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Responding to the foreclosure crisis—A conference summary

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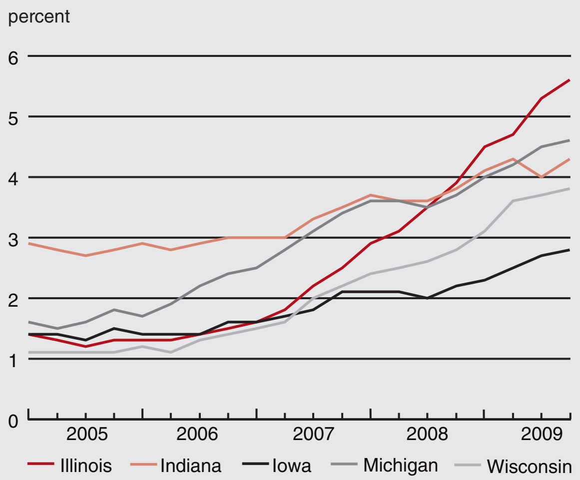
On December 9–10, 2009, the Federal Reserve Bank of Chicago hosted a conference on mortgage foreclosure policy with the help of the Chicago Community Trust, Neighborhood Housing Services of Chicago, the MacArthur Foundation, and the Woodstock Institute.

1. Foreclosure inventory rates in the Seventh District



NOTE: The figure shows foreclosure inventory for each state as a percentage of the state's total mortgages.
SOURCE: Mortgage Bankers Association from Haver Analytics.

The Chicago Fed has a long-standing commitment to addressing the causes and impacts of foreclosure, particularly in lower-income, lower-wealth areas of the Seventh District.[1] During the current financial crisis, foreclosures have reached historic levels in some communities. For example, the inventory of foreclosures in Illinois climbed from about 1% of total mortgages in the state at the end of 2005 to close to 6% at the end of 2009 (see figure 1). In response to this trend, the Chicago Fed partnered with Neighborhood Housing Services and the Chicago Community Trust to form the Regional Home Ownership Preservation Initiative in the spring of 2008; assumed leadership of the Federal Reserve System's Conference of Presidents Mortgage Outreach and Research Efforts (MORE) initiative, a national clearinghouse of research, resources, and communication related to foreclosure impacts, policy, and mitigation; and sponsored a number of conferences on the causes, ramifications, and policy options related to foreclosures.

The December conference brought together national experts from the advocacy, academic, financial, and government communities. This *Chicago Fed Letter* summarizes various proposals made by panelists, particularly concerning individual borrower defaults and the flow of credit for single- and multi-family housing. In a keynote address, Federal Reserve Board Governor Elizabeth Duke outlined her recommendations for a new market structure. These included simpler, more transparent markets; standardized contracts that spell out how the underlying mortgage can be amended; aligned incentives for all parties; and consumer protections, including support for housing counseling.[2] The recommendations presented below were made during the second day of the conference, when panelists were asked to talk about policies for the future.

Reaching distressed borrowers

Panelists agreed that the underlying causes of continuing high foreclosure rates have changed over the past year. In 2007 and 2008, single-family foreclosures were largely driven by unaffordable loan products; in 2009, they were increasingly triggered by a loss of income, unemployment, falling home values, and "strategic defaults." The last refers to defaults by borrowers who can afford to make their mortgage payments but choose not to do so, or try to renegotiate terms with the lender, often because their mortgage balances now exceed the market value of their homes. Panelists also agreed on the bleak prospects for a significant turnaround in the coming year. According to Mark Pearce, North Carolina Deputy Commissioner of Banks, nationwide one in four families with a mortgage will owe more than their home is worth in 2010.

Lender responses to the flood of defaults are also changing. Whereas nationwide, according to Pearce, one out of every two foreclosures initiated in 2008 was completed, the ratio for 2009 was one in seven. Lenders are learning that the cost of a vacant home (which may deteriorate and sell for less than an occupied home) can quickly outweigh foregone mortgage payments. However, Craig Nickerson, National Community Stabilization Trust, noted that as more lenders opt to keep nonpaying homeowners in their properties, they risk encouraging others to seek similar relief or simply withhold payments.

A number of speakers stressed the importance of identifying distressed borrowers, as opposed to strategic defaulters, and communicating effectively with them about how they can avoid default. Sendhil Mullainathan, Harvard University, explained that counseling and modification programs have to be designed with the understanding that distressed borrowers tend to avoid contact with their lenders and servicers—even when it is in their best interest to make contact and explore their options. Mullainathan argued that policy efforts should focus on getting services to this hard-to-reach population before lenders foreclose.

For example, in North Carolina, Pearce explained, the law requires loan servicers to provide the state banking agency with a notice of foreclosure 45 days in advance of the filing. This gives the agency a chance to encourage delinquent homeowners to contact local housing counselors. The state calculates that it has helped prevent 2,500 foreclosures in one year with this program and has reached about 12% of the targeted population.

Keeping people in their homes

Panelists also proposed: 1) expanding the use of mandatory mediation between borrowers and lenders; 2) streamlining the Obama administration's Home Affordable Modification Program (HAMP) process so that loan modifications are made permanent after three months of steady payments; 3) enacting bankruptcy reform that protects primary residences; and 4) imposing a moratorium on foreclosures for people who lose their jobs.

When borrowers cannot avoid default, Dean Baker, Center for Economic and Policy Research, proposed allowing them to stay in their homes as renters after foreclosure. He noted that Fannie Mae has recently started doing this under its Deed for Lease Program. This way, the community avoids adding to its inventory of vacant homes, which attract crime and reduce property values for everyone, and the lender retains an income stream from the property. Baker suggested that homeowners who convert to rental agreements could be allowed to convert back to ownership status after a defined period, assuming they have consistently made their full rental payments on time.

Elyse Cherry, Boston Community Capital (BCC), described the organization's SUN (Stabilizing Urban Neighborhoods) initiative, which allows defaulted homeowners to obtain a new loan on their existing home, based on a new appraised value. The new loans are structured such that borrowers cannot realize a near-term profit if markets improve, which helps to address concerns about fairness and moral hazard.

Mayor Jay Williams of Youngstown, Ohio, talked about his city's program to help build home equity as an incentive for homeowners to stay current on their mortgages. Williams explained that Youngstown's housing supply was developed for the population that lived in the city prior to the collapse of the steel industry. Because this now represents a significant oversupply, home prices are not going to recover on their own. In response, the city developed a plan to demolish vacant single-family units based on a comprehensive review of each neighborhood. The goal is to spark an appreciation in home values within the next five to 15 years.

In Chicago, two newly formed cooperatives in the west and south suburbs are using Neighborhood Stabilization Program[3] funds to seed property reclamation and redevelopment efforts. The key innovation of these groups, according to Robin Snyderman, Metropolitan Planning Council, and Jacques Sandberg, IFF (formerly Illinois Facilities Fund), is to encourage cooperation on housing, transportation, and land-use policies among municipalities that do not have the capacity to develop their own comprehensive solutions.

As noted earlier, unemployment has been an increasingly important factor in foreclosures since 2009, and community revitalization efforts clearly need to focus on jobs as well as home values. James Carr, National Community Reinvestment Coalition, suggested a job growth strategy based on job training and the promotion of business ownership.

Finally, Mullainathan encouraged people to think about mortgages and foreclosures as part of a broader consumer finance package and recommended the creation of programs to help people save for emergencies. Automatic savings mechanisms, like employer-sponsored plans that help workers save for retirement, would help people build up a financial buffer and, thereby, help prevent future foreclosure crises.

Housing markets and the flow of credit

A critical issue in the recovery of the housing markets is the flow of credit to single-family and multi-family housing, particularly for lower-income households. Although 2009 was one of the most affordable times in recent history to buy a house—with low interest rates and

More information on the conference is available at www.chicagofed.org/webpages/events/2009/mortgage_foreclosure_policy.cfm.

falling home prices—market volume was about half the size of that in the early part of the decade. James Linnane, Wells Fargo Home Mortgage, cited factors on both the demand and supply sides that inhibited the flow of mortgage credit. Consumer confidence fell to its lowest point since 1980. And with the elimination of many mortgage products and brokers and the consolidation of lenders, the remaining mortgage originators had to build their capacity to accommodate the unprecedented volume of business.[4] The transition from less restrictive to more restrictive underwriting and the implementation of hundreds of credit policy changes created additional complexity for lenders.

Several panelists highlighted the need to prevent the "financial pendulum," as Debra Schwartz, MacArthur Foundation, put it, from swinging too far back from a regulatory standpoint and cutting off credit to the lower end of the market. While policymakers and regulators are legitimately concerned about improving loan quality, getting credit flowing to borrowers is essential to recovery, not only for housing markets but for the economy as a whole.

Ellen Seidman, New America Foundation and ShoreBank Corporation, reminded the audience that in the 1990s, when "subprime mortgage" was not a pejorative term, the criteria that enabled lenders to lend safely to, by conventional standards, higher-risk borrowers were 1) products with no surprises regarding payment or escrows; 2) thorough and legitimate underwriting; and 3) collaboration among lenders, community organizations, and state and local governments, which in some cases provided subordinated, forgivable, or nonamortizing debt and other credit supports or enhancements. Seidman cautioned that a return to pre-1990 underwriting standards would have a negative impact on lower-income communities.

Keith Ernst, Center for Responsible Lending, noted that in recent years, borrowers at the low end of the credit spectrum were often targeted for poorly underwritten loan products. Today, he added, such borrowers are finding it increasingly difficult to access mortgages at any price. This is having an adverse impact on many minority borrowers in particular. Ernst called for reasonable lending policies that allow responsibly underwritten credit to flow to impacted communities while prohibiting predatory lending.

Craig Nickerson, National Community Stabilization Trust, also described a mortgage system divided increasingly into the "haves" and "have-nots." Homeowners in the have-not neighborhoods are becoming less willing to pay their own mortgages as nearby properties deteriorate and their neighborhoods lose access to credit; the result is inevitable neighborhood decline. Nickerson identified the critical need for (but dearth of) capital to acquire and renovate distressed properties to stem this tide. He explained that low-cost capital to renovate properties is needed to attract lenders to provide first mortgages. He recommended leveraging government funds with private sector capital for this purpose.

Several panelists also discussed the role of government-sponsored enterprises (GSEs), such as Fannie Mae and Freddie Mac, and the Federal Housing Administration (FHA) in providing competition in the market for mortgages. Both Nickerson and Mark Willis, visiting scholar at the Ford Foundation, gave their support to the GSE model that balances shareholder interests with public sector obligations. Craig Marchbanks, Chicago Fed, argued that the GSEs' success would depend on their ability to engender confidence in their underwriting standards. This is a basic requirement to generate confidence in the secondary market, where mortgages are bundled and sold to investors. Willis also noted that whatever regulations are put in place for the GSEs, thought has to be given to creating a level playing field for the industry as a whole. He noted that unless all providers of mortgage credit are regulated equally, there will be a race to the bottom; the least regulated players will offer the mortgages they want, while the more regulated players will lose market share.

Panelists agreed that the FHA has an important role in offering mortgage credit to borrowers with modest incomes or relatively weak credit histories. They gave the FHA high marks for its administrative improvements in making the application process friendlier to both borrowers and lenders. Linnane observed that FHA loans are less costly than other conventional loans with high loan-to-value ratios (i.e., low down payments) once mortgage insurance costs and other add-ons are included. Nickerson downplayed the risks associated with the FHA's market share growing from 3% to 30% between 2005 and 2009, as the FHA has hired new risk managers. He would nonetheless like to see the ratio of FHA-insured mortgages decline to 15%, he added, as other lenders compete for borrowers. Linnane noted that certain FHA lenders do face the risk of adverse selection as a growing number of other FHA lenders impose their own (internally developed) minimum credit scores on traditional FHA guidelines. He said it might be better to limit FHA lenders to applying FHA credit standards, with no authority to impose additional, more stringent criteria.

Willis drew on his experience with the Community Reinvestment Act (CRA) to illustrate the complexities associated with developing regulatory policy. CRA motivated many banks to dialogue with community groups and to set up specialized

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units to learn the intricacies of lending in low- and moderate-income communities. However, to ensure the CRA's effectiveness and impact going forward, Willis suggested that the four bank regulators[5] need to reach consensus on enforcement practices and adapt tenets of the law to comply with changes in the financial landscape that have taken place over time. Mainly, these adaptations should recognize the larger geographic markets of many institutions; spur the building of more mixed-income housing, with up to 50% of units targeted to lower-income residents; and encourage economic development activities aside from housing. The challenge, he added, is that changing the legislation has proven difficult in the past, and despite evidence to the contrary, the CRA has been linked to (and tarnished by) the financial crisis.

Erika Poethig, U.S. Department of Housing and Urban Development, discussed credit flows to the multi-family rental market. Like the single-family market, the multi-family market has seen rising delinquencies and defaults. John (Jack) Markowski, Community Investment Corporation, suggested increasing rental subsidies to keep people in their apartments. He also noted that maintaining the stock of multi-family rental housing is crucial so that affordable rentals are available once the current trend of combining households tapers off. Poethig explained that the Obama administration intends to promote a "balanced" housing policy, including giving more thought to improving the tenure security of renters. She also noted that the administration is advocating the use of the Low Income Housing Tax Credit (LIHTC) to rehab existing rental buildings that have benefited from federal investment, and has put preservation activity at the top of its agenda.[6]

Conclusion

The foreclosure crisis is fundamentally linked to conditions in the broader economy, including loss of income, high unemployment rates, and falling home prices. While there are no easy fixes, a few common principles for addressing this crisis emerged from the various recommendations. One was that the federal government should treat the states as partners in mitigating foreclosures, recognizing that many state and local governments are already working on ways to keep people in their homes. Another was that the risk of excluding whole neighborhoods—and even whole groups of potential borrowers—from the mortgage market is real; the intervention message needs to change from "we are trying to help only the vulnerable" to "by helping the vulnerable, we help everyone." Conference speakers broadly agreed that the longer it takes to follow through with bold actions, the more families and communities will face economic hardships and the slower and more challenging the road to recovery will be.

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1 The Seventh District comprises all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin.

2 Governor Duke's speech is available at www.federalreserve.gov/newsevents/speech/duke20091210a.htm. A more complete overview of the conference will be published in an upcoming edition of *Profitwise News and Views*, the Community Affairs publication of the Chicago Fed.

3 This is a program of the U.S. Department of Housing and Urban Development. For details, see www.hud.gov/offices/cpd/communitydevelopment/programs/neighborhoodspg/.

4 For example, Wells Fargo went from around $14 billion to about $44 billion in monthly mortgage loan volume.

5 The Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision.

6 State and local LIHTC-allocating agencies have the authority to issue tax credits to investors for the acquisition, rehabilitation, or new construction of rental housing targeted to lower-income households.