistical Annual.*

Figure 2: The Servicing Industry Also Consolidated Over this Period



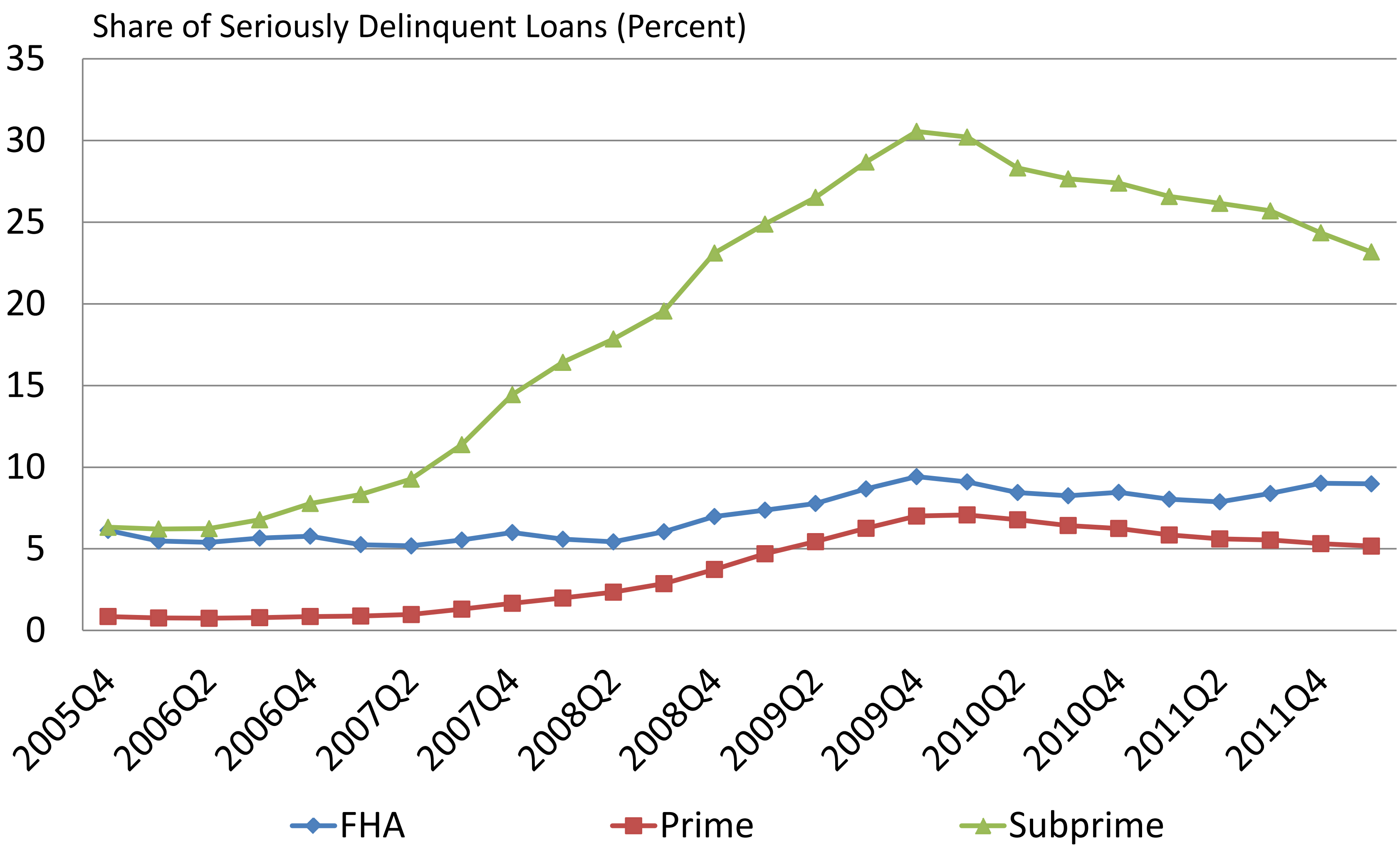
Note: Market share is measured by dollar volume of loans.
Source: Inside Mortgage Finance, *2011 Mortgage Market Statistical Annual.*

Figure 3: High Cost Lending Continued to Rise



Note: Market share is measured by dollar volume of loans.
Source: Inside Mortgage Finance, *Mortgage Market Statistical Annual*.

Figure 4: Subprime Delinquency Rates Climbed Sharply After 2006 and Remain High Today

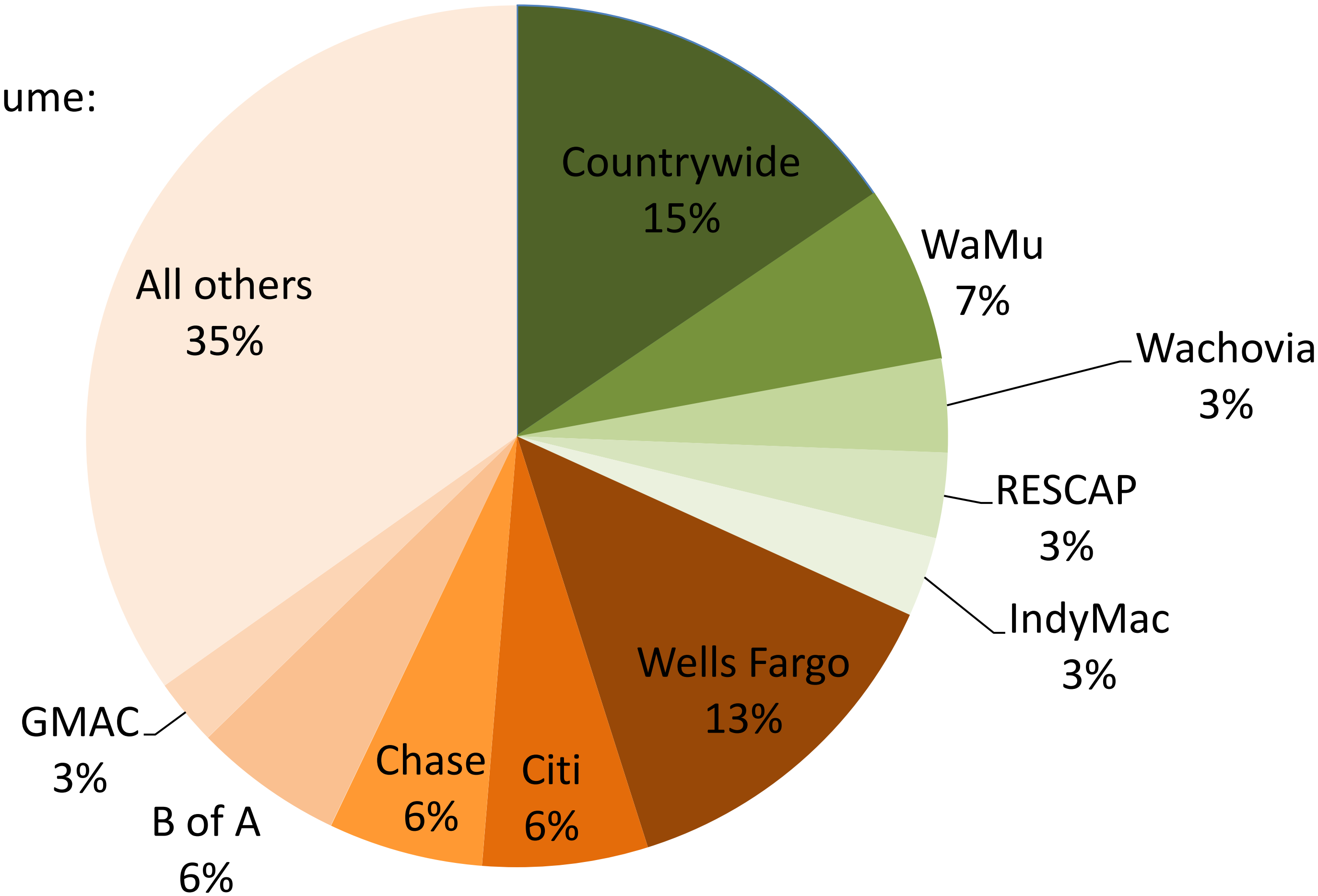


Notes: Seriously delinquent loans are 90+ days past due or in foreclosure. Loan shares are not seasonally adjusted.
Source: Mortgage Bankers Association, National Delinquency Surveys.

Figure 5: Five of the Ten Largest Loan Originators in 2006 Were Out of Business by 2010...

Aggregate Origination Volume: $3 Trillion

No Longer in Business in 2010:
- Countrywide
- WaMu
- Wachovia
- RESCAP
- IndyMac

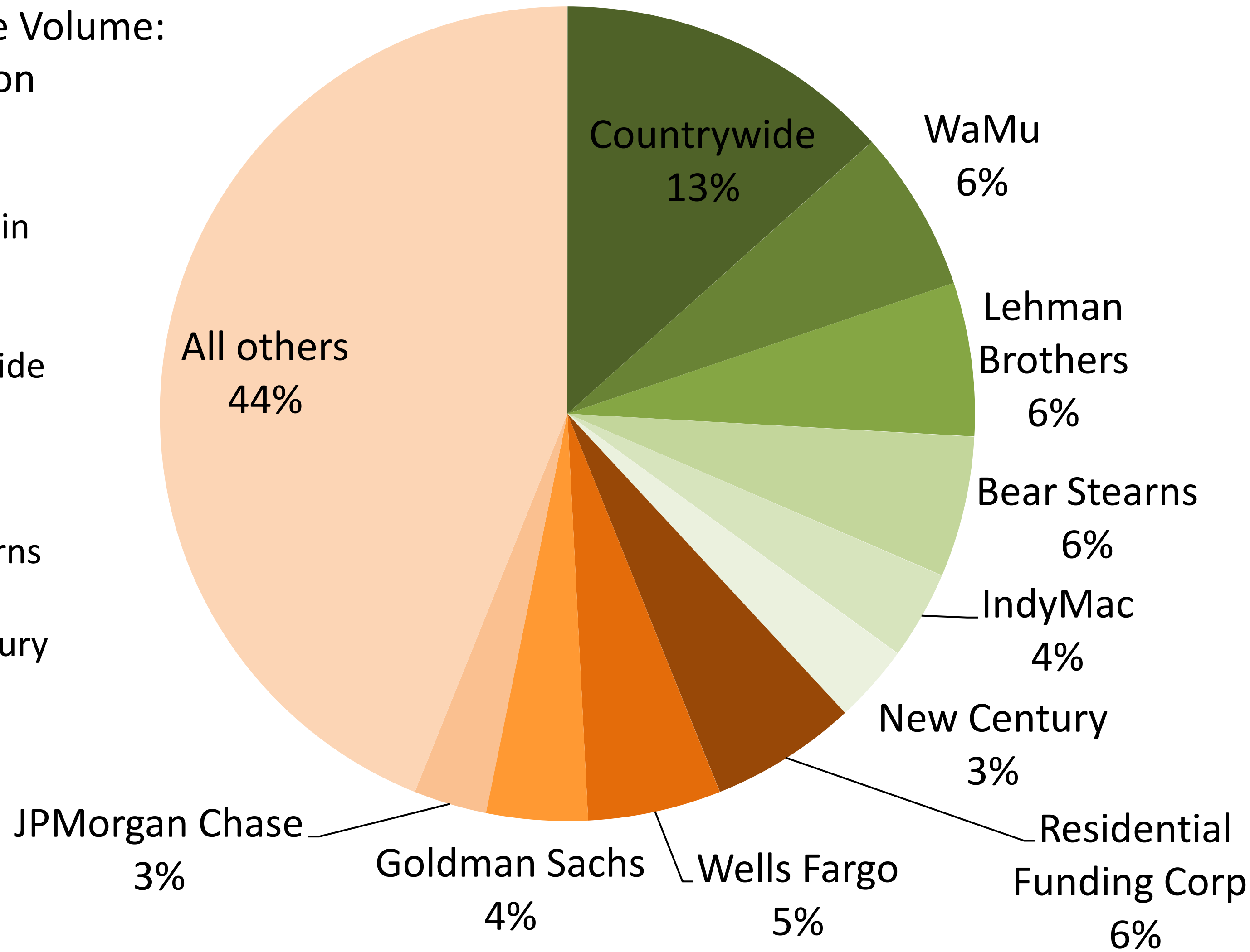


Note: Market share is measured by dollar volume of loans.
Source: Inside Mortgage Finance, *2011 Mortgage Market Statistical Annual.*

Figure 6: … Along with Six of the Ten Top Private MBS Issuers

Aggregate Volume:
$1.1 Trillion

No Longer in Business in 2010:
- Countrywide
- WaMu
- Lehman Brothers
- Bear Stearns
- IndyMac
- New Century



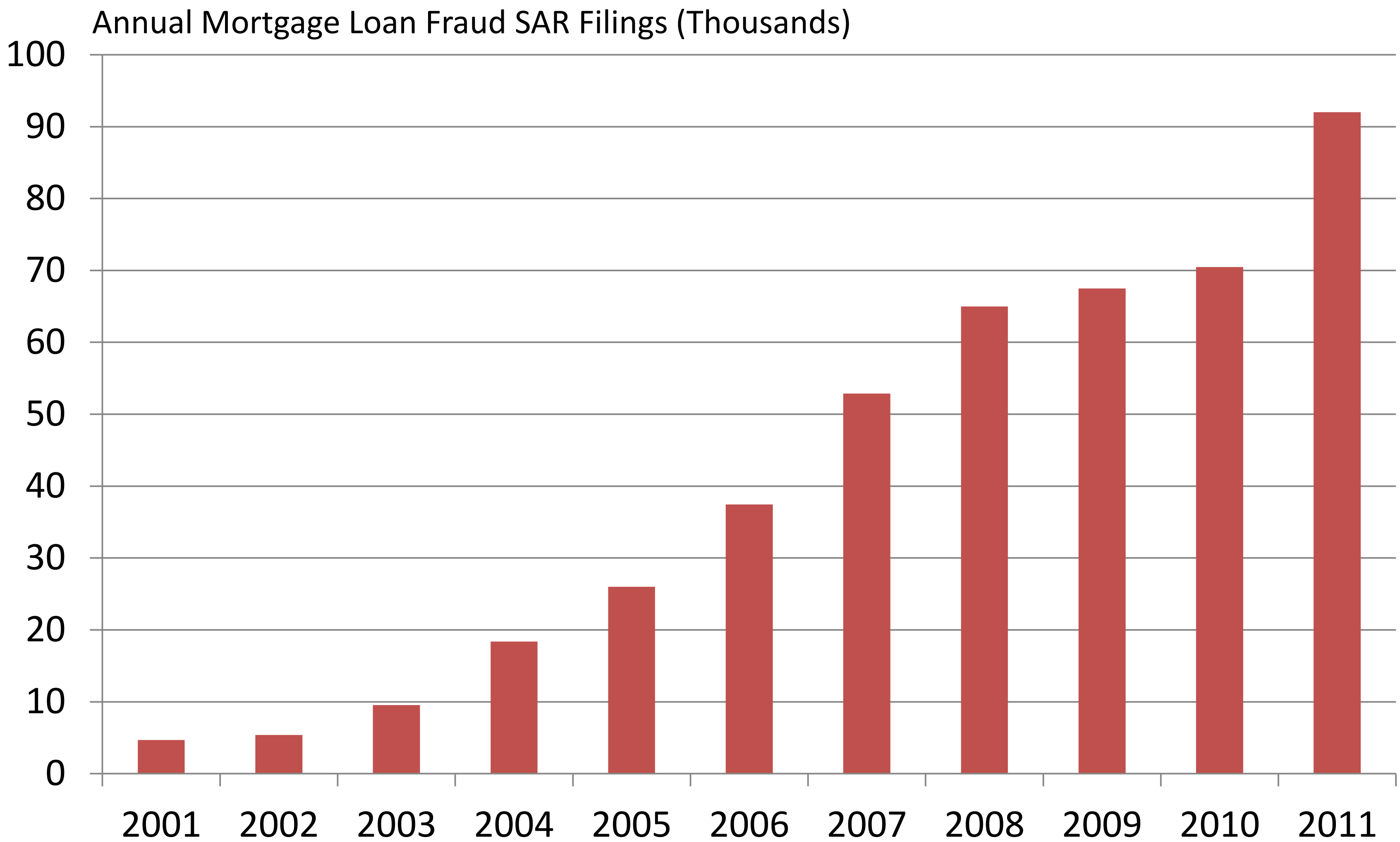
Notes: Non-agency MBS issuers. Market share is measured by dollar volume of loans.
Source: Inside Mortgage Finance, *2011 Mortgage Market Statistical Annual.*

Figure 7: Neighborhoods with Higher Shares of Risky Loans Faced Higher Foreclosures by the End of the Decade

		Owner Occupied		Non-Owner Occupied	
		Low Distress	Intense Distress	Low Distress	Intense Distress
Home Purchase in 2006 (thousands)		2,374	850	357	235
Share of 2006 Loans (Percent)					
	High Cost	16	42	21	40
	Independent Mortgage Companies	40	56	35	47
	Piggyback	19	34	13	16
	Government Backed	9	6	0.04	0.02
Refinance in 2006 (thousands)		2,042	1,115	198	166
Share of 2006 Loans (Percent)					
	High Cost	24	39	22	39
	Independent Mortgage Companies	42	55	34	47
	Piggyback	5	6	3	3
	Government Backed	2	2	0.13	0.05

Notes: High-cost loans have an APR at least 3 percentage points above a Treasury security of comparable maturity. Piggyback loans are junior-liens taken out in conjunction with the primary mortgage. Government-backed loans are insured by the FHA or guaranteed from the VA, the Farm Service Agency, or the Rural Housing Service.
Source: JCHS enhanced HMDA database.

Figure 8: Mortgage Loan Fraud Suspicious Activity Reports Have Dramatically Increased Since Before the Boom

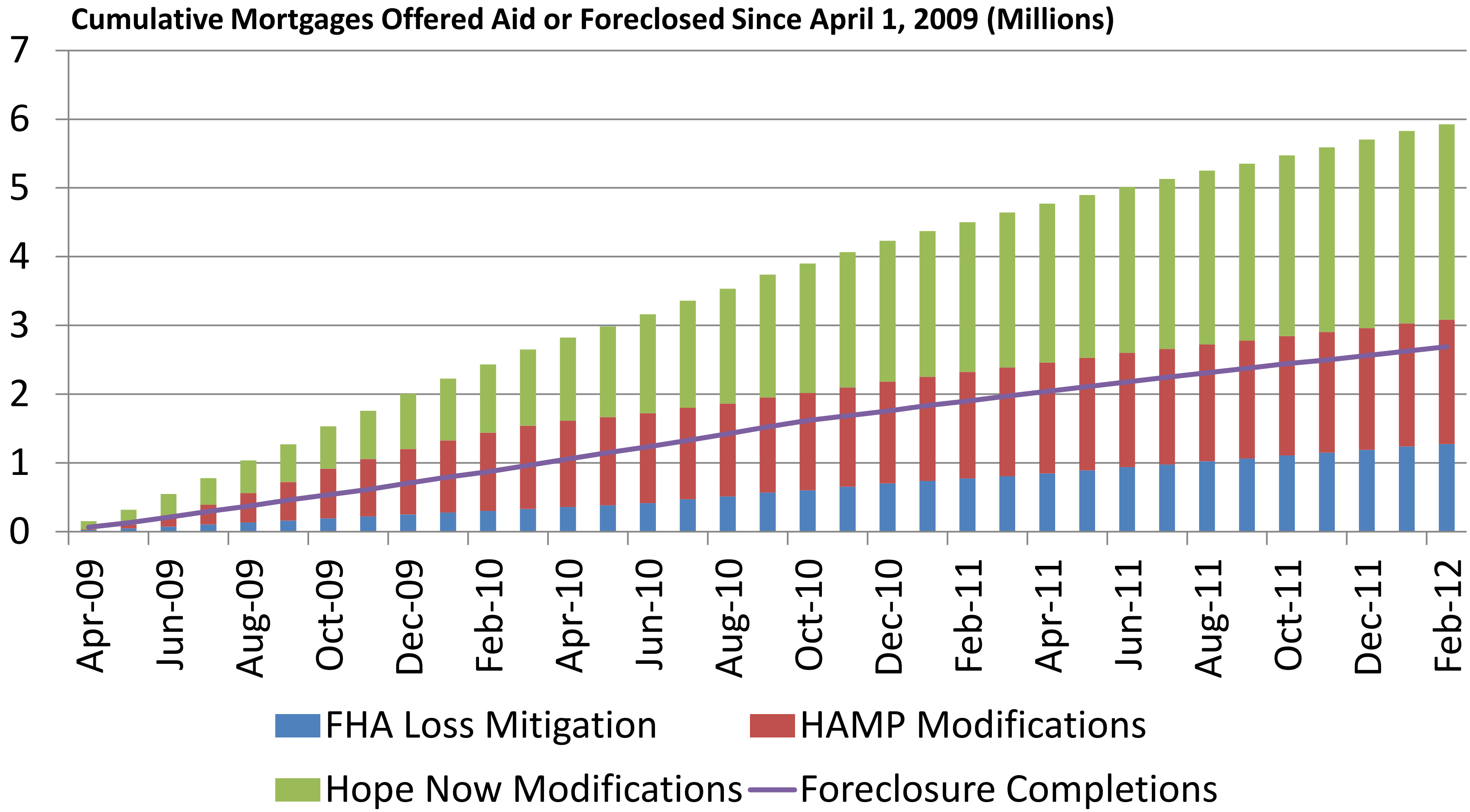


Note: SAR filing year does not correspond with the year in which the suspicious activity was committed.
Source: FinCEN, *Mortgage Loan Fraud Update: Suspicious Activity Report Filings from January 1 – December 31, 2011*.

Figure 9: The Government Launched Multiple Efforts to Stabilize the Housing Market

- Treasury/FRB support for the GSEs to keep the mortgage market functioning during the crisis
- Treasury/FRB purchase of $1.4 trillion agency MBS pushed mortgage rates to historic lows
- TARP purchased distressed mortgage assets to help stabilize the banking system
- Making Home Affordable program helped reduce mortgage payments and prevent avoidable foreclosures
- Neighborhood Stabilization Program allocated new resources to help areas hard hit by foreclosure
- The HFA Initiative, the Hardest Hit Fund and the Emergency Homeowners Loan Program supported locally designed foreclosure prevention initiatives
- New FHA home purchase and refinance products assisted homeowners not well served by the conventional market

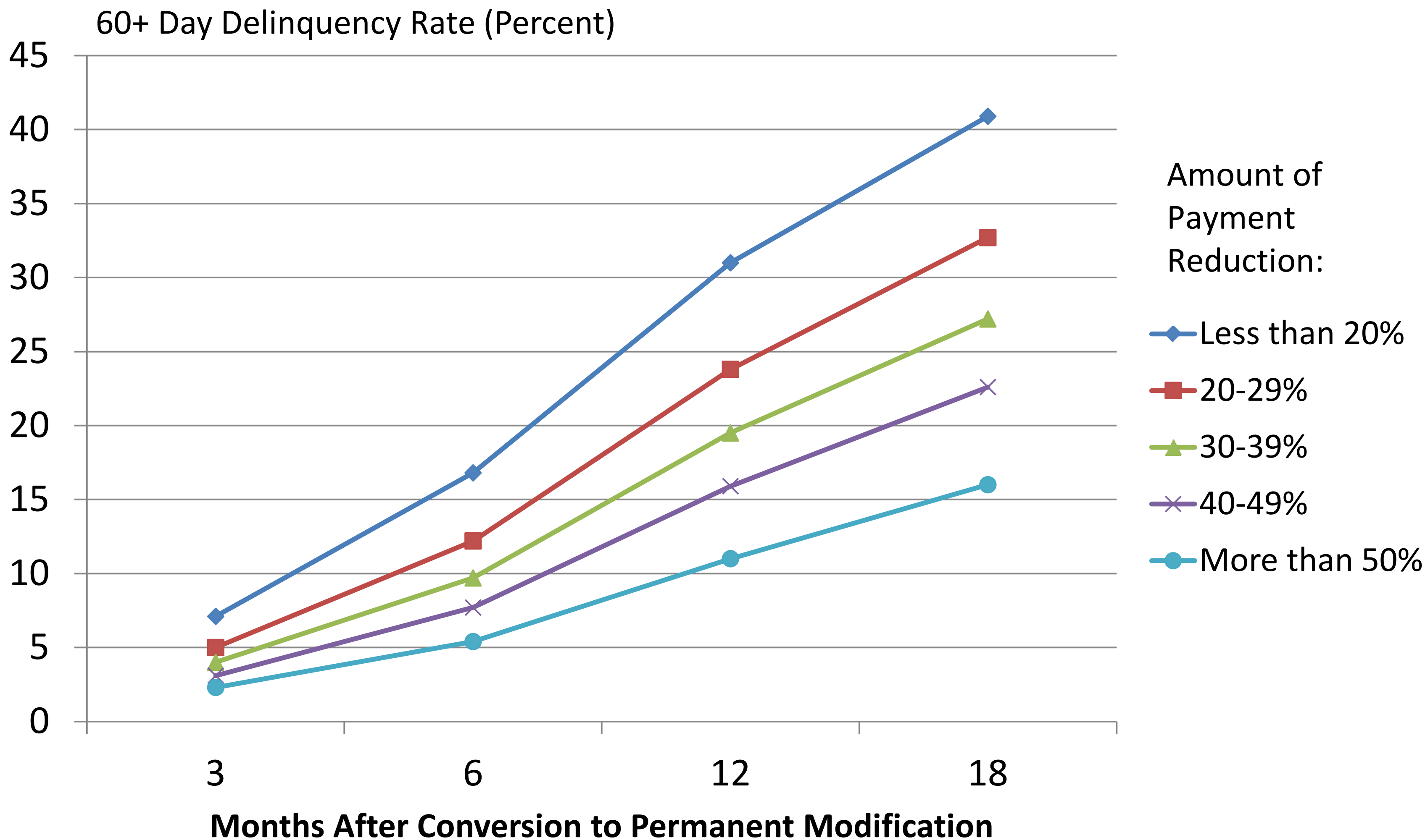
Figure 10: New Mortgage Initiatives Helped Millions Delay or Avoid Foreclosure



Notes: Cumulative HAMP modifications started, FHA loss mitigation and early delinquency interventions, plus proprietary modifications completed as reported by Hope Now Alliance. Some homeowners may be counted in more than one category. Foreclosure completions are properties entering Real Estate Owned (REO) as reported by Realty Trac.

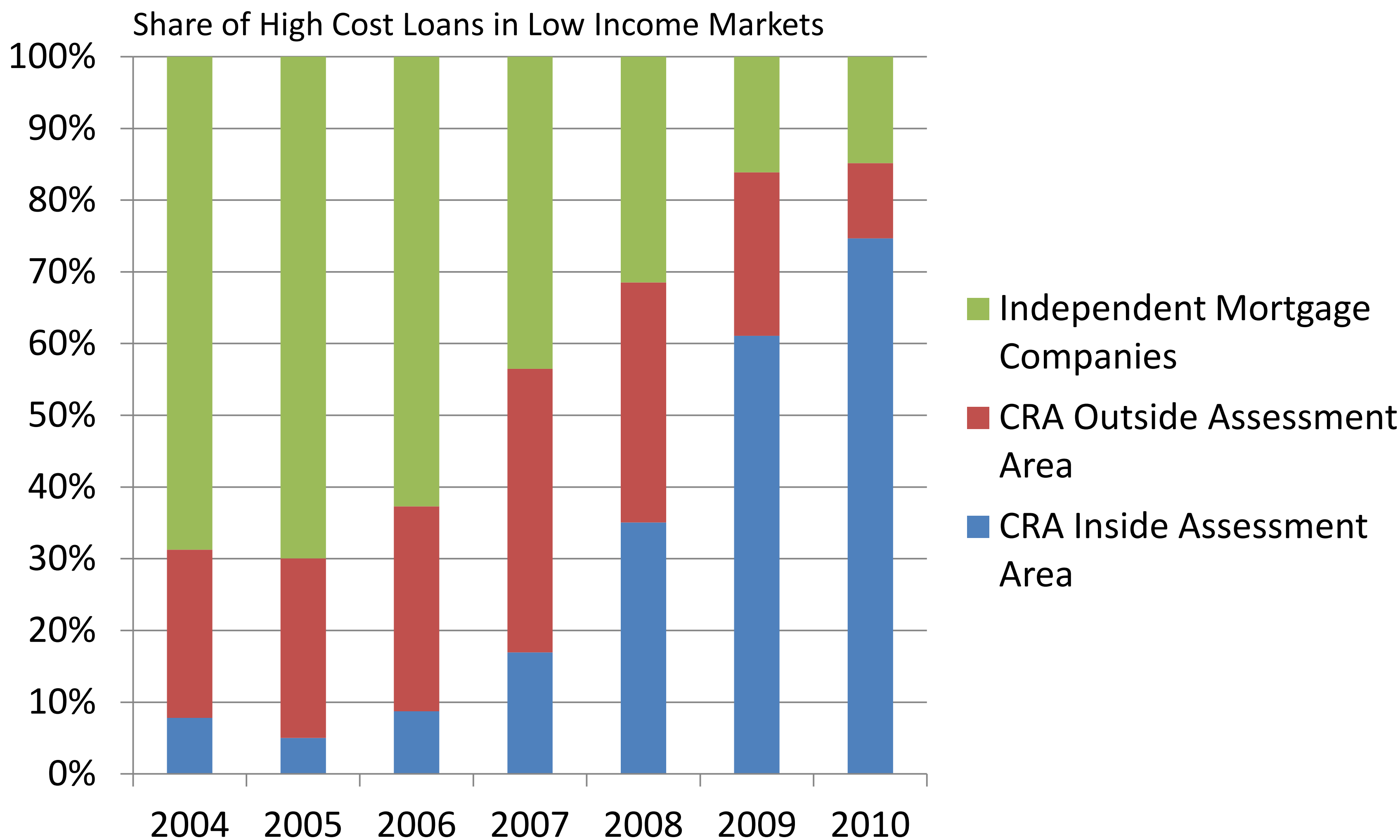
Sources: HUD, Dept of Treasury, Hope Now Alliance, and Realty Trac

Figure 11: Deeper HAMP Modifications Can Help Borrowers Stay Current on Their Mortgage Payments Longer



Note: For permanent loans aged at least 3 months as of November 30, 2011, as reported by servicers through December 16, 2011.
Source: US Department of the Treasury, *December 2011 Making Home Affordable*

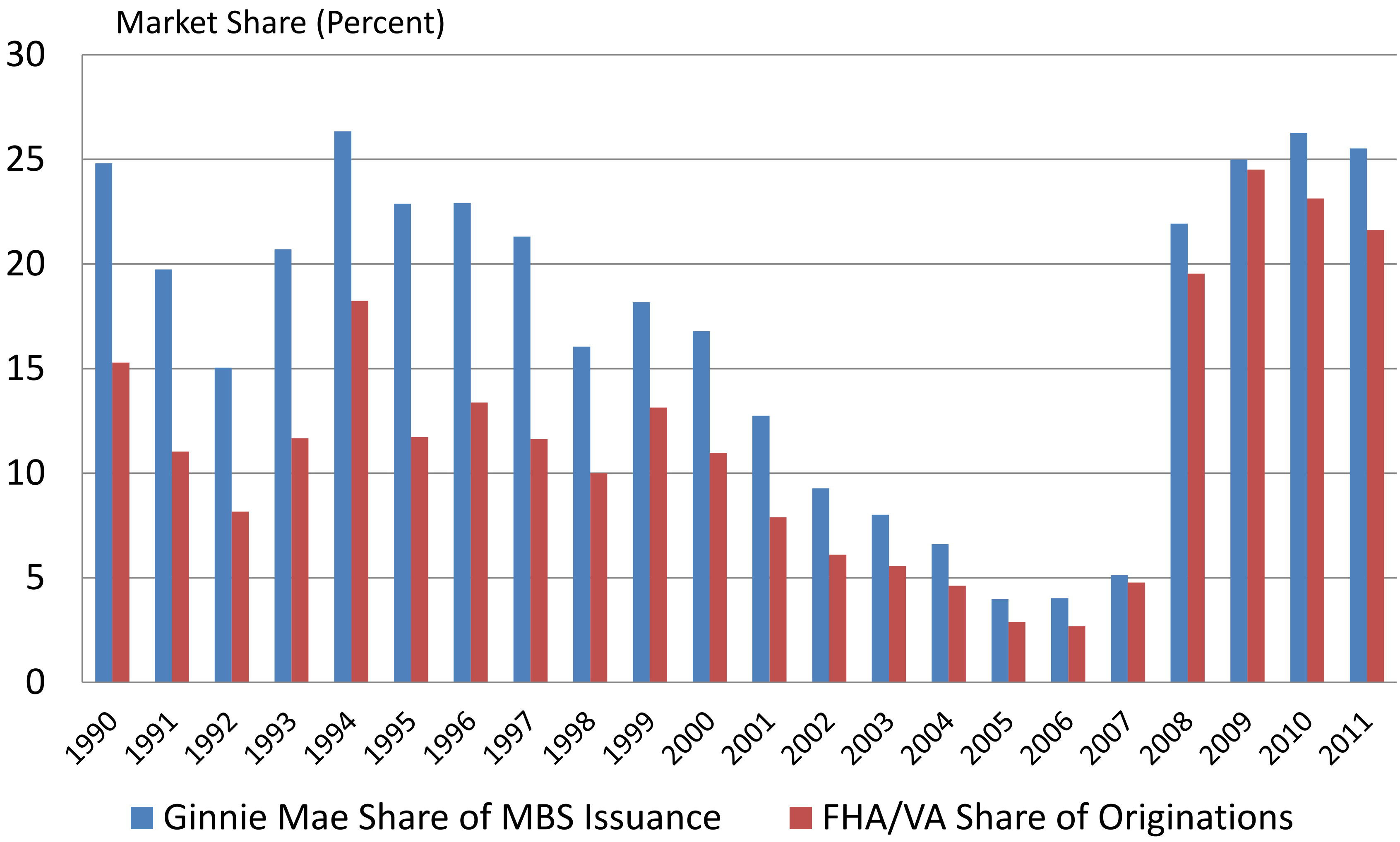
Figure 12: CRA Assessment Area Lending Accounted for Only a Small Share of Risky Lending



Notes: Lower-Income Borrower/Lower-Income Neighborhood defined as a personal or median neighborhood income less than 80% of the area median income. Higher-priced (subprime) loans are defined as having an APR at least 3 percentage points above a Treasury security of comparable maturity. The low-income loan market includes loans to low-income borrowers and to any borrowers living low-income neighborhoods. Chart includes conventional first-lien loans for owner-occupied site-built on-to-four family properties, purchase or refinance.

Source: JCHS enhanced HMDA database.

Figure 13: Government-Backed Lending Played Its Traditional Countercyclical Role



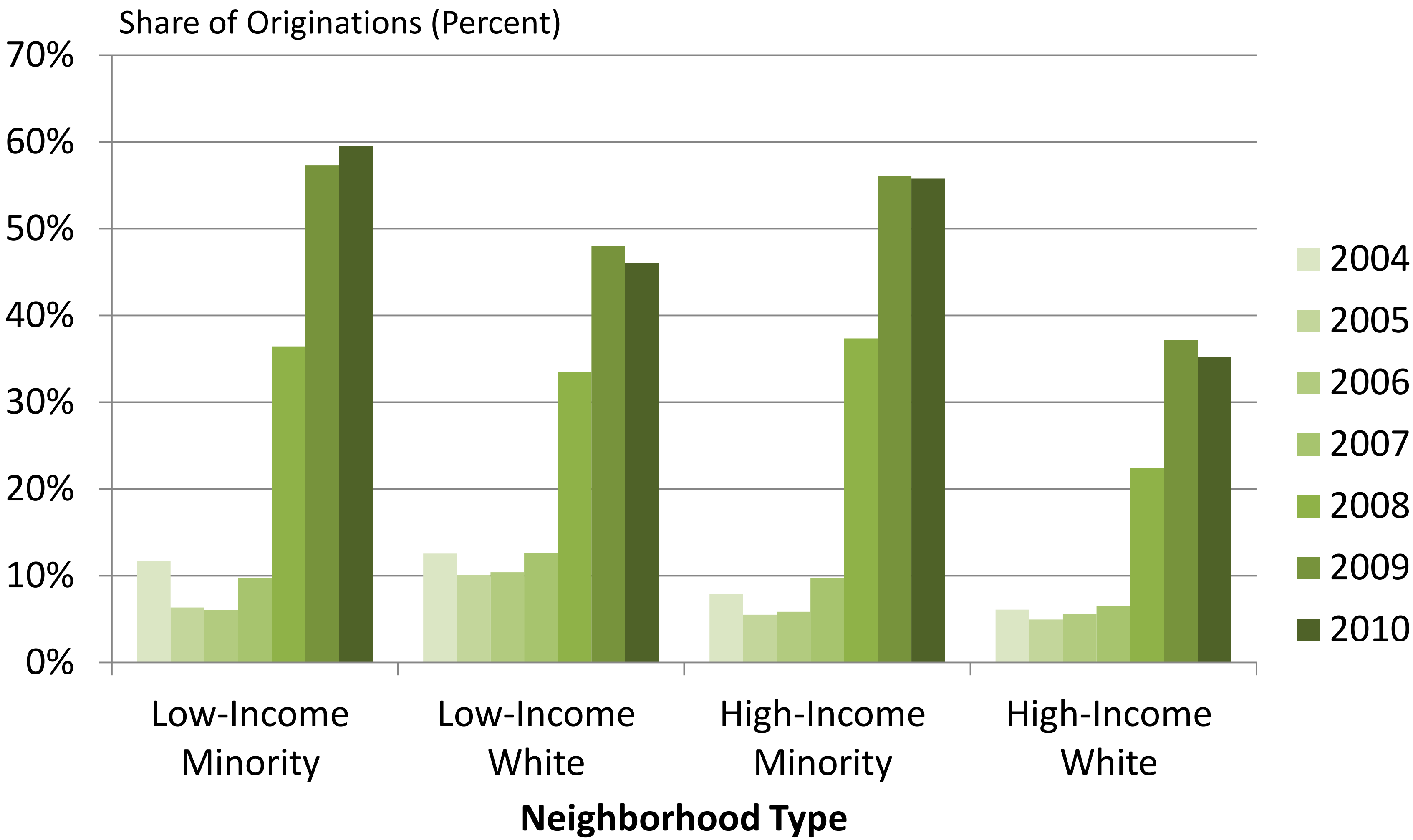
Source: Inside Mortgage Finance, *2012 Mortgage Market Statistical Annual.*

Figure 14: Most Home Purchase Loans to Minorities are Now Government-Backed

Share Gov't Backed	2004	2005	2006	2007	2008	2009	2010
All Minorities	13.7	8.2	8.0	13.0	45.9	63.5	64.2
African American	21.8	14.2	13.5	21.4	64.3	82.0	82.9
Hispanic	13.6	7.3	6.3	11.5	51.7	75.1	76.3
Asian/Other	4.2	2.7	3.2	4.2	17.6	30.7	30.7
White	10.9	8.5	9.0	10.8	35.0	52.0	50.1
Unknown	8.4	4.6	5.6	8.4	31.8	49.7	48.5
All Borrowers	11.4	8.0	8.4	11.1	37.2	54.4	53.3

Notes. Includes only loans for purchase of owner-occupied homes; manufactured housing is excluded. Government-backed loans are insured by the FHA or guaranteed from the VA, the Farm Service Agency, or the Rural Housing Service.
Source: JCHS enhanced HMDA database.

Figure 15: Government-Backed Lending Has Played a Vital Role in Restoring Mortgage Activity in a Wide Range of Neighborhoods



Notes: Low-/moderate-/high-income neighborhoods are census tracts with a median family income less than 80%/80-120%/more than 120% of area median. Government-backed loans are insured by the FHA or guaranteed from the VA, the Farm Service Agency, or the Rural Housing Service.
Source: JCHS enhanced HMDA database