Informing the Future of Housing Finance: Lessons from the Recent Past

Remarks for the
Indianapolis Neighborhood Housing Partnership (INHP)
Community Breakfast
Indianapolis, IN
August 24, 2010

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

FEDERAL RESERVE BANK OF CHICAGO

Informing the Future of Housing Finance: Lessons from the Recent Past

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

It's a pleasure to be here this morning. Since the start of the financial crisis, the Federal Reserve System has undertaken a series of unprecedented actions to help stabilize the financial markets and promote economic recovery. What is less well known is that the Federal Reserve has also been working to respond to the foreclosure crisis on Main Street, leveraging its research, community affairs and supervision and regulation functions to support innovative foreclosure prevention and neighborhood stabilization strategies at the local level. Today, I want to focus my remarks on some of those efforts as well as on other public policies that have been used to address the foreclosure crisis. Finally, I'd like to offer a few thoughts on policy alternatives that may prevent similar problems from occurring in the future.

As a nation we value homeownership because of the many benefits it brings, for both families and communities.[1] Perhaps foremost is its potential for building household wealth. In addition, communities with high levels of homeownership tend to have greater involvement in school and civic organizations, higher graduation rates, lower housing turnover and higher home values. Simply stated, homeowners tend to put down deeper roots, and that is good for communities as well as families.

Recognition of these benefits has made encouraging homeownership a national priority. Tax incentives, FHA mortgage insurance and sponsorship of Fannie Mae and Freddie Mac all contributed to a long rise in U.S. homeownership—from 45 percent in 1940 to a peak of 69 percent in 2004.

Of course, homeownership is only good for families and communities if it can be sustained. Home purchases that are very highly leveraged or unaffordable subject the borrower to a great deal of risk. There's no guarantee, as we've learned recently, that prices have to rise. Moreover, even in a strong economy, unforeseen life events and risks in local real estate markets represent vulnerabilities for highly leveraged borrowers.

Thus it was very destructive when, in the early part of this decade, dubious underwriting practices and mortgage products inappropriate for mass consumption became more common. It is difficult to understand how loose underwriting, high degrees of leverage and the broad marketing of exotic and often very high-cost mortgage products can promote homeownership. In fact, these practices actually took us in the other direction, as homeownership began to decline even while mortgage underwriting standards continued to loosen. Moreover, partly as a result of these practices, we've seen an unprecedented housing market collapse that contributed to a very deep recession marked by many lost jobs. And now homeownership has declined for six straight years.

Although there are some encouraging signs of general economic recovery and some evidence of home price stabilization, we are certainly not out of the woods. Projections suggest foreclosed housing units could reach as high as 3 million in 2010 with over a million lender repossessions. Mortgage distress is not limited to those with subprime loans. For example, in the state of Indiana, the inventory of subprime foreclosures actually decreased by about 4 percent from 2008 to 2009, while the inventory of prime foreclosures rose by over 36 percent. This is because job loss and unemployment are now causing more defaults than imprudent lending.

Public policy response to the housing market collapse has become increasingly aggressive as its seriousness and difficulty has been more fully recognized. Foreclosures are very costly for borrowers, lenders and communities. Prices of foreclosed homes often drop dramatically, implying big losses for lenders. Values of nearby homes are also affected, so large clusters of foreclosures can be devastating to communities.

One might expect lenders to modify mortgages, making them more affordable for borrowers, rather than accept large losses on foreclosed properties. However, the securitization process appears to have created conflicts between the interests of servicers and lenders. These and other impediments have kept the number of modifications lower than we might have hoped. The desire to see more modifications and fewer foreclosures has led to federal efforts, such as the Home Affordable Mortgage Program, or HAMP. To date, the number of successful modifications remains relatively small compared with the scale of the problem. Thus the search for solutions goes on. Some recent additions to HAMP include assistance for unemployed homeowners, more principal write-downs and plans to launch the FHA Refinance Option later this year. While the number of loan modifications are small compared with the number of foreclosures, one success the industry cites is that the programs have brought some standardization and consistency to the market.

In addition to federal interventions, many local and state agencies, as well as local practitioners have worked to lessen the effects of the crisis. They have pursued strategies ranging from land banking to court prescribed mediation between borrowers and lenders. The Chicago Fed has been very happy to partner with other organizations in many of these efforts, lending its resources to assist throughout the Seventh Federal Reserve District.

We've convened meetings of the key groups working toward mitigating the effects of the crisis. We have participated in research efforts to identify gaps in resources needed for foreclosure mitigation. And we've formed work groups to bring resources to the hardest hit areas. Home buyer counseling is a critical need in hard-hit areas, and we've helped many of our community development partners to organize daylong "mega-events" that have served thousands of troubled borrowers. Moreover, we've partnered with and brought together housing advocates, lenders, academics and key government officials to discuss foreclosure issues and develop solutions. In some cases, alliances have been formed right on the spot to create and implement programs to keep people in their homes.

Here in Indiana, the Chicago Fed has had a long-standing working relationship with the Indianapolis Neighborhood Housing Partnership (INHP) on affordable housing and homeownership preservation issues. We've also worked with others throughout Indiana, such as the Mortgage Fraud and Foreclosure Task Force, the Indiana Mortgage Bankers Association and the Indiana Foreclosure Prevention Network. We regularly participate in homeownership preservation seminars, which provide delinquent borrowers with access to their mortgage lenders for the purpose of finding options for staying in their homes. And, as job loss has become a leading cause of foreclosures, we've been working with a number of organizations in Indiana to help promote employment in local communities.

It's easy to be discouraged about the outcomes of efforts to deal with the mortgage crisis. While we can point to efforts that have saved thousands of homeowners from foreclosures, millions are still losing their homes. But, while we could always hope for more, I think the groups like INHP that have worked on this very difficult problem have a lot to be proud of.

I'd now like to talk briefly about the question of what can be done to prevent problems like this from recurring in the future—a topic that I think is informed by some recent research done at the Chicago Fed, including on a paper on a program run by INHP. The mortgage crisis was caused in part by the use of inappropriate mortgage products. While economists usually give great respect to individual choice, in this case it seems that many borrowers made poor choices and that at least some lenders abetted those poor choices. People who had no business getting exotic mortgages, such as those without amortization, not only got them, but got them without having their income and ability to pay verified.

How might public policy respond to evidence of people being put into inappropriate nonstandard mortgage products?[2] One possibility would be to impose very stringent regulatory oversight that eliminates such products all together. Such a policy would certainly prevent unqualified borrowers from obtaining high-risk mortgage products. However, such specialized products may actually be appropriate for certain people, so such a policy would have some real costs.

An alternative approach would be to place few restrictions on the choices available to borrowers and rely instead on better educating them about homeownership and mortgages. That would make borrowers better prepared to make informed financial decisions. Such an approach might keep those who shouldn't be in exotic mortgages from getting them while leaving such mortgages available to the small group of people for whom they are appropriate. A big question, however, is whether financial education can work.

Staff members at the Chicago Fed have recently undertaken a thorough review of studies evaluating the effects of financial education.[3] What they find is that the evidence on the effectiveness of education and counseling is rather mixed. Some financial education programs improve financial outcomes, and some portion of this effect is due to increased financial literacy. However, other programs are less successful. More rigorous evaluation of specific programs is necessary to understand what can be done. My take is that financial education can work, but the programs must be very well designed and rigorous for financial education to be truly effective. Whether such programs can be implemented on a wide scale at reasonable costs is an open question.

One of the programs our staff evaluated was that of the INHP.[4] As many of you know, the INHP program serves low- and moderate-income households, on a strictly voluntary basis. The goal is to prepare borrowers for homeownership by shoring up their finances. Classes and one-on-one counseling sessions cover money management, budgeting, credit score maintenance and home buying mechanics.

The program can take up to two years, and clients are considered successful if they are able to satisfy underwriting guidelines of external lending partners or the INHP lending committee. The program has strict requirements, and clients that cannot keep up may be asked to leave. Importantly, INHP continues to work with the client after the home purchase and is actively involved with the client if problems occur.

Previous research showed that INHP clients improved their credit scores during counseling, better preparing them for the mortgage application process.[5] Our researchers evaluated whether this translated into better loan performance. The answer appears to be that it did. Compared with other borrowers, INHP clients on average started with significantly lower FICO scores and incomes. They also typically had lower down payments. Yet, despite entering the mortgage process in worse financial shape relative to other borrowers, INHP clients had a lower default rate over a 12-month period—they had a rate of 3.8 percent versus 6.3 percent for other borrowers. Importantly, after controlling for an array of additional influences, the difference between the default rates of the two groups appears even stronger—the 12-month default rate was typically 8–9 percentage points lower for INHP clients than for comparable borrowers not participating in the program. This is impressive and I want to recognize the INHP for its efforts.

That said, the success of counseling is certainly not guaranteed. Our researchers also evaluated the effects of a mandatory counseling program introduced in Chicago as a result of a controversial piece of legislation called Illinois House Bill 4050.[6] This law grew out of concerns that predatory lenders were taking advantage of naïve, less sophisticated borrowers in certain markets. It required low FICO score applicants or those taking out nontraditional, high-risk mortgages in certain zip codes to go through a brief counseling session with a HUD-accredited counselor prior to the contract closing. The purpose was to discuss the contract terms and whether the loan product was a good fit for the mortgage applicant. This session typically occurred a few days prior to the closing. Our researchers found that such counseling had little effect. This is perhaps unsurprising given its extent and when it took place. Increasing participants' financial sophistication is not easy.

The ineffectiveness of the program's counseling did not, however, mean this program had no impact. In fact, our researchers found that the introduction of the mandatory counseling program significantly changed the behavior and performance of borrowers. Specifically, fewer high-risk loans were originated because some lenders, concerned about having their mortgage terms scrutinized by counselors and being accused of predatory lending, chose to exit the market. Additionally, borrowers were able to avoid the counseling sessions by taking alternative mortgage products that did not require financial counseling. While one can argue that this decrease in the supply of mortgages had a downside in terms of decreasing borrowers' choices, the analysis found that the borrowers who were able to obtain mortgages performed significantly better than similar applicants in zip codes without the counseling requirement.

These two programs each affected the performance of loans, but they did so in quite different ways. In the case of INHP, the counseling apparently affected the behavior of potential borrowers and helped applicants better perform on their mortgage arrangements. In the Chicago program, a positive impact resulted from some lenders avoiding the new environment and borrowers choosing products that did not require counseling.

These findings fit quite well with the principles of a relatively new school of thought known as behavioral economics, which recognizes that people frequently make substantial mistakes in their economic decisions. In fact, these mistakes are so systematic that it is possible to alleviate many of their worst consequences by marginally adjusting the context in which the decisions are made. The costs resulting from the adjustment may be relatively minor and less costly, for example, than the consequences of prohibiting certain products altogether. In mortgage markets, prohibitions of products intended to "protect" borrowers could result in significant reductions in the availability of credit. This could prove costly as it would preclude some qualified customers from obtaining higher-risk mortgage products that they readily understand and can repay.

Additionally, behaviorists would argue that mass-scale counseling to promote informed financial decision-making may be very difficult and costly. A behaviorist's approach would be to give consumers choices, but to incent them to make what policymakers would consider most likely the proper choice more frequently. For example, in the affected Chicago markets, the borrowers were free to choose among alternative product offerings, but had to participate in the counseling program if they took out a high-risk mortgage product. Thus this relatively low-cost incentive to avoid the high-risk product was quite effective at "nudging" borrowers toward the low-risk product option—usually the "proper choice" from a public policy perspective. We may look to behavioral economics more often as we evaluate new policy options aimed at avoiding the mortgage market problems we have seen in the recent past.

In summary, I've discussed the public policy response, including the role of the Federal Reserve Bank of Chicago, as the housing market crisis has evolved. I have also discussed the means to protect against future foreclosure problems by better preparing loan applicants for the homeownership process. While financial education and counseling can be effective in generating more knowledgeable homeowners, they must be administered in a way that is timely and appropriate for both the borrower and the lender. Obviously, effective programs require significant time and effort if they are to result in significant changes in behavior and financial performance. Alternative approaches that attach small costs to choices that are likely to be risky are, I think, also well worth considering. At the Fed, we will continue to do our part to encourage further research, participate in the dialogue and coordinate concerned groups that want to work toward sustainable housing markets, whatever form they may take.

Thank you.

---

[1] See, for example, Daniel Aaronson, 2000, "A note on the benefits of homeownership," *Journal of Urban Economics*, Vol. 47, No. 3, May, pp. 356–369; Robert D. Dietz, 2003, "The social consequences of homeownership," Homeownership Alliance, report, June; Denise DiPasquale and Edward L. Glaeser, 1999, "Incentives and social capital: Are homeowners better citizens?," *Journal of Urban Economics*, Vol. 45, No. 2, March, pp. 354–384; and Richard K. Green and Michelle J. White, 1997, "Measuring the benefits of homeowning: Effect on children," *Journal of Urban Economics*, Vol. 41, No. 3, May, pp. 441–461.

[2] In the future, finding that correct balance will be the responsibility of the newly created Consumer Financial Protection Bureau introduced by the recent passage of the financial regulatory reform bill (H.R. 4173, also known as the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010). The bureau will essentially have independent rule-writing for consumer protection laws and examination authority over large financial and nonfinancial institutions.

[3] See Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet and Douglas D. Evanoff, 2010, "Financial counseling, financial literacy and household decision-making" in *Financial Literacy: Implications for Retirement Security and the Financial Marketplace*, Olivia S. Mitchell and Annamaria Lusardi (eds.), New York and Oxford, UK: Oxford University Press, forthcoming.

[4] Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet and Douglas D. Evanoff, 2010, "Learning to cope: Voluntary financial education programs and loan performance during a housing crisis," *American Economic Review*, Vol. 100, No. 2, May, pp. 495–500.

[5] Eric Hangen, 2007, "Case study: Impacts of homeownership education and counseling on purchasing power of clients of INHP, Indianapolis, IN," Center for Housing Policy, report, November.

[6] Sumit Agarwal, Gene Amromin, Itzhak Ben-David, Souphala Chomsisengphet and Douglas D. Evanoff, 2008, "Do financial counseling mandates improve mortgage choice performance? Evidence from a legislative experiment," Ohio State University, Fisher College of Business, working paper, No. 2008-03-019.