THE AMERICAN DREAM DEFERRED

THE HOUSING CRISIS AND HOW TO Fix IT
Restoring the Dream

The collapse of the housing bubble need not destroy homeownership as the anchor of the middle class.
But we need much bolder government action.

BY BARRY ZIGAS

After more than 70 years of steady and remarkable success, America’s housing and homeownership policies have been rocked by the rise of subprime lending, the financial sector’s subsequent collapse, and the millions of resulting mortgage delinquencies, defaults, and foreclosures. Housing continues to be a drag on the recovery. The confidence Americans once had in homeownership as a path to family wealth has been shaken. And a backward conservative narrative has capitalized on regulatory and market failures to launch an all-out assault on any government role in housing. Progressives and advocates for families and communities are struggling to make sense of the wreckage and are asking themselves what future housing policies should look like.

But the very scale of the crisis provides an urgent opportunity to rethink and reset housing policy—to learn the right lessons from the mess and to focus on the needs of both homeowners and renters. A stable and durable policy platform could emphasize these goals:

- safe and sustainable opportunities for homeownership;
- restoration of housing as a source of family asset accumulation, especially for less affluent Americans;
- policy shifts to focus tax subsidies where they are most needed;
- a mortgage finance system that supports a deep and liquid market without inviting or tolerating reckless practices;
- renewed attention to the needs of renters, especially low-income and working renters

Housing in the U.S. has been supported by deliberate federal policies going all the way back to Thomas Jefferson’s egalitarian land-tenure policies and the Homestead Act of the Lincoln era. The modern system, dating to the 1930s, is deep and pervasive. The Federal Home Loan Bank System was created in 1932 to give savings and loan associations and other thrift institutions a reliable source of credit to make home loans. The Federal Housing Administration created the first long-term fixed-rate mortgages in 1934 by putting the government’s full faith and credit guarantee behind working families’ home loans. Fannie Mae was enacted in 1938 to create a “secondary mortgage market”—a liquid source of refunding for lenders making long-term mortgage loans. At first, Fannie was a government agency. After it was privatized in 1968, an implicit government guarantee of its commitments was generally understood. Then in 2008, with its takeover by a government conservator, Fannie again became an explicit government responsibility. Freddie Mac, a second quasi-public entity, followed a similar path. Federal deposit insurance further encouraged capital to flow into the housing sector.

But this framework and the policies that underlay it have been severely challenged by the current crisis. One in four mortgaged homeowners nationally is carrying more mortgage debt than their home is worth; 2.8 million owners have received foreclosure notices, with millions more likely to be foreclosed on as well; 3 million more are dealing with some kind of modification to their mortgage to stave off a default; and entire neighborhoods have been ravaged by the flood of foreclosed and abandoned homes.

Some argue that federal policies bred the crisis by encouraging too much home-
ownership and encouraging credit to too many families who could not handle it; critics contend that homeownership is suitable only for those wealthy enough to come to the closing table with a large down payment. The very premise that buying a home is a safe investment and a path to building wealth is being questioned. House Republicans recently proposed eliminating funding for the Obama administration’s loan-modification program, complaining that it helped too few households.

Mistakes were surely made in encouraging “the American dream.” Predators took advantage of lax regulation. Speculators were allowed to run rampant. And some families’ homeownership reach far exceeded their financial grasp. But it’s important not to draw the wrong lessons. To do so risks slowing the housing-market recovery, delays the revitalization of neighborhoods devastated by predatory lending and subsequent foreclosures, and closes the door to security and wealth building for millions of American families.

**BUILDING WEALTH**

Homeownership historically has been a powerful wealth-building opportunity for American families. The Federal Reserve’s Survey of Consumer Finances documented that in 2007, 69 percent of all U.S. households surveyed owned their primary residence. Even in the lowest quintile, this figure was 41 percent, or more than three times the share holding retirement accounts. In the second quintile, 55 percent owned their home, more than 50 percent greater than the share holding retirement accounts.

The value of primary residences also far exceeded that of retirement accounts, with a median primary-residence value of $200,000 overall, and $100,000 for the lowest quintile, $120,000 for the second lowest, and $150,000 for the third lowest. These figures do not take into account the debt that households have on the properties; their equity in the homes is obviously smaller than the total value. And while these values undoubtedly have declined since 2007, the difference in both participation rates and overall asset size documented in these figures is striking.

Homeownership will continue to be the single most valuable asset for families as they age as well as their most significant source of potential retirement savings. A sample of moderate income borrowers studied by the Center for Community Capital experienced steady appreciation and earned a remarkable annualized 29 percent return on their original equity. This wealth-building effect is a critical reason housing policy should continue to help new homeowners—where else in America today can a working family put down a small amount of money and leverage it for a significant return with a historically high likelihood of success?

Over the last 30 years, house prices nationally actually rose at a modest pace before the bubble and crash—about 3 percent nominally and 1 percent after accounting for inflation, leading some to suggest that renters would be better served by investing in super-safe Treasury bonds. But a $1,000 Treasury note costs $1,000. Any gains are based on the full investment. A 3.5 percent downpayment home purchase allows you to buy the equivalent of a $1,000 Treasury note for $35 but get the interest and appreciation on the entire $1,000. Plus, the buyer gets a consumption benefit on this investment that otherwise would have to be paid in rent—as well as tax advantages. It’s no wonder that the single biggest factor in wealth disparities for moderate income families in America today is whether a family owns a home.

No doubt, we are better off today without the culture of “flip this house” and expectations of unending double-digit growth of house prices. But even with minimal appreciation, the combination of housing consumption and forced savings through the repayment of a stable long-term fixed-rate loan remains the single most important way for American families to build wealth. Thus support for sensible and sustainable home lending should remain an important objective for housing policy.

**GOOD PRODUCTS WORK**

The immediate pre-crisis housing market was marked by unsavory practices that accelerated the housing boom and exposed consumers to unsafe and unstable mortgages. These subprime and so-called Alt-A mortgages were promoted to borrowers as “affordability” products as the housing-market bubble inflated and costs outstripped everyday families’ ability to purchase. They were touted to investors as can’t-lose, high-yield assets. By layering in such features as low “teaser” rates for adjustable mortgages whose rates later skyrocketed; low or no documentation of income, assets, or employment; interest-only loans that did not amortize the principal owed; prepayment provisions that kept consumers from refinancing out of mortgages they couldn’t handle; and balloon payments, lenders fooled many borrowers into taking out unaffordable loans. Investors, meanwhile, were willing to pay a premium for loans converted to supposedly safe securities, because of their projected higher yields.

But there is a much longer history of responsible lending that predates the headlong deterioration of underwriting standards to feed Wall Street securitization machines. That history belies the notion that only consumers who are rich and have sterling credit can be trusted with home loans.

Starting in the 1990s, with encouragement from the Community Reinvestment Act (CRA) and demand from neighborhood and urban leaders, banks began tentatively offering home loans to borrowers in neighborhoods the banks had shunned for years. These borrowers had nontraditional ways of documenting their creditworthiness and could make only lower down payments. In 1994, Fannie Mae began offering to finance loans with 3 percent down payments. Throughout the next 10 years, these practices pro-
duced strong positive results, as long as they were not mixed with shabby underwriting practices and dubious mortgage products such as subprime loans.

One example is Self Help Venture Fund in North Carolina, which joined with the Ford Foundation and Fannie Mae in 1998 to foster responsible lending to low-wealth borrowers. (See “A Needless Housing Collapse” by Alyssa Katz, page A7.) Community land trusts and city programs that work closely with borrowers play an active role in overseeing the kinds of mortgage products borrowers receive, and also help shield borrowers from predatory advances. These programs have shown high levels of success in promoting sustainable ownership. In 2010, the Center for American Progress reported that “a 2009 examination of the foreclosure experiences of five city-based affordable homeownership programs in Boston, Chicago, Los Angeles, New York, and San Francisco found that out of nearly 9,000 low-income families who turned to these programs to purchase their homes, the overall default rate was below 1 percent.”

These approaches have a common focus on addressing the full slate of obstacles that can frustrate and defeat low-wealth borrowers. The loans are fully underwritten and documented. Borrowers don’t have to have perfect credit records, but they have to demonstrate the ability and willingness to repay debts. The real and persistent lack of savings caused by stagnant wages and the lack of intergenerational wealth must be addressed through low down payments or public financing that contributes equity on a shared or temporary basis. And families that have never experienced both the joys and the hardships of homeownership—broken appliances, heating or air-conditioning failures—need support through education and ongoing help.

Even when not part of specialized programs, low down-payment lending has a successful history. Economist Mark Zandi wrote in a recent paper that “while there is no question that larger down payments correlate with better loan performance, low down payment mortgages that are well underwritten have historically expe-

rienced manageable default rates, even under significant economic or market stress.” He cited data from the Mortgage Guaranty Insurance Corporation showing that foreclosure rates for mortgages made to borrowers with good credit and 45 percent debt-to-income ratios, with only 3 percent down payments in 2006–2007, at the height of the boom, were only 4.7 percent. Subprime serious delinquency and foreclosure rates from the same period are well above 20 percent.

Of course, not all homeowners are successful. Historically, the overwhelming causes of failure are simple: death or serious illness of a wage earner, divorce, or the loss of a job. In the last 10 years, homeowners’ odds of success were shortened brutally by aggressive sales of high-risk mortgages both to buy and refinance homes that put millions underwater or drowned them altogether. The odds of homeownership success can be increased if national policy fosters responsible lending and safe products. The Dodd-Frank legislation adopted last year goes a long way toward establishing new national standards for mortgage lending. The bill tilts the table heavily toward straightforward long-term loans without exotic and unstable features. It severely restricts the ability to pay loan originators premiums for selling consumers more expensive products that provide little or no benefit to them. And it requires lenders to underwrite a loan on the basis of a borrower’s ability to repay it.

The new Consumer Financial Protection Bureau will have broad authority over these and other provisions of the law designed to make mortgage lending safer for consumers. It’s a welcome change from the unregulated chaos that led to the mortgage crisis, and it should go a long way toward restoring what has historically been a very stable and valuable set of policies for consumers.

MATCHING SUPPLY WITH DEMAND

The sudden and unprecedented plunge in housing values in 2008 has cost American families trillions in market value and equity. For those who bought at the height of the market, these losses can be devastating. But while about a quarter of all mortgaged owners are estimated to be “underwater” on their mortgages today, the bubble’s impact varies dramatically by state and by metropolitan area. CoreLogic’s February 2011 report on real-estate prices and values documents that in November 2010, the share of negative equity in 11 states was less than 10 percent; another 16 had negative equity shares between 10 percent and 15 percent. Only eight states have negative equity shares above 10 percent; another 16 had negative equity shares between 10 percent and 15 percent. Only eight states have negative equity shares above the national average, and a few of these have levels that are startlingly high—Nevada at 66.9 percent; Arizona at 49 percent; Florida at 45.7 percent. Within these states, certain metro areas are hit even harder—Las Vegas with 71.6 percent, Phoenix with 54.7 percent, and Orlando–Kissimmee at 53.3 percent.

Further, in some of these hardest-hit markets, speculators and investors, not aspiring homeowners, were big drivers of the bubble’s inflation. The blocks of empty condominiums in Miami are the result of speculation and investor-driven overbuilding, not of affordable lending to aspiring working-class homeowners, for instance.

The questions for policy-makers...
are complicated. The severe contrast between what borrowers owe and what their houses will fetch is a serious drag on the economy. Owners in high negative-equity states cannot refinance their mortgages to get lower rates. They can’t sell without taking significant losses that they cannot cover with savings.

The Obama administration’s policies to deal with this problem have been weak and ineffectual. The Home Affordable Modification Program (HAMP) overpromised results for 3 million to 4 million homeowners and has been branded a failure for directly helping only about 600,000 owners. Participation by servicers was and remains voluntary. Servicers began slowly and subjected applicants to such hurdles as lost documentation, missing files, inconsistent points of contact, and robo-signing of documents to speed foreclosures. More-robust approaches are needed to attack high loan delinquencies and defaults:

- **Government** should step in and buy troubled mortgages from investors and resolve them through a single, streamlined program. Many distressed owners probably could succeed if they were refinanced into a lower balance with a decent mortgage. This was proposed to the Obama administration in 2009 but was rejected. It’s time to try again.

- **Borrowers** should have ultimate recourse through bankruptcy to have their home loans modified. The Obama administration supported legislation to do this in 2009, but tepidly and without conviction. The other big banks stonewalled a solution even when Citigroup was ready to agree. It’s still the right idea.

- **State and local governments** where delinquencies and foreclosures are heavily clustered should consider using eminent domain to acquire the properties and restructure them. Eminent domain once displaced the urban poor—now it can be used to help them. The banks’ poor decisions and lousy loans are causing whole neighborhoods to become blighted. The properties can be resold to provide affordable home purchases or as rentals for families that desperately need them. Local governments and others can follow Boston Community Capital’s example and buy foreclosed homes at distressed prices before owners move out and resell them to the owners so they can remain in place with a greatly reduced mortgage. Loans that are modified with principal reductions rather than lower interest rates alone have better success records, particularly where homes are significantly underwater. This tool needs to be used more widely and aggressively.

These moves would help slow the steady flow of foreclosed homes onto the market, where they are depressing prices and keeping the market off balance. But without effective demand, the market will not find a bottom, either. Lenders already have tightened up their minimum requirements for borrower credit profiles, and Fannie and Freddie have increased their fees. All of these make it harder for consumers to buy—at exactly the time when prices in many markets and interest rates are at generational lows. Unfortunately, the administration’s February white-paper recommendations

### In many hard-hit markets, it was speculators, not aspiring homeowners, who inflated the housing bubble.

...to raise fees and down payments for Fannie and Freddie as well as fees for the Federal Housing Administration would create even more hurdles.

Lately, much of the financial industry and many in both parties have been promoting higher down payments as a one-size-fits-all brand of reform. It doesn’t require advanced math to conclude that high down payments will shut out millions of aspiring borrowers who would be good credit risks.

A presentation by Harvard University’s Joint Center for Housing Studies to a recent FDIC session noted that median cash savings for white, non-Hispanic renters in a 2007 Federal Reserve study was about $1,000; for minority renters the median was less than $500. Even the 75th percentile of white renters had cash savings of only a little more than $5,000; that group of minority renters had just over $2,000. Total wealth for median white renters was about $7,500; for minority renters it is just over $2,000. Even the 75th percentile of white renters had only about $33,000 in total wealth; minorities in this group had net wealth of about $11,000. Assuming a relatively modest home price of $150,000, far below current levels in many markets even in this depressed economy, the ability to come up with $15,000 for a 10 percent down payment, or $30,000 for 20 percent, is obviously far beyond the reach of most renters.

Home prices will remain depressed and the housing economy sluggish unless two things occur: effective demand by buyers increases, and the supply of surplus homes declines. Neither one of these is going to happen unless pro-consumer policies that support credit to responsible borrowers are steadied and readied.

### TAX AND SPEND

The congressional Joint Tax Committee estimates that deductions for mortgage interest on owner-occupied homes will cost the Treasury $101 billion in the current fiscal year. But roughly 95 percent of the value of the deductions flow to the top two income quintiles. Shifting the home mortgage deduction to a more progressive credit focused on first-time homebuyers or restricted by income would yield a much better result. The idea of substituting a credit, once far-fetched, is gaining ground. The Bipartisan Policy Center’s Deficit Reduction Task Force proposed substituting a 15 percent credit for the current mortgage interest deduction as part of a comprehensive tax overhaul, for instance.

This is also an opportunity to consider a refundable renter’s tax credit. Harvard’s Joint Center for Housing Studies reported in 2010 that one-quarter of all renter households paid more than 50 percent of their income for rent. Another 21 percent of all renter families paid between 30 percent and 50 percent of their income for rent. About 75 percent
of the most heavily cost-burdened renters were in the bottom income quintile, and about half of all bottom-quintile households had these high burdens, the report noted. During the last 50 years, the share of renter households paying more than half their income for rent has doubled. The National Low Income Housing Coalition reports that “over two years (2007–2009), the number of extremely low income (ELI) renters grew from 9.3 million to 10 million households while affordable units decreased from 7.1 million to 6.5 million.”

Tax policy alone will not enable these renters to escape such heavy burdens. Funding for rental-assistance programs such as Section 8 vouchers to help tenants, and money to underwrite the preservation of existing affordable rental housing is desperately needed. The Harvard Joint Center on Housing Studies found last year that “despite federal support for rental assistance of about $45 billion per year, only about one-quarter of eligible renter households report receiving housing assistance.”

Even with no increase in net government support, a progressive restructuring of the income-tax advantages now flowing to the top two income quintiles could produce a budget-neutral dividend that would help close the shortfall in those households receiving low-income assistance.

HIGH FINANCE
The future success of both the single- and multifamily markets will depend on the re-establishment of a functioning secondary mortgage market. The collapse of Fannie Mae and Freddie Mac in September 2008 has set the stage for a major fight over their future and that of the entire system of funding for mortgages. (See “Fannie, Freddie, and the Future” by Dan Immergluck, page A19.)

The Obama administration released a white paper on this topic in early February. The paper offered only a broad outline of what a future system might look like, providing three options and a host of observations about their respective pros and cons. Rep. Jeb Hensarling, a Republican from Texas, recently reintroduced legislation that would wind down the two companies in two to five years and with them, federal support for this market. His colleagues in the House Financial Services Committee leadership have turned cautious on this topic, however, and the Senate appears likely to take considerable time before proposing any specific directions.

Because of Fannie’s and Freddie’s spectacular failure, this debate likely will be highly polarized, and it is unlikely that anything significant will be adopted before 2013. But some form of federal support will be necessary in the future to assure continued consumer access to affordable long-term, fixed-rate mortgages, which are by far the safest and most advantageous home loans for consumers. The market will have to be regulated to assure that region- and community banks and credit unions are not shut out of the market by the largest banks that already have increased their share of the mortgage market. Safeguards will be needed to prevent “creaming” in the market that leaves some borrowers and communities underserved.

A SOBERING OUTLOOK
Congress and the administration are locked in what promises to be a drawn-out war of attrition over the budget. The Federal Housing Administration, Fannie Mae, and Freddie Mac have already tightened their credit terms, making it harder for borrowers to qualify, and the administration’s white paper suggests that more constraints are likely on the horizon.

The Republican House has passed bills to zero out funding for the HAMP loan-modification program, the Neighborhood Stabilization Program that authorized $7 billion to state and local governments to cope with foreclosures as well as $3 billion in short-term relief for unemployed homeowners. Without these supports, further significant house-price declines could put more owners underwater. The pipeline of foreclosures remains a powerful brake on home sales and starts, undermining broader economic recovery.

Bolder actions that could accelerate the clearing of the housing market are politically unattainable for now. For instance, aggressive government purchases of distressed mortgages could enable them to be restructured immediately and on patient terms for distressed owner-occupants. The rest could be sold at steep discounts with shared equity to assure the government of a portion of future appreciation.

In the short term, it’s important to focus on the areas where the administration can act without Congress. But the recommendations in the February white paper bode ill for consumers. The White House already has raised Federal Housing Administration premiums by a quarter of a percent. Its paper calls for a 10 percent minimum down payment and significantly higher fees for loans eligible for purchase by Fannie and Freddie. The white paper has emboldened Republicans who want to kill off these entities.

Unfortunately for Middle America, the combination of conservative exploitation of a crisis caused by conservative deregulatory policies to push for further reductions in the federal role, cautious administration policies, and congressional gridlock likely signals a significant further tightening of housing credit. This could relegate homeownership only to those with high savings or rich parents and do nothing to alleviate high-rent burdens for poor families. The facts don’t support this course. But it will take determined advocacy and pressure to turn around the trend. TAP

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A Needless Housing Collapse

The success of a pioneering program for moderate-income buyers proves that the subprime disaster was not the fault of homeowners and shouldn't have happened.

BY ALYSSA KATZ

John Smith's four-bedroom house stands tall on Cleveland's East Side, its tidy cream siding and green lawn oblivious to the devastation that has scarred the surrounding neighborhood. It is everything thousands of foreclosed homes in the area are not: occupied, intact, and still an asset to the family that lives in it. Smith purchased the home in 2005 through a nonprofit dedicated to repopulating the city with working- and middle-class homeowners. But Smith's investment was one of a few drops in a bucket with no bottom: The census tract he lives in, with about 600 homes, has seen more than 200 foreclosure sales in the past 15 years. "We know the inner city is the inner city, and it's no big surprise to us," Smith says. But even he is stunned at the level of devastation around him. "Whole neighborhoods are almost totally down."

The Smith family has come close to the precipice. In 2008, Smith, then 38, lost his job as a financial analyst for a bank and had trouble paying his mortgage. His credit-card debt shot into six figures. When his lender initiated foreclosure proceedings that December, the notice was a month late because the bank did not have the correct address on file for its own borrower.

Smith could have ended up like another Cleveland homeowner, truck driver Larry Saulsberry. In 2004, Saulsberry got a letter from a mortgage broker, offering to help him extract cash from the home he had owned since 1972. Saulsberry refinanced his old mortgage, on which he owed just $16,000, for a new one at $88,000 and higher interest rates, intending to use the proceeds to buy a new truck and bankroll badly needed repairs on his 90-year-old home. "Desperate people," Saulsberry explains, "do desperate things."

Only after he had signed the papers did Saulsberry discover that he had paid his broker nearly $10,000 in fees that had not been previously disclosed and that his payments to Argent Mortgage were $1,100 a month, not the promised $800—and what's more, the interest rate would adjust in the future. In 2008, the county sheriff sold his beloved home.

A twist of fate saved Smith. After receiving the foreclosure notice, he called his lender, which sent him to Fannie Mae, which would only say that the mortgage was held by a "private investor." A month later, Fannie finally gave him a number in Durham, North Carolina. On the other end of the phone was a counselor from Self-Help, the nonprofit organization that unbeknownst to Smith—and nearly 52,000 borrowers like him—had adopted his mortgage under a program that bought affordable home loans from banks under strict guidelines Self-Help had created. Self-Help shepherded Smith through a loan modification.

Smith is employed again, but far from liberated. The house that he bought in 2005 for $218,900 is now worth half that, putting Smith among the nearly one in four of all mortgage borrowers who owe more than their home is worth. It’s no accident that Smith has been able to weather the storm of the foreclosure crisis while similarly indebted neighbors succumbed. Thanks to Self-Help, his mortgage had a fixed interest rate, where as Saulsberry’s was adjustable. Modest closing costs were clearly disclosed. And Smith obtained his loan from a bank, not a broker. The features of Smith’s loan were standard on mortgages sponsored by Self-Help.

**SELF-HELP WAS FOUNDED** in 1984. In 1998, it teamed up with Fannie Mae to make custom-built safe loans available to high-risk borrowers from coast to coast. The Ford Foundation made the project possible through a $50 million grant that Self-Help used to guarantee the mortgages. The partnership sought not just to help the relative handful of borrowers the organization could aid through its purchases of affordable mortgages from its bank partners but to transform the lending business just when subprime lending was surging as a malign alternative. Self-Help demonstrated that it was a sound business proposition to design mortgages that vulnerable borrowers—many already struggling with high debts and low incomes—could actually pay.

Since then, with additional funding from Ford, a team of researchers at the University of North Carolina has tracked a sample of borrowers whose loans were purchased from their original lenders by Self-Help. The 3,700 Self-Help borrowers under the microscope look very much like subprime America. Four in 10 are black, Latino, or Asian, and most have annual incomes between $20,000 and $50,000; the typical borrower earns just 62 percent of his area’s median income.

At first glance, the Self-Help loans look rather like the toxic mortgages that devoured John Smith’s neighborhood. The median borrower took out a loan for 97 percent of the purchase price, leaving home buyers heavily leveraged. A near majority had to pay more than 38 percent of their income toward debts. Many had questionable credit ratings.

But if Self-Help mortgages appeared similar to subprimes in their loose qualifying standards for borrowers, the mortgages themselves couldn’t have been more different. Self-Help mortgages carry fixed interest rates, and they do not include the toxic features that sabotaged many subprime borrowers, such as
penalties for refinancing. What’s more, borrowers’ income and assets were fully documented. Risks were based on fact, not fantasy.

Thirteen years later, in the rubble of the foreclosure crisis, the Self-Help experiment makes it possible to answer the great “what if”: What if the borrowers who succumbed to subprime mortgages had received soundly structured loans instead? Tracking borrowers in real time, first during the housing bubble and then through the bust, the research has given the world unique insight into why some homeowners were equipped to weather the credit bubble while others quickly went bust.

The answer, quite simply, is that borrowers who had fixed-rate loans without hidden costs were far likelier to hold on to their homes. Subprime borrowers with adjustable-rate mortgages have cumulatively faced a “serious delinquency” rate approaching 40 percent, meaning that four out of 10 borrowers ended up at least three months late on their mortgages. From there, it’s usually very hard for them to avoid foreclosure. By contrast, only 8.5 percent of Self-Help borrowers—in the same cities and with the same financial profiles—have fallen into such deep trouble, and fewer than 5 percent have ended up losing their homes to foreclosure.

“In the statistical analysis, we were able to isolate the risks of the mortgages from the risks of the borrowers. What we learned is that mortgage products can amplify the risks or minimize the risks,” says Roberto Quercia, principal investigator and director of the Center for Community Capital at the University of North Carolina. “The right product is crucial.”

The experiment has much to offer the Obama administration as it rebuilds a broken system of housing finance, in the midst of ongoing partisan warfare over what caused the mortgage market to collapse in the first place. Blaming the Community Reinvestment Act—the 1977 law that calls on federally regulated lenders to meet the credit needs of entire communities—remains popular blood sport among Republicans, pandering to racist stereotypes about minority homebuyers. The facts are poised to speak more loudly, if anyone chooses to listen.

The researchers and their sponsors hope Congress and the administration will pay attention to their findings: Without a forceful commitment from those rebuilding the credit system, borrowers like John Smith—who have everything it takes to pay a mortgage except a pot of gold in the bank—may be shut out of owning property in the future.

**THE IDEA THAT HOMEOWNERSHIP could be a force to better low-income people’s lives drove the Ford Foundation to call the University of North Carolina’s Michael Stegman in 1998, asking him to lead the research on the results of Ford’s investment in affordable homeownership. The solution, it seemed to all involved, would have to include a big role for Fannie Mae and Freddie Mac, which, along with government-run Ginnie Mae, bankrolled more than half of the entire mortgage market. “The idea was to just take the existing machinery, making it work better and close the gap,” says Janneke Ratcliffe, executive director of the Center for Community Capital.**

In Durham, Self-Help Community Credit Union had already been financing loan products for high-risk borrowers, both through its own lending and through purchases of batches of other banks’ loans. But it was impossible for Self-Help to sell these mortgages to Fannie or Freddie. That obstacle kept this market at a tiny scale, while millions of eligible borrowers remained unserved. To Self-Help CEO Martin Eakes, it seemed absurd. His borrowers were making their payments on time, and his credit union was making money. Why wouldn’t Fannie and Freddie want a piece of the action? With his early results and Ford’s support, Eakes convinced Fannie Mae to commit to a national-scale loan-financing program, in which it would sell $2 billion in Self-Help-backed mortgages to investors, and Ford’s money would absorb any losses.

The project sought to outdo the subprime market—engineering and disseminating a better product that would eventually force its way mainstream. It was reasonable to expect that Fannie and Freddie—operating under a mandate from Congress to finance loans for low- and moderate-income borrowers—would embrace the kind of innovative lending Self-Help was pioneering. “We hoped that the rigorous analysis of the performance of the mortgages over time would reveal that the actual credit risk
associated with these mortgages was significantly less than the risks perceived by the lending industry,” says Frank DeGiovanni, director of financial assets at the Ford Foundation. “The ultimate goal of the demonstration, beyond assisting 40,000 low-income households to become homeowners, was to change the way that the financial industry approached the provision of mortgage financing for low-income and minority households.” At the time the project started, just four in 10 African American and Latino households owned their homes, in contrast to seven in 10 white households.

But this promising experiment, though immensely helpful to homeowners like John Smith, has been swamped by the wider damage of subprime. Fannie and Freddie are now wards of the federal government—largely because they took the low road to reaching underserved borrowers, following Wall Street’s subprime-lending stampede. (Fannie stopped buying Self-Help mortgages in 2009.) While the crisis thwarted the Self-Help program’s original goal, however, the research on its prime loans for subprime borrowers continues to pour out—and may be more important than ever. The scholars possess data that shows that the popular wisdom on subprime lending was wrong. The problem wasn’t that the borrowers couldn’t afford to be homebuyers; it was that they had been set up to fail.

What’s more, low-income homebuyers realized meaningful benefits. As real-estate prices soared, owners who bought their homes before 2005—before the entire market veered into unreality—saw sharp rises in their equity that have not been entirely wiped out. Low-income buyers were much less burdened by the expenses of home maintenance than earlier assumed. The research has also contradicted the standard ways that lenders label low-income borrowers “high risk”: It turns out that credit ratings are a poor predictor of which low-income homeowners will catch up on their mortgage debt after late payments and which are doomed to lose their homes.

We now know that it’s possible to lend to high-risk, low-income borrowers with minimal chance of default. Yet the kinds of loans that help those borrowers succeed are precisely those that are now most endangered. The North Carolina team found that just three perverse loan features overwhelmingly determined whether a borrower would default: a loan is sold by a mortgage broker; has adjustable interest rates; or imposes prepayment penalties on borrowers who seek to sell or refinance.

The 2010 Dodd-Frank Act has drained some of the poison: Mortgage brokers now can’t be incentivized to sell harmful loans, and adjustable-rate mortgages now must be based on borrowers’ ability to pay the real interest rate, not a teaser. But adjustable rates and prepayment penalties are not going anywhere; more likely, they will become more prevalent than ever.

“It may be more difficult for many Americans to afford the traditional pre-payable, 30-year fixed-rate mortgage,” warns the Obama administration’s blue-

print for housing finance reform. Historically, U.S. borrowers could get into long-term, fixed-rate mortgages cheaply and get out of them easily, because an implied government guarantee effectively absorbed the resulting risk—that fluctuating interest rates over time will reduce the value of those mortgages to investors as they’re packaged into securities. For mortgage products lacking a government guarantee, Wall Street came to rely on prepayment penalties and adjustable rates to deflect the risk back onto borrowers—and as we now know from the North Carolina research, these features were the most harmful to consumers.

In the current spasms of reform, Fannie Mae and Freddie Mac could well dis-appear, shuttering the institutions that for more than seven decades sponsored the widespread availability of fixed-rate, long-term mortgages. Even if some form of government guarantee remains, home mortgages are likely to become more expensive, and beyond the reach of low-wealth renters. Proposed guidelines under Dodd-Frank are likely to establish a 20 percent down payment for most loans financed through mortgage-backed securities—excluding millions of would-be homebuyers who can’t scrounge together tens of thousands in cash up front. Even the Federal Housing Administration insurance program, historically a low-down-payment option for upwardly mobile working-class buyers, is now requiring down payments of at least 10 percent for those with less than sterling credit.

Such rules are built not on statistical evidence but on political jockeying and on broad-stroke formulas to protect banks and investors. Quite likely, they overreach. And no one has yet figured out what it would take to ensure loans remain available to the millions of households whose credit ratings decayed in the recession. “There’s no information out there, and that’s startling,” says Ratcliffe of the Center for Community Capital. “The fact that people are making these big policy decisions without research is really problematic.”

The U.S. may soon lose a generation of homeowners, as households who would have once qualified to buy a home get locked out. Stegman, who now heads policy for the MacArthur Foundation, is comforted that the research he instigated isn’t going away. “What’s really exciting about it is that the longer it goes, the more it’s going to be able to inform policy,” he reflects. “Ultimately, when the political environment becomes less poisonous and evidence begins to matter again, then this becomes a very powerful voice.”

**Borrowers who had fixed-rate loans without hidden charges were far likelier to hold on to their home.**

**TAP**

_Alyssa Katz_ is the Jack Newfield professor of journalism at Hunter College, senior fellow at the Pratt Center for Community Development, and author of Our Lot: How Real Estate Came to Own Us.
Designed to Fail

The Obama administration’s mortgage-modification program was created more to help lenders than homeowners. It’s time to reverse priorities.

BY MARCUS STANLEY

Two years into its life, the Obama administration’s headline housing effort, the Home Affordable Modification Program, or HAMP, is struggling, and so are the families it’s supposed to help. Well over a million homes have been lost to foreclosure since the HAMP program began, and more than 4 million additional homes are either in the foreclosure pipeline or likely to default over the next few years. But more than 60 percent of seriously delinquent homeowners are never even contacted to discuss help with their mortgage. Even families who manage to keep their home are often burdened by crushing levels of mortgage debt inherited from the housing bubble. More than one in every 10 American mortgage holders has a loan at least 20 percent greater than the value of their home.

Yet HAMP has resulted in only about 540,000 permanent modifications to reduce homeowner mortgage payments. These modifications do significantly lower monthly payments (by an average of $527), but the number is modest compared to the magnitude of the problem and falls far short of the 3 million to 4 million modifications promised by the administration when the program began. The pace of new monthly modifications has also dropped by half in the past year, indicating that the bulk of the program’s impact may be behind it.

If the numbers look mediocre, the reality for homeowners is often even worse. Almost from the beginning of the program, journalists have been telling stories of families struggling with baroque and incomprehensible HAMP bureaucracy. Qualified homeowners often have to fight for more than a year to obtain a modification. Bruce Dorpalen, public affairs director for Affordable Housing Centers of America, describes HAMP—eligible families “in limbo” for six, 12, or even 18 months and possibly going into foreclosure during that time. “It’s very common for our housing counselors to be working with a family the day before a foreclosure sale in order to stop it. … The sale will then be postponed a month and the process has to be repeated.”

A homeowner’s journey through HAMP usually starts with reaching out to the servicer—the private company that collects mortgage checks, typically a specialized subsidiary of a large bank. Usually the mortgage servicer does not own the loan but passes payments on to the investors who are the actual owner. The servicer then handles the entire HAMP process, from verifying borrower income to determining eligibility to offering the modification. In practice, almost every step in this process has been at best confusing and at worst maddening for borrowers.

Servicers reject more than a fifth of borrower applications for paperwork reasons—often due to lost paperwork by the servicer itself. An October, 2010 ProPublica survey found that homeowners seeking modifications had to send the same documents an average of six times before they were received. If the paperwork hurdle is passed, servicer bureaucracy results in substantial delays in determining eligibility. Servicers often reject modifications if they decide the borrower isn’t in enough financial trouble. When they do grant modifications, they rarely reduce the total debt burden of the consumer. Instead, modifications generally cut interest rates temporarily and reschedule payments.

While borrowers wait for the servicer to determine eligibility, the foreclosure divisions of the same servicer often continue the foreclosure process, sometimes leading to borrowers getting foreclosure notices from the same servicers with whom they are negotiating a modification. Although servicers are technically required to follow extensive government guidelines, the federal government does not levy fines or penalties for violations.

It wasn’t necessary to essentially hand the HAMP program over to loan servicers. Thanks to government-sponsored housing programs, the federal government has enormous resources and expertise in housing. Nor did the servicers have information unavailable to government. There are large national databases available that include data on almost all mortgage loans.

The government also could have legally mandated modifications. HAMP requires restructuring loans only if the modification is economically rational—that is, if the expected cash flow from modifying the loan exceeds the expected cash flow from leaving the loan as is and running an increased risk of foreclosure. In early 2009 when the program began, the big banks that own most major servicers were utterly dependent on taxpayer subsidies, leaving them in a poor position to contest mandates.

Indeed, a program that inspired HAMP shows how government could have sidestepped servicer issues to directly assist homeowners. When the Federal Deposit Insurance Corporation (FDIC) took over the failed IndyMac bank in 2007, it inherited a large portfolio of troubled loans. The FDIC simply analyzed the entire loan portfolio to see if a loan modification would save money compared to leaving the loan unmodified and risking foreclosure. If a modification appeared economically rational, the FDIC approached the borrower and directly offered the modification. If the borrower accepted, the modification was done. While this pro-
gram wasn’t perfect, it ran comparatively smoothly and avoided the massive paperwork problems experienced in HAMP.

Why didn’t HAMP follow the IndyMac model? IndyMac had already failed, and the FDIC temporarily owned it. But in the case of other large banks, the administration desperately wished to avoid bank takeovers. HAMP was also shaped by the desire of the administration, particularly the Treasury Department, to not disrupt the operations of the big banks it had recently rescued.

Another critical choice made early on was that HAMP would not mandate that banks actually reduce the total mortgage debt held by homeowners. Instead, only temporary reductions in interest rates were made. This choice meant that HAMP would put much less pressure on both bank balance sheets and government budgets. But it also meant that it would provide only limited assistance to the millions of homeowners struggling with a mortgage that was enormously greater than the current value of their home. **BY CHOOSING TO RELY SO HEAVILY ON MORTGAGE SERVICERS, THE GOVERNMENT WAS PUTTING ITS HOUSING STRATEGY IN THE HANDS OF A BASICALLY UNREGULATED INDUSTRY, ONE THAT HAD UNDERGONE A SIGNIFICANT TRANSFORMATION THAT MADE IT IN MANY WAYS UNSUITED TO THE TASK. A GENERATION AGO, WHEN MANY MORTGAGE LOANS WERE ORIGINATED AND HELD BY LOCAL BANKS, THE ORIGINATING BANK OFTEN COLLECTED THE MORTGAGE CHECKS AND SERVICED THE LOAN. THIS CREATED A CLOSE, SERVICE-ORIENTED RELATIONSHIP WITH THE HOMEOWNER, WHO WAS OFTEN A DEPOSITOR AT THE BANK AND A CUSTOMER FOR OTHER BANKING SERVICES. SINCE AROUND 1990, AS SECURITIZATION CAME TO DOMINATE THE MARKET, MORTGAGE SERVICING HAS BECOME A COMMODITY BUSINESS DOMINATED BY A FEW LARGE PLAYERS, WHO USE ECONOMIES OF SCALE AND INFORMATION TECHNOLOGY TO PROVIDE STANDARDIZED AND MOSTLY AUTOMATED BILL COLLECTING AND SERVICING. In 1989, the 10 largest mortgage servicers serviced just 11 percent of American mortgages. Today, the four largest—dominated by big banks such as Bank of America, Wells Fargo, and Citibank—service more than 70 percent of mortgages.

With millions of mortgages to manage, most of which are owned by faraway investors and not by the servicing banks themselves, servicers became bureaucratic and routinized and lost much of their flexibility in dealing with the situations of individual borrowers. Their business model relied on high-volume, low-cost standard procedures, not the “high touch” interactions sometimes necessary to help a borrower struggling with an unsustainable mortgage.

During the housing-bubble period, with home values increasing steadily, there was little need to renegotiate loans. If borrowers couldn’t pay their mortgage, it was generally possible for them to sell the house. And in the rare case of a foreclosure, the investor could easily recover the loan principal. But as delinquency can be exempt from the 5 percent skin-in-the-game rule. Since lenders want to avoid the 5 percent risk-retention requirement, QRM will set the standard for conventional mortgages and determine the loans that will most widely be available to consumers at the lowest costs.

Underwriting characteristics specified in Dodd-Frank to be considered in determining which loans meet the QRM standard include: the documentation of financial information used to qualify the borrower, debt-to-income ratios, product features, points and fees, and whether a loan has mortgage insurance or any other credit enhancement. In addition, certain loan characteristics are flatly prohibited from being included within the definition of a QRM, including negative amortization loans, balloon payments, and other inherently high-risk loan features.

Because multiple features influence loan performance, a multifactor approach is essential to avoid unnecessarily narrow, rigid, or arbitrary guidelines that could preclude homeownership for otherwise qualified borrowers. The FDIC released draft QRM rules on March 29 (continued on next page).
and foreclosure rates skyrocketed, and equity went negative during the housing collapse, servicers found themselves without the staff, resources, or organization to handle the problem. Not only do servicers lack capacity; it’s far from clear they had the right incentives to perform even economically rational mortgage modifications. Most loans aren’t owned by the banks that service them. Ownership of securitized loans is divided among dozens or hundreds of investors in mortgage-backed securities, and the mortgage servicer simply receives fees to manage the loan. So even if investors have an interest in avoiding a foreclosure, that’s not necessarily true for the servicer.

Servicer incentives depend on the balance between the servicing fees collected in the event of a delinquency or foreclosure and the fees collected for a modified loan that continues to perform. In many circumstances, servicing fees can be higher for a nonperforming loan followed by a foreclosure than for a loan restored to performing status through a modification. In the event of foreclosure, the servicer is often first in line to recover any fees and advances owed to them, while investors must take a loss. The HAMP program tried to counteract these negative incentives through bonus payments to servicers for completed modifications. But these bonuses haven’t been sufficient to counteract the twin forces of servicer incapacity to deal with borrowers and lack of incentives to perform socially beneficial modifications.

If the bonus “carrot” wasn’t sufficient to induce better servicer performance, a more effective “stick” might have done so. But even though most of the largest servicers were owned by major banks receiving TARP payments, the government failed to use this leverage. It also failed to press for an alternative route to mortgage modifications. Residential mortgages are one of the few types of debt that cannot be modified in bankruptcy. Early in the housing crisis, advocates championed a proposal to permit bankruptcy-court judges to modify mortgages. This would have provided an alternative way to relieve mortgage debt and created real pressure on servicers to provide modifications to avoid bankruptcy for homeowners. At various points—during the TARP negotiations and the stimulus debate—this proposal appeared to have sufficient congressional support to pass. But first Senator and then President Barack Obama failed to vigorously support the idea, and it lost due to financial sector opposition.

The decline of housing values from artificially inflated levels left homeowners

Bailed-out banks with record profits and cash reserves have not been required to use that money to restructure loans.

(continued from previous page) and has requested comments by the end of May. The draft represents the joint efforts of six federal agencies. Based on the draft recommendations, things do not look promising.

Under the rubric of discouraging dangerous practices, the draft rules establish narrow and rigid standards that threaten to slam the door to homeownership for millions of otherwise qualified borrowers while simultaneously failing to reduce the risks of default. The draft rules, for example, require a minimum down payment of 20 percent for qualified residential mortgages.

There is no reasonable justification for this rigid requirement. Safe, low down-payment mortgages have been a vital part of America’s homeownership success story for decades. And low down-payment mortgages have been essential in promoting sustainable homeownership for responsible moderate-income working families, minorities, and young adults in particular. In fact, even in the current conservative lending environment, the research firm CoreLogic estimates that almost 2.7 million borrowers put down less than 20 percent last year. And the Center for Responsible Lending estimates it would take the typical family 14 years to save for a 20 percent down payment on the median priced home.

Alternatively, individuals who do not have large amounts of savings would be required to pay substantially more for a loan or rely on the Federal Housing Administration. Loans guaranteed by the FHA are recommended to be exempt from the QRM. But the administration has already proposed, as part of its broader reform of the home-mortgage finance system, the reduction of loan volumes combined with increased fees at FHA.

Moreover, channeling borrowers to the FHA, which is a 100 percent federally guaranteed loan program, increases the federal government’s liability for home loans, contradicting the stated goal of mortgage-market reform to have the private-sector assume more of the risk of mortgage lending. Another important and near-term exception in the QRM draft rules is that loans guaranteed by the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac are exempt from the QRM standards while they remain in government conservatorship. This would allow for continued low down-payment mortgages unless subsequent rule changes require higher down payments for loans guaranteed by the GSEs or the GSEs are dissolved, both of which have been proposed by the Obama administration.

The nation’s housing bubble was allowed to inflate in plain sight for nearly a decade before busting—to the apparent surprise of the financial regulatory agencies that were responsible for ensuring the safety and soundness of the financial system. Now, in response to the catastrophic collapse of the markets, financial regulators are intervening in a manner that could greatly stifle the housing market’s correction and preclude millions of average Americans from accessing mortgage credit and the opportunity to become homeowners. The wrong kind of market regulation after the crash will not compensate for having missed the crisis in the first place. TAP

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who purchased during the housing bubble trapped with enormous debt burdens. The inflation of housing values was driven by a broader failure of the financial system; homeowners in many markets had no choice but to buy at inflated prices if they wanted to own a home. A fair division of the fallout from this societal failure would have split the costs between financial institutions and affected homeowners and society as a whole. Such a division would also have been a more effective way of addressing the recession, as outsized debt burdens left over from the housing bubble have been a significant factor holding back broader economic recovery.

But the burden of housing debt has not been shared fairly. Buoyed by a range of recovery programs, banks today are showing record profits and cash reserves. Meanwhile, the burden on consumers from negative housing equity has barely declined over the past two years. Unfortunately, the attitude that created the shortcomings of the HAMP program is still alive and well. The consent decree recently proposed by federal banking regulators to address evidence of widespread servicer fraud and abuse continues to give enormous discretion to servicers in controlling the modification process, and it doesn’t require real remedies for homeowners. The regulator proposal may undermine the drive for tougher penalties and stricter servicer requirements by the Justice Department and state attorneys general pursuing a criminal case.

Indeed, despite all its flaws, many Washington insiders continue to view HAMP as a qualified success, a program that has helped several hundred thousand homeowners reduce mortgage payments at a low cost to both government and the banks. Until we get serious about requiring banks and servicers to assist deserving borrowers on a scale commensurate with the foreclosure crisis, we’ll continue to reproduce the timid incrementalism shown by HAMP. TAP

**Marcus Stanley** is the policy director of Americans for Financial Reform. The views expressed in this article are his own and do not necessarily represent those of his employer.

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**Not With My Home**

*Homeowners have been at the mercy of banks since the foreclosure crisis began. A network of activists and organizers is trying to change that.*

**BY REBECCA RUIZ**

In 2004, Egyptian immigrant Mohamed Nour and his wife, Heba, decided they could do better than their cramped two-bedroom apartment in Boston. They were expecting their second child, and rent was more expensive each year. They found a two-story, three-bedroom home on a tree-lined block in suburban Revere.

Nour, now 41, bought the house for $337,000. In 2007, the interest on his original adjustable-rate-mortgage loan shot up by 3 percentage points. He was able to refinance at a more favorable rate, but then in 2008, his 4-year-old son, Pheras, was diagnosed with a glioma, a malignant brain tumor. Nour, a limo driver, began missing work shifts to bring his son to chemotherapy treatments.

After a losing struggle to persuade his loan servicer, IndyMac, to modify the loan, Nour was told in that his only option was a forced sale to the bank for $170,000, roughly the house’s present market value. Since Nour bought his home, values in Revere have plummeted 32 percent. Rejecting the so-called short sale, he asked for a loan modification at that current market value—a mortgage he could afford. “If you’re going to sell it to someone else for $170,000,” he asked, “why won’t you just resell it to me?” The bank refused.

Up to this point, Nour’s story was like that of millions of other American homeowners. Stonewalled by the bank and without a lawyer, Nour seemingly had no options. That’s when he discovered CityLife/VidaUrbana, an activist group in the Jamaica Plain neighborhood of Boston that works on housing issues.

Nour attended his first of CLVU’s Tuesday-night meetings in November 2009. He was joined by dozens of homeowners like him—behind on their payments, nearing foreclosure, in the middle of it, or close to eviction. As is the ritual for each newcomer to CLVU, Nour was asked to stand up, introduce himself, explain his situation, and then wield a 4-foot plastic sword and large shield, painted silver and emblazoned with the words “No One Leaves.” The crowd shouted in unison: “What if the bank attacks?” Thrusting the sword and shield into the air, he replied: “Stand up and fight back!”

The experience changed Nour’s mentality. “You feel embarrassed for something because you didn’t pay your mortgage, and they’re going to take your house from you,” he says. “But when you’re inside a group and some people they listen to you and they try to help you, I think you feel stronger and you try to fight to get your house.”

The central tenet of CLVU’s foreclosure activism is that no one should vacate a home until all legal options have been exhausted. Despite foreclosure, bank auction, and eviction notices, Nour never left. In a unique twist, he may also be able to buy back his home from a nonprofit community-development organization called Boston Community Capital.

Nour is lucky to live in Boston, which has become ground zero for modeling how to bring the foreclosure machinery to a halt—and win back homes. Here, CLVU has partnered with Greater Boston Legal Services, Harvard Legal Services, and Boston Community Capital to provide homeowners peer support, legal resources, and in rigorously screened cases, an option to buy back a foreclosed home.
WHILE THE BOSTON MODEL has yet to be fully replicated across the country, there are similar movements in the cities and states hardest-hit by the housing crisis. Some groups are rallying homeowners to confront banks with demands for loan modifications at shareholder meetings and protests outside of corporate offices. And for the most part, these aren’t old hands at civil disobedience risking arrest at vigils and blockades in front of foreclosed homes; they are first-time activists. In many cases, the threat or experience of foreclosure has forged a newfound political identity for individuals who once saw themselves as just beleaguered homeowners. What they need now is a national movement to call their own.

In Boston, anti-foreclosure activism is methodically organized. Greater Boston Legal Services and Harvard Legal Services, both legal-aid groups, scour local notices and trade journals for listings of homes nearing foreclosure. Delegates from both organizations are then sent on door-knocking trips where they invite homeowners to the weekly CLVU meetings. Those who show up are referred to a clinic to review legal options with a lawyer or housing counselor.

GBLS and HLS lawyers also appear weekly at the Boston and Chelsea housing courts, offering their services and approaching homeowners without representation. Diminished state funding for legal-aid services has forced GBLS to turn away 60 percent of potential clients; the organization tries to focus on homeowners who can afford a modified mortgage payment or whose cases might change state law. As a case unfolds in court, the homeowner is encouraged to continue attending weekly CLVU meetings for emotional support, and also to participate in direct-action strategizing. “Someone who has gone through this process becomes a leader themselves,” says Zoe Cronin, a GBLS lawyer.

Consider Melonie Griffiths, a former special-education teacher who was marketed a subprime loan. In late 2007, Griffiths had just agreed in housing court to move out of her foreclosed two-family, four-bedroom house in North Dorchester when she discovered CLVU. In January 2008, she received a 48-hour eviction notice. Instead of uprooting her three children with nowhere to go, she practiced the CLVU creed: No one leaves. Instead, dozens of volunteers blockaded Griffiths’ home so the police could not physically remove her. She eventually did move, but only when she found an apartment down the street so her children wouldn’t have to change schools.

Griffiths had never been involved in organizing, but she spent the next few years on the front lines of CLVU’s No One Leaves initiative. She recently became the group’s lead organizer. “People are comfortable here,” Griffiths says. “It’s the one place you’re not ridiculed or blamed. But it also gets you angry … when you see how similar everyone’s story is.”

In the fall of 2009, CLVU, GBLS, and HLS partnered with Boston Community Capital in a pilot program designed to win back homes for borrowers who could afford a lower mortgage payment but lost their house anyway. BCC provides the organizations with income tables and property-value charts by neighborhood in order to identify potential candidates for the program. Preliminary screening involves determining whether a reduced mortgage payment would equal no more than 38 percent of the client’s gross income and whether the property value has dropped enough so that BCC can purchase the home from the lender and still offer it back to the client at a discount. Nearly 100 Boston residents have repurchased their homes through the project. CEO Elyse Cherry says BCC’s novel program will need billions in funding before it can be taken to scale nationally.

ACROSS THE COUNTRY, a broad coalition of embattled homeowners is emerging. Its member organizations include such community, labor, and faith-based organizing outfits as People Improving Communities through Organizing (PICO), National People’s Action, Alliance for a Just Society, Industrial Areas Foundation Southeast, Alliance of Californians for Community Empowerment, and the Service Employees International Union. Together, these organizations have reached out to their 3.5 million members to offer foreclosure-resistance resources and opportunities to participate in direct action against banks.

A joint campaign called “Crime Shouldn’t Pay” is designed to put public pressure on policy-makers and banks, often through embarrassing protests at meetings and corporate offices. Each organization also has its own locally specific initiatives, the tactics of which vary across the coalition. National People’s Action, for example, supports an Iowa affiliate that organized hundreds of residents to pressure Attorney General Tom Miller, the architect of the proposed 50-state bank-settlement agreement, into hearing the concerns of homeowners.

The Alliance of Californians for Community Empowerment (ACCE) led its own statewide campaign called “Refund California,” which is lobbying for two changes to state law: the establishment of a $20,000 fee for servicers that improperly proceed with foreclosure, and a prohibition of “dual tracking,” a practice that allows banks to foreclose before a loan-modification evaluation is complete. The ACCE, like the NPA and others in the coalition, works to connect homeowners with housing counselors and legal-aid services. The organizations have also found success in grouping cases by lender and then lobbying on behalf of those members in face-to-face meetings with bank representatives.

PICO, A NETWORK of faith-based activist groups in 17 states, has been using direct-action tactics against banks since 2008 as the foreclosure crisis developed. PICO pastors and organizers were hearing from a growing number of frus-
trated homeowners whose attempts to modify loans were routinely ignored by the banks. Such reports were particularly concentrated in the nine-county Bay Area where 2 percent of homes and condos would eventually be foreclosed on in 2008. An initial round of meetings produced only stonewalling.

“How do you build enough leverage and power over a bank that has 3.2 trillion in assets?” Tim Lilienthal, a PICO spokesperson asks. “It’s David and Goliath, and you have to find a way to develop some slingshots.” In November 2008, the group staged a prayer rally on the steps of the U.S. Treasury Building. As pastors prayed, 200 demonstrators implored administration officials to use the bailout as a way of halting preventable foreclosures.

Soon PICO was organizing Bank of America customers to close their accounts in protest of the bank’s handling of foreclosure cases. Homeowners started appearing at shareholder meetings to confront bank executives. At a May 2010 JPMorgan Chase & Co. meeting, a PICO representative pressured CEO Jamie Dimon into setting up a meeting between the organizing group and JPMorgan’s home-lending director.

Such tactics have worked for Ken Kelly, an Antioch, California, homeowner. In the fall of 2009, Kelly attended a meeting at the Contra Costa Interfaith Supporting Community Organization, a PICO affiliate. At the time, Kelly was trying to finalize a loan modification from Bank of America for the mortgages on his two-story, five-bedroom home. A general contractor, Kelly bought the property in 2002 for $289,000 and later took out a home-equity loan to help pay for his older child’s college education. When the recession hit and new-home building stalled, his income quickly dropped.

After months of trying to obtain a loan modification from Bank of America, Kelly finally had an agreement in late summer of 2008. The monthly payment was steep, but Kelly felt he had no choice. “I thought this was better than losing the house,” he says. Kelly submitted the notarized paperwork but never heard from the bank. Several months passed, and Kelly called to arrange a payment schedule. The bank representative mentioned a “gray area” in the paperwork and said it would need to be revised. Kelly says he was instructed to skip payments until the issue was resolved and was promised that the modification terms would remain the same. When the paperwork arrived in January 2010, however, the interest rate and payments were higher, and he’d been charged fees and penalties for two months of nonpayment. Kelly refused to sign it.

At the same time, PICO had long been trying to schedule a meeting with Barbara Desoer, president of Bank of America’s home loans and insurance division. The bank finally agreed, and in February 2010, PICO selected nine of their most compelling cases and speakers and paid for the homeowners, among them Kelly, to travel to the sit-down at the bank’s headquarters in Charlotte, North Carolina.

Armed with supporting documents, Kelly presented his experience to Desoer. A few days after returning home, the bank called, ready to offer him a modification through the government’s Home Affordable Modification Program with more favorable interest and payment rates. Kelly estimates that his payments are $1,000 less than prior to the first modification. “They helped by getting me access to people who I could never get access to,” Kelly says. Lilienthal estimates that roughly 100 PICO members have received loan modifications through the group’s assistance.

Kelly, who is 44, had never before protested or been involved in activism. “I’ve never known the power of organizing and having your voice heard,” he says. “I was thinking my part would be going to events and holding up a sign. But right off the bat, I was asked to speak, and it kept going from there.”

As the organizing infrastructure evolves, more homeowners like Kelly will find a PICO, CLVU, or an NPA. But budget cuts are reducing the capacity of housing counselors and legal-aid attorneys. Bruce Dorpalen of the Affordable Housing Centers of America, a non-profit counseling and brokerage agency for low-income individuals that has been approved by the Department of Housing and Urban Development, says that a 78 percent reduction in federal funding in the last year and a half has led to widespread cutbacks.

Mohamed Nour will find out in May whether Boston Community Capital can strike a deal with the bank to buy back his house, where he and his family still live. In the meantime, Nour continues to attend CityLife/VidaUrbana meetings and looks for opportunities to be more politically active. In January, he attended a protest held by Boston’s Egyptian community, demonstrating against the Egyptian government’s crackdown of democracy reformers. He has mentioned the possibility of moving to his children. His son, Pheras, who has finished chemotherapy but is not yet in remission, was resolute: “I’m not going anywhere,” he said. TAP
Cleaning Up the Aftermath of Subprime

Welcome to the Kafkaesque world of mortgage loan servicing. It’s time for national consumer standards—and prosecutions for fraud, too.

BY MIKE KONCZAL

JPMorgan Chase trumpeted some impressive news on Jan. 14, 2011. It had earned a record $17.4 billion in quarterly profits in fiscal year 2010, a 47 percent jump from the previous quarter. Three days later, the bank quietly released a less flattering statement. Its mortgage-servicing division, the third largest in the country, had overcharged some 4,000 active-duty troops on their mortgages and improperly foreclosed on 14 of them, violating a law called the Servicemembers Civil Relief Act. This story broke because of embarrassing litigation. A Marine F-18 fighter pilot, Capt. Jonathan Rowles, who had been faithfully paying his mortgage, was marked delinquent. He and his wife hired a lawyer and spent two years fighting to get JPMorgan Chase to relent.

The foreclosure mess is the sequel to the subprime calamity. During the housing bubble, investment bankers sought to move as many mortgages as they could, sound or otherwise. No-documentation loans packaged by Wall Street were blessed by the ratings agencies and sold to investors who would go on to lose a ton of money. The aftermath is just as messy. A business model that lost trillions during the crash is now pursuing profit by further bilking the victims. But servicers are also finding that basic paperwork trails were not properly created during the boom. So as they try to expedite foreclosures, they play fast and loose with the law.

Three elements are needed to reform this broken system. The first is an in-depth investigation of the mortgage-servicing industry’s abuses. The second is the creation of a proper system for the servicing of debt with enforceable consumer protections. The last is a more effective plan to limit foreclosures and get a floor under housing prices, using better and more comprehensive loan modifications.

Iowa Attorney General Tom Miller has been leading his fellow state attorneys general in investigating servicer fraud and working on a potential settlement that would combine procedural reforms with a onetime fine for past abuses. The proceeds could underwrite loan modifications. The plan, a bit jerry-built, has the support of the Obama administration but is being mightily resisted by the banking industry.

WHAT WENT SO WRONG with mortgage servicing? Picture two entirely dissimilar businesses, a call center and a surgery clinic. A call center can be run like a high-volume factory. Workers function by reading scripts, without a lot of skill or training. But in the surgery clinic, each patient will be different, and the surgeon will often have to rely on extensive expertise in making judgments. This is not a business that can be run on the cheap.

Mortgage servicing has elements of both business lines. The call-center equivalent is taking in mortgage payments and passing them along to investors. It’s paint-by-the-numbers. The more customized business line, analogous to a surgery clinic, kicks in when mortgages go bad. An effective loan modification takes time, extensive communication, and detailed knowledge of the customer.

The servicers have stuck to the first kind of high-volume business model, which worked fine to pump out new mortgages during a housing bubble—but now they have to carry out the second line of business in the crash. The temptation for servicers is to make up the difference by gouging customers and pushing more fees when times are rough. A 2007 earnings report by Countrywide Mortgage (which later went broke) put this bluntly, noting that “increased operating expenses in times like this tend to be fully offset by increases in ancillary income in our servicing operation, greater fee income from items like late charges, and importantly from insourced vendor functions.” Translation: They’ll make a windfall out of junk fees and foreclosures in a downturn that will balance out the bad housing market. The business line is only profitable when consumers and investors are being gouged.

In addition to the fixed fee they get for processing each individual mortgage, servicers make money from default fees such as late charges. Servicers also collect fees when mortgages go into foreclosure. But a good loan modification reduces principal, avoids foreclosure, and produces no windfall fees—exactly what servicers aren’t incentivized to do.

CONSIDER ONE COMMON SCAM that often shows up in foreclosure litigation. We all know about abusive credit-card fees. You overdrew your account slightly or are a day late on a credit-card payment, and a $3 cup of coffee becomes a $33 cup of coffee. It’s painful but not the end of the world. In many mortgage-servicing fraud cases, however, a late fee is added to the loan balance. Though the next payment comes in on time, part of it is applied to the fee first, so there isn’t enough to cover the monthly payment. This makes that payment late, creating a cascade of more fees, more arrears, and pushing the homeowner closer to delinquency. By the time the homeowner is aware of this, a servicer is threatening to foreclose unless a huge payment or refinancing happens.

This abuse is called “pyramiding late fees”; it is only one of many new ways servicers extract money from investors.
and homeowners. A related abuse is so-called dual tracking, where consumers work in good faith with lenders to negotiate a modification while other employees of the servicer relentlessly pursue a foreclosure. As Capt. Rowles found out when JPMorgan Chase told him his loan was delinquent, it can take years and costly legal expenses to set things right.

The system is designed to prevent people from accessing information. We don’t really know how pervasive such practices as pyramiding and overcharging are, how difficult it is for consumers to get errors corrected, or the extent to which services fail to hold valid notes and liens that legally allow them to foreclose. So the first step for reform is an in-depth investigation into how seriously servicers have exploited these conflicts and how it has affected both borrowers and lenders. This process is proceeding piecemeal though litigation and action by state attorneys general—but not comprehensively.

A full investigation would produce a public record of practices, based on the examination of records and testimony by witnesses. Once the scope and the particulars of abuses are clear, we need to establish responsibilities and rules for servicers to follow.

**A ROUGH DRAFT OF DECENT** rules is contained in a proposed general settlement drafted by the state attorneys general. The settlement would require that proper procedures be followed. For example, monthly payments must be applied to interest and principal first. Each monthly statement must be a comprehensive record of all money supposedly owed, by category. Dual tracking is flatly prohibited—servicers may not initiate foreclosure proceedings while a borrower is working in good faith on a loan modification. There must be a single point of contact between the servicer and the borrower. Documentation of liens and notes is required. There are also detailed procedures required for loan modifications.

This proposal is a promising start. But critics point out that it could let servicers and affiliated banks off the hook too easily. Some abuses were so extreme and fraudulent that they invite criminal prosecution, which should not be precluded by an across-the-board set-

In a speech to the Federalist Society right before he acted to pre-empt Georgia law, Comptroller John D. Hawke Jr., who headed the OCC, stated: “The private-investor secondary mortgage market in those states has been hard hit, particularly for subprime mortgages, because of actions taken by the rating agencies in reaction to those states’ predatory lending laws.”

Rather than creating rules up front, Hawke said he would seek out and stop abusive practices after the fact. As the crisis deepened last fall, *Mother Jones* reporter Andy Kroll asked officials how many complaints they investigated over the past decade. The OCC couldn’t think of any.

The enforcement of any settlement—or better yet, of tough regulations—needs to fall to the Consumer Financial Protection Bureau and be backed up by the state attorneys general, agencies better aligned with protecting the interests of consumers. But the new consumer bureau does not open for business until July, and without a permanent leader, it can’t take over many of the necessary responsibilities.

Whatever the problems of the settlement crafted by the attorneys general, the current counteroffer by the banks is even worse. The leaked settlement offer by the banks is nothing but a promise to do what they should have been doing all along. But whatever trust the largest banks may have had has been destroyed in the post-crash era, and any plan that has weak or nonexistent enforcement and penalties should be considered dead on arrival for progressives.

**PRESIDENT BARACK OBAMA’S** administration seems to be struggling with the question of whether foreclosures are a good thing or bad thing for the economy. The industry and some policy-makers contend that the housing sector has so many foreclosures to get through that the quicker we get through them, the better. If borrowers got mortgages that they didn’t deserve and couldn’t afford, the quicker these mortgages are dispensed with, the faster recovery will come. In this view, as long as the fore-


How many homeowners are underwater?

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Any consumer-protection plan with weak enforcement should be considered dead on arrival for progressives.

Foreclosures are spaced out enough to keep pressure off the banks, letting foreclosures happen ultimately gets us back to a better economy.

But this thinking is perverse. Foreclosures have huge social costs and put pressures on an already weak market. They put disinflationary pressures on an economy that is resorting to unorthodox monetary policy to keep prices steady. Foreclosures reduce the value of neighboring properties, causing uncertainty and retrenchment by neighbors.

As properties remain abandoned, blight and crime enter. The costs of a foreclosure to a municipality, which one study estimates is around $20,000 per event if the property is abandoned, put pressure on already weak local budgets. At that rate, two foreclosures is close to a teacher’s salary. The decision not to seek a comprehensive solution to the foreclosure crisis will likely be remembered by history as being as disastrous as Treasury Secretary Andrew Mellon’s infamous call to “purge the rottenness out of the system” through mass liquidation during the Great Depression.

The modifications that are most likely to work are ones with a serious reduction of principal owed. A recent study from the Federal Reserve Bank of Chicago has shown that modifications with a serious principal write-down are far more likely to work than ones that only reduce interest rates. Since servicers are paid first and as a percent of the balance, they take a loss to their business if they do a good write-down and gain income if they do a bad modification (since interest-rate cuts often come with increased principal amounts).

Studies also show that mortgages held on banks’ books where there are no servicers are far more likely to have a modification. Remember that a foreclosure is also a principal-reduction event, with current losses estimated to be as high as 70 percent. So the choice isn’t between a principal reduction and nothing but between a principal reduction that keeps the present owner from being displaced and one that results in a vacant, foreclosed house sold at a massive discount.

Rules for modifications can also deal with the conflicts of interest when the servicer is also a lender to the household. In the case of a second mortgage, the servicer’s position would have to be completely eliminated before a good loan modification can go through. Making servicers responsible for the entire loan, not just their part of it, can change their incentives.

Another part of the solution is to allow the modification of mortgages in bankruptcy. Under current law, judges aren’t able to modify a primary mortgage under bankruptcy as they do with other forms of debt. Bankruptcy is a central part of the safety net for middle-class families in the United States. It provides a way for people who have become overwhelmed by debts to discharge them, conditional on certain rules. It is a tool that can be adjusted to deal with new problems as they arise, and it is appropriate to change the code to deal with this new problem.

Adam Levitin of Georgetown Law School has proposed a “Chapter M” bankruptcy provision, a modified, partial bankruptcy to enable distressed homeowners to reduce the cost of their mortgage debts without suffering general bankruptcy. This approach would move foreclosure actions from state court to federal bankruptcy court. Successful petitions could be offered via a standardized, prepackaged bankruptcy plan. The plan might include a “claw-back” mechanism to address potential future housing-price appreciation. If the homeowner were to default again, the foreclosure process could be sped up. Going through the process could give the lender a clean title, which would help solve the documentation problems now pervading the industry.

The failure of the loan-servicing business model, from the robo-signing of bogus foreclosure documents, to junk fees, to blocked modifications, are not just assaulting consumers a second time but threatening the integrity of property records. This fiasco is also making the payment system for the largest lending market in the largest economy in the history of the world untrustworthy. The normal market forces that would bring this back into a healthy state have broken down. The government has a responsibility to expose bad practices, streamline regulations, and stop foreclosures from wrecking the economy. What needs to be done is clear. The only question is whether the political will exists.

Mike Konczal is a fellow with the Roosevelt Institute, where he works on financial reform and the larger economy. A former financial engineer, he blogs at Rortybomb and New Deal 2.0.
Fannie, Freddie, and the Future

The secondary mortgage market worked better when it was a true public institution.

BY DAN IMMERGLUCK

In the aftermath of the greatest housing crisis since the Great Depression, a fundamental debate is under way about the architecture of U.S. mortgage markets. At the heart of this debate is the future of Fannie Mae and Freddie Mac, the so-called government-sponsored enterprises (GSEs) that support the retail mortgage market. The eventual decision will have major implications for households and communities for generations to come.

The dominant proposals being offered rely heavily on private securitization of mortgages and minimize the role of the federal government in housing finance. For those who observed with alarm the house of cards built by Wall Street’s speculative mortgage products since the late 1990s, relying on private securitization and minimizing federal involvement to remedy the ensuing crisis may seem more than a bit odd.

In the late 1990s, subprime securitization engineered by investment bankers fueled the stripping of home equity from vulnerable homeowners and littered central-city neighborhoods with vacant properties. This “private label” securitization—so called because its sponsors did not go through Fannie or Freddie—fueled the largest housing boom and bust that the nation has ever seen. If reforms are dominated by private-label securitization, they are unlikely to restore a system that will provide loans that are both affordable and sound.

FROM PUBLIC AGENCY TO PRIVATE SPECULATION

Some history is in order to provide context. From its creation in 1938 until the late 1960s—a period of growing middle-class homeownership and stable mortgage markets—the Federal National Mortgage Association—or FNMA, nicknamed Fannie Mae—was not a “government sponsored” private enterprise. It was first a government agency—and later a government-owned corporation—created to purchase Federal Housing Administration (FHA)—insured loans from lenders in order to provide them with the liquidity they needed to make more loans. This government invention became known as the secondary mortgage market. Fannie financed its own operations by selling bonds.

Then, during the Vietnam War era, Fannie Mae was privatized. Thus began its status as a GSE, a private corporation with a public mission (providing housing credit) and a tacit government guarantee of its bonds. Soon thereafter, in 1970, a second GSE was created, the Federal Home Loan Mortgage Corporation, nicknamed Freddie Mac. In the 1970s, the two GSEs began pooling and securitizing conventional mortgages, leaving FHA loans to be securitized via the still public Government National Mortgage Association, inevitably nicknamed Ginnie Mae. (Ginnie and its partner, the FHA, incidentally, came through the recent crisis relatively unscathed.)

In the 1980s and 1990s, Fannie Mae and Freddie Mac expanded. They became a bigger risk to the U.S. economy because they were lightly regulated and increasingly behaved more like their purely private competitors. Then, in the 1990s and 2000s, Wall Street firms began issuing risky private-label mortgage-backed securities, whose lower standards did not require approval of the GSEs, to provide funding to subprime lenders. As subprime lending and its close cousin, “Alt-A” mortgages, boomed in the 2000s, the GSEs lost market share in the secondary market. To please their shareholders and regain market share, the GSEs began to enter higher-risk, higher-return segments of the mortgage market, first by investing in private-label securities. Later, in the mid-2000s, they began purchasing some riskier loans themselves, especially Alt-A loans, which typically required little or no borrower income documentation. Fannie and Freddie also beat back legislative efforts to increase regulatory oversight and the amount of equity capital they would need to hold in the event of financial problems.

By the eve of the collapse, the GSEs were engaged in purchasing individual mortgages from lenders and securitizing large pools of these mortgages by selling bonds to investors. They were also providing bond insurance on their securitizations and investing their own capital in both individual mortgages and private-label securities.

The subprime collapse took down Fannie and Freddie, which were deeply invested in subprime securities. The federal government put Fannie and Freddie into receivership in order to stabilize mortgage markets. Since the collapse of subprime and related mortgage-backed securities in 2007, the private-label market for mortgage-backed bonds has all but dried up, and the GSEs have funded almost all home loans other than those insured by the FHA.

BACK TO THE FUTURE

The reform of the secondary mortgage market is now the subject of a fierce debate that has ideological, political, and interest-group dimensions. Free-market purists want government out of the business of financing or insuring mortgage loans. The premise is that this activity is better handled by the free market, and if the result is more barriers to homeownership, this is just the correct and necessary verdict of the market.

Most of the housing industry—realtors,
homebuilders, mortgage bankers, and affordable-housing advocates—wants to retain some government involvement, for fear of an even steeper housing-market collapse. However, there is little support for continuing Fannie and Freddie in their present form. The large investment banks that invented private-label securities would like to provide many of the functions now served by Fannie and Freddie, though they want a government backstop to protect them against catastrophic failure and to help draw in critical investment capital.

In February, the Obama administration laid out three broad policy options for the long-term restructuring of the GSEs: 1) full privatization of secondary mortgage markets; 2) privatization with an “emergency” federal guarantee that would kick in only in crisis situations; and 3) a system of insuring mortgage-backed securities through a number of federally chartered, private mortgage bond insurance firms, or “private mortgage guarantors.” These firms would put private capital at risk before a federal reinsurance backstop would kick in. In option 3, Wall Street sees yet another new profit center, with government protecting against losses.

The options proposed by the administration seem to have been chosen based primarily on their ability to draw global capital back into the U.S. housing market relatively quickly, with less attention given to whether they will provide for a sound, fair, and affordable mortgage market. Moreover, some of the options are unlikely to reduce the mortgage market’s systemic risks to taxpayers.

**The Right’s Deceptive War on Government**

Among conservative commentators who have portrayed the GSEs as a driver of the subprime crisis is a particularly prominent group at the conservative [American Enterprise Institute](https://www.aei.org). This group has depicted the GSEs as a culprit in part by attempting to expand the definition of “subprime lending” by orders of magnitude. Traditionally, subprime mortgages include loans labeled subprime by issuers of private-label securities, which have high interest rates and payments. AEI’s group has [shrewdly attempted to redefine “subprime”](https://www.aei.org/), so that the term would include a much broader swath of outstanding mortgages, including many market-rate, conventional loans. In doing so, the group has suggested that 12 million subprime and Alt-A loans were purchased or guaranteed by the GSEs, while the traditional subprime definition yields a figure of fewer than 3 million. As the Financial Crisis Inquiry Commission’s final report argues, “The grouping of all of these loans together is misleading.... GSE loans with some riskier characteristics... are not at all equivalent to those mortgages in securitizations labeled subprime and Alt-A by issuers.” For example, GSE loans with credit scores below 660 had a delinquency rate of 6.2 percent, while traditionally defined subprime loans with a credit score below 660 had a delinquency rate of more than 28 percent. —D.J.

**The Perils of Privatization**

Options 1 and 2—those effectively calling for privatization—are the simplest to understand and are popular with Tea Party—wooing politicians who have latched onto “the GSEs did it” narrative of the mortgage crisis—one that seems to persist no matter the evidence to the contrary. Fans of privatization are frequently also in favor of repealing the Dodd-Frank Act. They would reinvent the same elements of the system that generated the subprime debacle. Some privatization proponents cling to the myth that government involvement in mortgage markets was a primary cause of the subprime crisis. In fact, it was too little, not too much, federal involvement—especially in terms of regulation—that was the main culprit. The crisis stemmed from under-regulated mortgage markets that had become fragile, overly leveraged, and highly susceptible to changes in home values.

None of this is to argue that the GSEs were sufficiently regulated. And the GSEs certainly participated in the subprime and Alt-A lending booms, especially by investing in private-label securities. However, they played a subordinate and trailing role. The core activity of the GSEs is to directly purchase loans. In the run-up to the crash, these loans were predominantly prime mortgages. Despite housing price declines of at least 30 percent, they have held up far better than mortgages funded by private-label securities. It was the loss of GSE market share that led Fannie and Freddie to invest in private-label bonds and purchase Alt-A mortgages.

Weak regulation and pursuit of profit for their shareholders—not carrying out their public mission—led Fannie and Freddie to invest in riskier assets.

Privatization proponents argue that, by removing explicit guarantees from the housing-financial system, they will protect taxpayers. This is a fatal mistake. The mortgage market will always be a large part of the economy and is increasingly dominated by a few large and potentially systemically important banks. As a result, implicit “too big to fail” guarantees will not be eliminated under a privatization scheme. On the contrary, without limited and explicit guarantees and associated oversight, the problem of implicit guarantees and their probability of being used actually increases. Moreover, as large banks are liable for poorly written loans, other explicit federal guarantees—in the form of deposit insurance—come into play. The U.S. mortgage market is simply too large and systemically intertwined to be isolated from federal guarantees.

“Housing-finance risk is inherently socialized because of the centrality of housing to society and as an investment,” says Adam Levitin, a Georgetown University law professor and widely recognized expert on mortgage markets. “The only question is whether the risk is socialized implicitly or explicitly.” What is referred to as “privatization” ignores the reality that these plans would almost certainly result in large and systemically important firms dominating the market, firms that will benefit from both explicit and implicit federal guarantees. As Janneke Ratcliffe, executive director of the Center for Community Capital at the University of North Carolina, recently told members of the Senate Banking Committee, “History has shown us that a housing-
finance system left to private markets will be subject to a level of volatility that is not systemically tolerable.”

Mortgages and housing values are susceptible to contagion effects that spread from home to home. Risky lending and higher foreclosures depress property values, leading to higher foreclosure rates among nearby homes, even among those with conservatively underwritten mortgages. Housing-finance systems should not fuel pricing booms that provide the basis for subsequent busts.

Because of these vicious cycles and interactions, mortgage markets are not like most other markets, where the harm from unwise transactions is mostly limited to the buyers and sellers. Moreover, contagion effects, and the size of the housing sector, mean that securitization and financial derivatives often spread—and magnify—risks that can trigger global financial problems. This means that it is important to develop mortgage-market systems that leave little room for reckless lending—and that effectively crowd out irresponsible, high-risk lenders. One way to do this is to write and enforce strong regulations. However, the vigor of regulation will inevitably ebb and flow over time. Therefore, an important complement to regulation is to preclude irresponsible or unaffordable loans in the design of the system itself.

The U.S. mortgage market is too large and intertwined without government backup and standards.

The U.S. mortgage market is too large and intertwined without government backup and standards.

THE CAP PROPOSAL: IMPROVING ON OPTION 3

Several groups—including the powerful Financial Services Roundtable representing the banking industry—have offered plans similar to the administration’s option 3. Among the stronger of these is a proposal prepared by the Mortgage Finance Working Group convened by the Center for American Progress.

The CAP proposal is similar to option 3 in that it relies primarily on federal reinsurance of federally chartered mortgage-bond insurers as the key vehicle for supporting the mainstream mortgage market. However, the CAP proposal includes several improvements and specifications. These include a duty-to-serve, or anti-creaming, provision that seeks to prevent bond insurers from creaming off more affluent market segments. It also provides funding measures and tools to support affordable homeownership and rental housing. The CAP proposal also calls for tight regulation of the bond insurers, explicitly favors long-term, “plain vanilla” fixed-rate mortgages, and calls for strong consumer-protection and financial regulations.

Despite such improvements, the CAP model relies too heavily on the assumption of a near flawless regulatory system. But recent history shows that purveyors of complex mortgage products tend to overwhelm regulators. It is preferable to design a simpler, more transparent, and more public system.

Even when Congress legislates strong rules, those measures are often weakened in later years or made obsolete by structural changes in financial markets. Regulatory agencies frequently fail to enforce the statutes adequately. A critical complementary strategy to stronger regulation is to constrain risk and irresponsible finance via the structure of the housing-finance system itself. The privatization proposals clearly fail in this respect. Option 3 and the CAP proposal are better than the others, but they are still overly dependent on regulators looking over the shoulders of the private securitization market, which is likely to seek opportunities to “innovate” around their regulators.

A key, underlying assumption of all three of the administration’s policy options is that, as secondary markets are dominated—and controlled—by private capital, they will become more accountable and averse to risky lending. There is certainly an argument for developing systems where lenders, investors, and servicers have interests that are aligned with sound and fair lending. But it is not at all clear that minimizing government involvement in secondary markets or marginalizing it to an indirect role will be a successful approach for achieving these ends, especially in the long run. Over the last 60 to 70 years, the only period during which a large portion of the mortgage market was essentially “privately” funded was the subprime-dominated period of the mid-2000s. From the 1930s through the late 1960s, deposits at commercial banks and savings and loan associations used for funding mortgages were fundamentally enabled by federal deposit insurance, and the secondary mortgage market was fundamentally a public institution.

The subprime crisis revealed the myriad conflicts among the many parties involved in the mortgage-origination and securitization chain. By precluding a direct government role, option 3 and its variants would make it more difficult to ensure that the mortgage market limits risks and conflicts of interest. While the CAP proposal generally prohibits access
to federal reinsurance for high-risk loans, the plan builds in a constituency that will seek to push the envelope—and lobby for increasingly relaxed boundaries on what can be included in insured pools. In the face of weakened standards or regulations in the CAP or option 3 models, competition among bond insurers could result in a race to the bottom, where lax insurers would be able to gain market share, just as Wall Street issuers of private-label securities captured market share from the GSEs.

A PUBLIC OPTION

A better alternative to all of these variants on privatization would be a model based on the advantages of government authority, centralization, standardization, and transparency. A government-owned corporation—call it the Public Mortgage Corporation, or PMC—with a public purpose would purchase mortgages and issue securities. This corporation would have no private shareholders and would return any excess earnings to the U.S. Treasury, much the way the Federal Reserve does.

The corporation would be prohibited from lobbying and be governed by a presidentially appointed governing body including members from the financial-services and housing industries as well as individuals with backgrounds in consumer protection, community development, and other areas. The PMC would not be a line agency of the government and would be given substantial autonomy to change guidelines and procedures for its operations, with only occasional review by Congress. However, there would be broad oversight of the PMC by Congress as well as an inspector general to ensure that the PMC was maintaining sound lending and securitization standards, that its fees were actuarially sound, and that it was not engaging in either disparate treatment or disparate impact discrimination of any sort. Moreover, the PMC would impose a fee on all securitization activity that would be used to provide support for affordable homeownership and rental-housing programs in safe and sound ways.

The PMC would provide only partial insurance for most of its mortgage-backed securities, with insurance levels dropping for bonds comprising larger loans and/or lower-risk borrowers. Moreover, it would be able to work in partnership with private bond insurers to blend private and public sources of insurance and leave private insurers to bear the first loss. The PMC proposal shares many of the goals of the CAP proposal. However, by centralizing the purchase, aggregation, and securitization processes, it will work to crowd out many issuers of dubious mortgage products.

The fundamental goal is to create a governance structure that provides public accountability to the primary mechanisms of the purchase, pooling, and securitization of mortgages. Providing a government-controlled, centralized, and standardized channel through which most mortgages flow will reduce housing-market and systemic risks compared to a privatized market where profit can be extracted by concealing rather than revealing underlying risks. It should also prove more efficient.

Some skeptics have expressed concern that a government-owned securitization firm would not be able to recruit the talent needed to maintain strong secondary markets. However, the PMC would not need to be subject to regular government salary caps and, like banking regulators, would be able to pay more to recruit staff with sufficient financial experience. At the same time, the goal should not be to use oversized salaries to recruit those normally attracted to high-risk Wall Street jobs. The goal, in fact, should be to limit the speculative nature of employment in mortgage securitization and motivate employees through generous but reasonable salaries and other career-building benefits. Organizations such as the Centers for Disease Control and Prevention, the National Institutes of Health, the government labs, and many other organizations have demonstrated that top-flight talent can be attracted and retained without mammoth salaries. The talents, skills, and knowledge needed in these organizations are at least as demanding as those needed in the secondary-mortgage-market arena. After all, secondary markets are not rocket science, and if they begin to look like rocket science, we are setting ourselves up for more problems.

One of the key advantages of the GSEs loan circuit compared to the private-label securities circuit was the much greater degree of standardization in loan origination, securitization, and servicing. There was also far greater transparency. Some argue that the privatization and bond reinsurance models would provide more opportunities for “innovation.” However, the financial collapse was partly caused by innovations intended to conceal and shift risks. And the potential for real innovations that benefit homeowners is more limited than private securitization proponents contend. If the collapse demonstrates anything, it shows that financial innovation should be carefully regulated. The PMC model would allow for careful and reasonable innovations that serve the interests of borrowers as well as lenders.

Whatever the final model, it should be judged on its ability to provide the public with some of the benefits from mortgage-market securitization, instead of solely having to absorb the downside of risks. Most important, the structure should complement and reinforce improved regulation in reducing the volatility of mortgage and housing markets by providing for a reliable governing mechanism on the flow of capital to finance affordable and secure homeownership.

The best alternative to replace a private Fannie Mae is a new public corporation with public accountability.

Dan Immergluck is a professor in the School of City and Regional Planning at Georgia Tech in Atlanta and the author of Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America’s Mortgage Market.
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