

Responding to the Foreclosure Crisis

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Abstract

Regional economic downturns, speculation on skyrocketing home prices, and rampant unfair and deceptive mortgage lending practices have combined to create the perfect foreclosure storm in America. More than 2 million foreclosures are expected to occur during the next 12 to 18 months. Common to all three of these contributing factors is the reality that effective regulation of the mortgage market would have greatly limited damage from foreclosures.

This article traces the origins of the subprime market crisis and the resulting impact of foreclosures on the housing market, minority households, and the economy. The article also reviews the effectiveness of current interventions to mitigate or limit foreclosures and recommends broader solutions to help families maintain their homes.

Keywords: Foreclosure; Homeownership; Subprime lending

Introduction

“It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance your home with a mortgage that has a one-in-five chance of putting the family out on the street....”

Elizabeth Warren (2007)
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Regional economic downturns, speculation on skyrocketing home prices, and rampant unfair and deceptive mortgage lending practices have combined to create the perfect foreclosure storm in America. According to the Federal Deposit Insurance Corporation, outstanding subprime mortgage debt equaled roughly \$1.3 trillion as of 2007 (Poirier 2007). In 2006 alone, more than \$600 billion in subprime mortgages were originated (“Top 20 Subprime Servicers” 2006). RealtyTrac data indicate that about 450,000 homes experi-

enced foreclosure in the third quarter of 2007; this is twice as many as there were during the same period a year ago (Yoon 2007). And although they are most heavily concentrated in 12 to 20 states, foreclosures are up in 45 of the 50 states. Federal Reserve Board Chairman Ben S. Bernanke (2008) reported that 21 percent of subprime adjustable-rate mortgages (ARMs) were 90 or more days delinquent as of January 2008, and according to the Center for Responsible Lending (CRL) (2007), fully one in five subprime loans is expected to fail. That is estimated to translate into more than 2 million families losing their homes to foreclosure during the next 12 to 18 months (CRL 2007). Estimates of the full economic cost of the foreclosure crisis vary greatly. The projections, however, all agree on the prospect of significant financial costs extending beyond the housing market.

Collapse of the subprime market

In November 2007, the U.S. House of Representatives voted overwhelmingly to approve a comprehensive anti-predatory lending bill (H.R. 3915). One of the key provisions of that legislation bars financial institutions from making mortgage loans to consumers who cannot repay those loans. This provision serves as a metaphor for the dysfunctional practices that have come to define the subprime market during the past decade. Studies and reports on subprime loans reveal problems in almost every aspect of the subprime lending process (Carr 2006; Carr and Kolluri 2001; CRL 2007; Engel and McCoy 2002; National Community Reinvestment Coalition [NCRC] 2002, 2005, 2007; Schloemer et al. 2006). In fact, nearly a decade ago, the North Carolina legislature passed a law that prohibits predatory lending (N.C. Gen. Stat. §24-1.1E). Inappropriate loan products, inadequate underwriting, bloated appraisals, abusive prepayment penalties, excessive broker fees, the steering of borrowers to high-cost products, and servicing abuses have been widely reported (Calem, Hershaff, and Wachter 2004; Eggert 2004; Engel and McCoy 2004; Farris and Richardson 2004; Lax et al. 2004; Quercia, Stegman, and Davis 2004; Renuart 2004; Seifert 2004; White 2004; Wyly, Atia, and Hammel 2004).

The funding of subprime loans has also played a major role in the crisis. The rating of securities as investment-grade products backed by loans that might aptly be described as subprime mortgage junk bonds fueled the funding pipeline that enabled the exponential growth of the subprime market. Without the extraordinary access to financing provided by securitization, the growth of that market would have been greatly limited and the financial damage to homeowners and the economy significantly reduced.

Before securitization, banks were meticulous about making sure that borrowers could repay their loans. That was because banks held the loans in their portfolio. In short, their own money, and that of their customers, was at risk. But with securitization, this self-regulatory incentive mechanism was lost.¹ And despite this transformation of the markets, federal regulation of the mortgage lending industry grew more and more inadequate. The result was increasingly risky behavior on the part of mortgage lenders, particularly in the subprime market. In recent years, a majority of the subprime mortgages peddled to consumers have not been structured or underwritten to sustain homeownership; rather, they were intended to lock borrowers into a financial relationship with mortgage brokers and mortgage finance companies whereby loans had to be refinanced, usually within two to three years, for payments to remain affordable. With each refinancing came another set of up-front broker and mortgage finance fees and servicing and securitization revenue. Securitization of the underlying assets allowed the risks of these products to be spread widely, literally to investors around the world (Landler 2007; National Public Radio 2007; Paletta and Hagerty 2007; Werdigier 2007). The result was billions of dollars in profit while millions of families were put at high risk for foreclosure.

Subprime lending increasingly became an unstable house of cards—a market that gave the appearance of performing well but in reality depended upon unrealistically high and unsustainable increases in home prices. In fact, irresponsible lending practices contributed greatly to the artificial ballooning of house prices by offering home buyers financing terms that created the illusion of affordability and encouraged them to purchase properties that were far beyond their financial reach. When house prices began to soften in 2005, the foundation under the subprime market's house of cards began to collapse. But it was not until losses led to the implosion of a billion-dollar Wall Street hedge fund (Morgenson 2007) that the woes of the subprime market rose to public prominence and almost daily press coverage. Today, the subprime market is a shambles, together with many of the blue-chip financial institutions that supported it. Major banks and investment firms have written off more than \$70 billion in losses (Mavin 2007). Billions in additional losses have yet to be recognized. According to Robert Barbera, chief economist at Investment Technology Group, “[T]here was financial alchemy at work” (Norris 2007).

¹An exception to this circumstance may be loans sold to Fannie Mae and Freddie Mac, whereby these government-sponsored enterprises tend to have more strict underwriting guidelines and more aggressively exercise recourse for loans that do not conform to those requirements.

Estimating the damage

According to the U.S. Congress's Joint Economic Committee (2007), an estimated \$71 billion in housing wealth will be lost directly as a result of foreclosures, and an additional \$32 billion will be lost indirectly by the spillover effects on neighboring properties. CRL estimates this combined loss of housing value at \$164 billion (Schloemer et al. 2006). Moreover, recently released studies indicate that the financial trauma will not be limited to losses in housing equity. As house prices slide, so do local real estate-based taxes. According to the U.S. Conference of Mayors, 10 states alone will lose an estimated \$6.6 billion in local revenue this year (Global Insight 2007). That same report projects a 1 percentage point reduction in gross domestic product growth, with a concomitant loss of more than a half a million jobs (Global Insight 2007). The *Wall Street Journal* reports total estimated losses from subprime and similar mortgages to be on the order of the S&L crisis of the 1980s, ranging from \$150 billion to \$400 billion (Ip, Whitehouse, and Lucchetti 2007).

According to Martin Feldstein, president and CEO of the National Bureau of Economic Research, a recession is likely (Berner and Greenlaw 2007; Isidore 2008). The prospect of a recession is particularly troubling because an increase in the number of jobs lost will further destabilize the housing market by placing an even greater number of borrowers at risk of foreclosure. And if the stock market's performance in the opening days of 2008 is an indication of things to come, 2008 will be a difficult year. Stock market losses in the first three days of 2008 were the largest opening-year three-day loss since 1932 (Karmin 2008). Moreover, unlike the 2001 recession, consumers will not have the same access to home equity to help them weather the economic storm. Economic distress could also further expose weaknesses in the prime market and its growing troubles with pay-option ARMs (option ARMs) (Reckard 2007). Resets on option ARMs, which were mostly limited to the prime market, will peak in 2009 and 2010 (Credit Suisse 2006).

The ripple effects of this foreclosure crisis are not limited to the United States. Securities backed by U.S. subprime loans have been sold around the world and are affecting businesses and international markets. In September 2007, for example, subprime losses caused a run on Northern Rock, a British bank, prompting the Bank of England to issue a blanket guarantee of all deposits at U.K. banks (Werdigier 2007). On November 12, 2007, Asian equity markets fell sharply, in part because of fears over the U.S. subprime market (National Public Radio 2007). In December, Europe's Central Bank poured an unprecedented half a trillion dollars into the financial system

for short-term loans to banks in hopes of averting a year-end meltdown in Europe's money markets (Paletta and Hagerty 2007). In fact, even the remote fishing village of Narvki, in Norway, was reported to have been harmed by the subprime market's collapse, due to the purchase of securities backed by U.S. subprime loans (Landler 2007).

The economic damage from the foreclosure crisis may not be limited to market losses. The number of legal actions is rising and may have a further chilling impact on lending. On January 8, 2008, Baltimore's mayor and city council announced a lawsuit (*Mayor and City Council of Baltimore v. Wells Fargo*) charging lending discrimination by Wells Fargo against black home buyers (Morgenson 2008). The suit claims that in 2006, 65 percent of loans made by Wells Fargo to black customers in Baltimore were high-cost mortgages, compared with only 13 percent of loans to white customers. A few days later, on January 11, the city of Cleveland sued 21 banks for their allegedly inappropriate role in financing failed subprime mortgages there (Pierog 2008). Depending on the success of these cases, other cities may follow suit. Also, at least two states are pursuing legal action against mortgage lenders for discrimination or fraud (Irwin and Johnson 2008).

Finally, in January 2008, the Federal Bureau of Investigation (FBI) announced an ongoing criminal probe of 14 companies for possible fraud in the subprime mortgage market. Although the names of the companies have not been released, fraud has been identified in all areas of the subprime mortgage market, including fraudulent underwriting, scam foreclosure rescue schemes, accounting fraud, insider trading, and trading of replicated mortgages on the secondary market. According to the FBI, mortgage fraud has been on the rise for the past few years and is spreading across the country; the number of complaints of suspicious activities rose from 3,000 cases in 2003 to more than 48,000 in 2007 (Dobbs 2008). The FBI is also working with the Securities and Exchange Commission on about three dozen civil investigations into the role of mortgage brokers, investment banks, and due-diligence companies involved in the underwriting and securitization of loans (Perez and Scannell 2008). Dozens of lawsuits involving homeowners, lenders, Wall Street banks, and investors are piling up (Bajaj 2008).

Disproportionate impact on minorities

While high foreclosures are impacting families across the income and racial/ethnic spectrum, the families and communities most negatively affected are black and Hispanic. According to a 2006 Federal Reserve study, fully 45 percent and 55 percent of the then outstanding home loans to Hispanic

and black households, respectively, were subprime. These utilization rates for subprime lending are three to four times those of non-Hispanic white families (Avery, Brevoort, and Canner 2007; NCRC 2003, 2007).

According to a 2008 report by the nonprofit policy center United for a Fair Economy, the foreclosure crisis will result in the greatest loss of wealth for people of color in recent U.S. history. The report estimates that black borrowers will lose between \$71 billion and \$122 billion, while Hispanic borrowers will lose between \$76 billion and \$129 billion (Rivera 2008). As is the case with other estimates of prospective economic impact mentioned earlier, it is not clear how precise these numbers are. But even if these estimates overstate the economic damage by 50 percent, the resulting damage to asset holdings for blacks and Hispanics would remain staggering for those households, given their relatively low wealth status at the outset.

Justification for intervention

One of the most frequently expressed arguments against helping homeowners facing foreclosure is concern over the moral hazard of aiding consumers who knowingly made risky choices. The most popular reflection of this sentiment is captured in the phrase “liar loans,” which refers to low- or no-documentation loans on which it is argued that borrowers knowingly and intentionally provided inaccurate personal financial information. While it is likely true that some homeowners intentionally misled lenders about their incomes and savings, it is equally true that subprime lenders were not diligent in soliciting factual information. It is also likely that borrowers actually submitted truthful information about their employment and income that was subsequently modified by brokers. It is plausible, too, that many financially unsophisticated borrowers followed the lead of their brokers or lenders and provided information consistent with what was required of them. Still other borrowers may have had no real understanding of the information contained on the contractual documents they signed. While the truth of what actually occurred is likely some combination of all of these explanations, the bottom line is that the problems now stemming from low- and no-documentation loans could have been prevented if lending regulations had required more rigorous and serious documentation from borrowers in the subprime market.

While no- and low-documentation aspects of loan underwriting are important components of current foreclosure problems, they were not the only form of abuse. Many other abuses contributed greatly to the crisis, including ARMs with high payment shock, the steering of borrowers to high-cost

loans, the underwriting of borrowers at introductory rates only, the failure to include taxes and insurance when qualifying borrowers for loans, abusive and unearned broker fees, fraudulent appraisals, and the failure to establish escrow accounts. Few of these provisions or actions were under borrowers' control; most provided no compensating benefits that would have encouraged borrowers knowingly to capitulate to the broker's or lender's terms (NCRC 2005).

The excessive abuses that have permeated the subprime market demand a comprehensive regulatory framework to ensure that this behavior will not happen again. Failure to adequately regulate the subprime market has threatened the financial well-being of millions of families, as well as the economy at large. In fact, most borrowers, prime and subprime, are paying for the abusive activities of the subprime market, not just those who took out subprime loans. Nationally, home prices are down more than 5 percent, with the prospect of a decline of 15 percent or more by 2009 (Makin 2008). According to the U.S. Department of Commerce, new home prices have fallen a full 13 percent across the country, with even greater declines in the areas hardest hit by the crisis, such as California, Nevada, and Florida ("Price of New Home Tumbles in October" 2007). Falling home prices introduce greater volatility into the housing market by squeezing the equity from owners.

Moreover, available evidence does not support the argument that lenders and servicers can address the foreclosure crisis through voluntary loan workouts. According to Moody's Investors Service, only 3.5 percent of loans scheduled for interest rate resets in the first nine months of 2007 were modified (Marfatia 2007). Further, the Mortgage Bankers Association finds that fully 40 percent of subprime ARMs that went into foreclosure in the third quarter of 2007 were loans that had previously experienced a modification or repayment plan (Brinkmann 2008). The principal challenge with most current loan modifications is that they provide consumers with only temporary relief rather than long-term affordable mortgage solutions. Temporary freezes in interest rates for relatively short periods of time, payment plans that add late payments and fees to the outstanding loan principal balance, and loan adjustments that address mortgage affordability but do not take into account severe losses in home values are typical of the relief now being offered.

Although the current credit crunch has squeezed many of the irresponsible and abusive lending practices out of the subprime market, strong anti-predatory lending legislation is needed to ensure that those practices do not return when housing markets recover. Legislation should address every aspect of the lending process including product type, underwriting standards

and criteria, payment shock, special features (such as prepayment penalties), broker fees, appraisal standards, steering and marketing, and lender and securitizer accountability. Many important improvements to the regulatory environment could be achieved through rule-making by regulatory agencies, but legislation can more comprehensively address each institutional entity in the lending process. Moreover, legislative mandates would provide meaningful private relief to borrowers and be more permanent.

Both the Bush administration (White House, Office of the Press Secretary 2007) and the Federal Reserve (Board of Governors of the Federal Reserve System 2007) are now on record acknowledging that unfair and deceptive practices contributed to the current foreclosure crisis. In addition, a case can be made to assist families that knowingly made risky decisions. Consumers, for example, do not have the option of waiving the mandatory state inspection of their vehicles even though millions might forgo the time and money required for inspections if they were allowed to. Safety inspections for cars, as well as minimum safety standards for electrical appliances, toys, food, and other products, protect consumers from personal harm and their neighbors from damage. Regulating the markets in a manner that provides a safe, sound financial environment and protects consumers from making risky choices that are beyond their reasonable ability fully to calculate, comprehend, or manage is a reasonable role for government. As a result, rather than seeing foreclosure intervention as a bailout for borrowers, it could be better perceived as a bailout of the economy in response to the lax regulation of the markets.

Current initiatives

Although news about the foreclosure crisis is aired and printed every day, little assistance is available for consumers at risk of losing their homes. And despite the growing and widely recognized existence of predatory lending, no national anti-predatory lending law has been enacted. The most significant initiatives available to at-risk homeowners are the HOPE Hotline initiative, which offers borrower counseling and is managed by the NeighborWorks® Center for Foreclosure Solutions, and the FHASecure program managed by the Federal Housing Administration (FHA). Also active is the National Homeownership Sustainability Fund, which provides loan workouts and refinancing and is managed by NCRC, and the Home Save Program, a similar initiative managed by the Neighborhood Assistance Corporation of America (NACA).

Proposed, but not yet fully operational, is a voluntary freeze on interest rates for select borrowers with adjustable subprime loans, as part of a HOPE NOW Partnership led by the U.S. Department of the Treasury. New rules related to anti-predatory lending regulations have recently been proposed by the Federal Reserve Board. Also pending is floor action on anti-predatory lending legislation in the U.S. Senate in response to a similar bill recently passed by the House. Bankruptcy code reform is being considered as well.

NeighborWorks HOPE Hotline and FHA Secure

NeighborWorks provides foreclosure prevention counseling through the HOPE Hotline, a toll-free number. Consumers calling the hotline are generally referred to lenders participating in the U.S. Department of the Treasury's HOPE NOW Alliance. As of the third quarter of 2007, that hotline was receiving 1,130 calls—resulting in nearly 199 foreclosure preventions—a day. However, because the program does not have access to a refinancing option, up to 87 of these 199 daily foreclosure avoidances (more than 40 percent) result in the sale of the home. Only 10 percent of the calls received (112 out of 1,130) result in loan workouts. And even then, the details of those arrangements, and therefore the sustainability of the resolutions, are not known. A recent congressional appropriation of \$200 million to the NeighborWorks program should enable the HOPE Hotline to expand its network of foreclosure counseling agencies and improve its reach in assisting borrowers at risk of losing their homes. While it is not immediately known why so many foreclosure avoidances result in the loss of the home, providing the program with access to refinancing resources would greatly enhance its ability to help families maintain their homes.

The FHA Secure program, introduced in August of 2007, provides additional flexibility in FHA underwriting guidelines, thus opening the door to refinancing for borrowers who have good credit histories but cannot afford the higher mortgage payments caused by a loan reset (White House, Office of the Press Secretary 2007). During the first three months of operation, FHA Secure received more than 120,000 applications and helped 35,000 homeowners refinance their loans. The FHA estimates that it will assist 300,000 homeowners by the end of 2008. While this is not an inconsequential number, it falls far short of the more than 2 million households estimated to be facing foreclosure (White House, Office of the Press Secretary 2007).²

²Although the FHA Secure program is designed for consumers who would not qualify for existing FHA insurance, more than 98 percent of the borrowers helped to date would have qualified for existing FHA products; only 541 borrowers who are the primary focus of FHA Secure have been aided (Paletta 2007).

National Homeownership Sustainability Fund (NHSF)

This fund, which provides loan workouts and refinancing, helps families holding high-risk mortgages or experiencing a change in financial circumstances that undermines their ability to repay. The program is a national effort with more than 30 participating NCRC member organizations in 15 states. It has helped more than 5,000 borrowers and estimates that it has preserved \$500 million in home equity.

NHSF is unique in that borrower assistance is not limited to counseling services. This is important because even after receiving counseling, many borrowers remain unprepared to engage successfully in the detailed and sophisticated conversations required to rework a loan. This reality can be observed in the limited success that current counseling programs have had in mitigating foreclosures. NHSF goes beyond counseling by providing homeowners with expert mortgage advisors who work on their behalf to tackle the complex and technical issues involved in achieving a successful loan workout or in securing refinancing.

Beyond restructuring and refinancing loans, NHSF provides an insight into unfair and deceptive lending practices that is not possible to get without access to detailed individual loan files. Information gained from these files has contributed to NCRC policy recommendations for new legislation, improved regulation, and potential lawsuits (NCRC and the Woodstock Institute 2006). Although the capacity of NHSF to date is relatively small, its real value lies in its successful borrower support and assistance format, which could become the model for a greatly expanded and successful federally supported homeownership sustainability program.

NACA's Home Save Program

The Home Save Program provides assistance that extends to helping borrowers refinance high-cost loans. NACA offers several forms of assistance, including a payment plan for borrowers who have an affordable mortgage but are experiencing a short-term financial setback, loan modification for homeowners who have an affordable payment but have experienced a long-term financial setback, and loan restructuring or a refinance product for homeowners who have high-cost or otherwise unaffordable loans. In the fall of 2007, NACA announced a major partnership with Countrywide, whereby its borrowers can receive assistance from NACA services. Participants in the Home Save Program complete a mortgage submission online, attend a workshop to learn about the process and options, meet with a mortgage consul-

tant, are referred to an underwriter, and ultimately have their file submitted to the lender for review. NACA has 33 offices nationwide and has committed \$1 billion to help homeowners (NACA 2008).

Other statewide and regional initiatives have been launched but are too numerous to be described in this review.

U.S. Department of the Treasury

On November 29, 2007, the department announced an initiative to help troubled homeowners. The plan divides borrowers into three categories:

1. Homeowners who are more than 60 days' delinquent or are already in foreclosure (including those whose interest rates reset before January 1, 2008)
2. Homeowners who are facing a reset in their mortgage rate (on or after January 1, 2008) and are current on their loan payments, but are deemed to be able to repay the loan following reset
3. Homeowners who are facing a reset in their mortgage interest rates (as of January 1, 2008), but are deemed unable to pay the reset rate or refinance

The plan helps only the last group of homeowners: those who face a rate increase that they are deemed unable to pay. For this group, it recommends a five-year freeze on mortgage interest rates at their initial teaser rates. The plan is of limited assistance because it targets only a small percentage of impacted borrowers. Analysts from Deutsche Bank forecast that only 90,000 of the 2.918 million borrowers who took out subprime ARMs from 2004 through 2007 (approximately 3 percent) will meet the requirements for relief under the plan (Shenn 2007). In a separate study, CRL (2008) also estimates that the plan will reach about 3 percent of at-risk homeowners. In fact, examining the details of this class of qualified borrowers offers insight into the narrow definition of who actually qualifies: "Owner-occupant borrowers with weak credit and a solid payment history on their securitized ARM loan with initial fixed rate of 36 months or less, originated between 1/1/05 and 7/31/07, with a LTV [loan-to-value] ratio of over 97 percent and which has an initial interest rate reset between 1/1/08 and 7/31/10 that will result in a payment increase of over 10 percent."³

³Kristopher Rengert, community development expert, Office of the Comptroller of the Currency, e-mail to author, 22 January 2008.

Yet even for those borrowers, the plan faces a range of technical problems. Of primary concern is that most subprime loans are held in securitized loan pools. Freezing rates or reducing the principal would constitute a change in the contractual terms of the subprime mortgage-backed securities that could be accomplished only in conformance with the pooling and servicing agreements between investors and servicers or, barring that, with the permission of the investors holding the security. Many pooling and servicing agreements, however, limit modifications to 5 percent of the loan pool. Where pooling and servicing agreements require an amendment to accommodate more loan modifications, it is unlikely that investors holding highly rated securities will voluntarily submit to receiving lower returns to help borrowers avoid foreclosure. Interviews with investment banking executives and experts on this topic have not been promising. According to Thomas Deutsch, who represented the American Securitization Forum in the development of the Treasury plan, “[T]he rate freeze is totally voluntary and will be based totally on what investors decide is in their self-interests. There is no mandate here” (Andrews 2007). And according to Roger W. Kirby, managing partner at Kirby McInerney, “Why would anybody in their right financial mind agree to a five-year price freeze?” (Andrews 2007).

If investors do agree to a five-year rate freeze, it is unclear how valuable that remedy would be in the long run. The plan does not indicate what might change for homeowners during the next five years to enable them to pay an amount they cannot afford today. Much of the foreclosure problem is directly attributable to borrowers accepting unaffordable mortgages in the hope that future home price appreciation would bail them out. Ironically, the Treasury’s five-year solution relies on the same house of cards strategy that led to the current crisis. Moreover, few housing economists see house prices recovering sufficiently within the next five years to enable hundreds of thousands of homeowners to refinance successfully out of their high-cost mortgages (Appelbaum 2008). If home prices do not recover as desired, the net effect of this plan would be to postpone the foreclosure crisis. This could have a chilling long-term impact on prices.

In addition, making only one of the three classes of borrowers mentioned earlier eligible for assistance raises fairness issues. For example, the plan does not help borrowers who face a reset but are estimated (based on credit scores of 600 or higher) to be able to repay their loans. In other words, the plan penalizes homeowners who have acted responsibly by remaining current on

their loans and who have managed the difficult financial trade-offs involved in maintaining good credit scores. It therefore sets the concept of risk-based pricing on its ear by enabling borrowers with low credit scores to receive low-cost loans while requiring consumers with high credit ratings to pay higher interest rates. Finally, it neither assists the economy nor promotes fairness to abandon borrowers who already have mortgages they cannot afford. Hundreds of thousands of families are currently enmeshed in the foreclosure process. And like homeowners whose rates do not change until this year, many were the victims of predatory lending or an otherwise poorly regulated mortgage market. Helping them retain their homes would have an immediate, positive impact on their communities and local economies.

Anti-predatory lending rules proposed by the Federal Reserve

On December 18, 2007, the Board of Governors of the Federal Reserve System proposed a series of new rules aimed at purging unfair and deceptive lending practices from the mortgage market. The proposed rules address almost every aspect of the lending process and therefore demonstrate the pervasiveness of predatory lending in the home mortgage market. At the same time, many of the proposals would limit abuses but not remove them from the market. Abusive broker fees, for example, are addressed by a requirement for greater disclosure. This rule would fail to protect consumers who have no idea how much is reasonable or typical. Brokers remain able to charge as much as, if not more than, 2 full percentage points above what is required by a lender to close a loan. As a result, financially unsophisticated borrowers whose experience with the mortgage market is the weakest would remain the most vulnerable to unfair and abusive fees.

For example, the proposed rules also require escrow for taxes and insurance for subprime loans, but allow borrowers to opt out of escrow after the first year. The only value of an opt-out would be to lower monthly mortgage payments. Inasmuch as taxes and insurance will, nevertheless, need to be paid, the value of the opt-out provision is unclear. This flexibility predisposes vulnerable consumers toward making financial decisions that are not in their best interest or that of the housing finance system. Also, prepayment penalties, which have not been shown to provide any benefit to borrowers in the subprime market, are further restricted but continue to be allowed. Several other provisions provide greater safety for consumers but fall short of fully purging the most harmful predatory lending practices from the subprime

market. A 90-day comment period will enable thorough consideration of these and other measures (Board of Governors of the Federal Reserve System 2007).

Pending anti-predatory lending legislation

The anti-predatory lending bill recently passed by the House of Representatives marks a starting point for effective legislation by addressing a range of unfair and deceptive practices. The bill as passed, however, allows mortgage brokers to continue steering customers toward high-cost loans and charging excessive and unjustifiable fees. Like the rules proposed by the Federal Reserve, the bill allows excessive broker fees if they are disclosed. Yet financially vulnerable borrowers have no way of determining which fees are appropriate or how much is too much. Failure to rein in excessive mortgage broker fees will continue to leave home buyers paying substantially more for their homes than is required on the basis of their incomes and credit scores. In addition, this practice will continue predisposing consumers to greater risks of default. Moreover, the more financially vulnerable consumers are, the more likely it is that they will be exploited through excess fees. This means that moderate-income and minority working families, as well as the elderly and women, will remain the disproportionate targets of subprime mortgage lending abuses.

The House bill also provides little additional accountability for securitizers that package and sell loans. Failure to hold lenders and securitizers accountable for packaging and selling products that involve unfair, deceptive, discriminatory, or fraudulent terms leaves the financing pipeline open to that kind of behavior in the future. More stringent legislation has been proposed in the Senate (S. 2452). That bill, as drafted, would eliminate the most serious predatory lending practices from the home mortgage market. At the time of this writing, however, it is not clear whether the bill is likely to pass.

Bankruptcy and tax law

Modification of loan terms in the context of a bankruptcy proceeding could offer immediate relief to homeowners facing foreclosure. But current bankruptcy law excludes the altering of loan terms on principal residences (Rao et al. 2007). Amending the code could enable bankruptcy judges to examine loan characteristics to determine whether alternative arrangements might realistically enable borrowers to maintain their properties. It could also

allow judges to determine whether loans contain characteristics suggestive of unfair and deceptive practices and specifically take these issues into account when modifying loans. H.R. 3609, the Emergency Home Ownership and Mortgage Equity Protection Act of 2007, amends federal law to allow bankruptcy judges to modify loan terms for home mortgages. Although reforming the bankruptcy code is controversial, it could provide one of the most direct and immediate routes to avoiding foreclosure.

Vacant and abandoned properties

There is no proposed initiative that addresses the issue of vacant and abandoned properties. Because subprime lending is particularly concentrated in minority communities, which are the most vulnerable financially, the prospect of huge inventories of vacant properties in these areas is significant. While excessive levels of foreclosures can severely and negatively affect even the most vibrant middle-income neighborhoods, large inventories of foreclosed properties in fragile minority areas can eviscerate the housing wealth of entire communities. In addition to foreclosure mitigation initiatives, important attention should be paid to finding ways to secure vacant properties that are abandoned specifically because of foreclosure and return them quickly to productive and affordable use.

Broader solutions needed

The scale of the current foreclosure crisis, limitations on what qualifies borrowers for assistance by the various initiatives, limitations on proposed solutions (the five-year interest rate freeze), and the technical difficulties involved in changing the underlying terms of mortgage assets held in securitized portfolios all suggest the need for a more comprehensive remedy. When faced with the major foreclosure crisis resulting from the economic turmoil of the Great Depression, the federal government responded with a new housing finance agency: the Home Owners' Loan Corporation (HOLC). A similar entity, the Resolution Trust Corporation (RTC), was established in the 1980s to help clean up the failing S&L industry.

During the 1930s, most loans were short term and required refinancing to maintain homeownership. HOLC issued government bonds; refinanced consumers into long-term affordable, fixed-rate mortgages; and closed its doors as a solvent institution seven years later after having stabilized the housing market. HOLC issued more than a million loans between 1933 and

1936. Wall Street Without Walls, in cooperation with the Ford Foundation, and the Center for American Progress have separately recommended alternative strategies for foreclosure intervention that build on the HOLC concept (Jakabovics 2007; McCarthy and Ratcliffe 2007). John Makin, a visiting scholar at the American Enterprise Institute, has also suggested that an RTC-type mechanism might be considered (2008).

An alternative proposal being developed by NCRC builds on the HOLC model, but relies on existing institutions such as FHA, Fannie Mae, Freddie Mac, and Federal Home Loan Banks to provide financing or insure loans (NCRC 2008). By avoiding the added time that would likely be required to create and staff a new agency, this proposal could become operational in much less time. The NCRC proposal recommends that the federal government offer to purchase, at a discount, loans held in securitized pools. Discounting the purchase of loan pools would strike a balance between assisting homeowners and ensuring that lenders and securitizers are not rewarded for financing predatory loans. Borrowers would then be allowed to refinance their loans at terms that are reasonable given their financial circumstances.

Under this proposal, refinanced loans, in addition to being affordable, fixed rate, self-amortizing mortgage products, would have their initial principal balance adjusted to reflect the current appraised value of the home. The discounted value of the home would be captured by the government in the form of a soft second mortgage that would be repaid from the future appreciated value when the home is sold or refinanced. Homeowners would have no repayment obligation in excess of that which could be captured by appreciation. Losses would be borne by the federal government. Nonprofit intermediaries with expertise as home loan counselors, mortgage advisors, or lenders would be funded to contact borrowers and help them refinance (NCRC 2008). Studies have shown that many borrowers are wary of contacting their lenders or servicers to request assistance. Given the level of unfair and deceptive practices in the subprime market, such concern is understandable.

The final piece of the proposal would give the U.S. Department of Housing and Urban Development (HUD) expanded authority and resources to develop a plan and work with nonprofit development organizations to address foreclosed properties that are vacant and abandoned. The focus of HUD's efforts would be to ensure that properties are returned to productive *and affordable* use as quickly as possible. As part of this program, consumers who have recently experienced a foreclosure would have the right of first refusal to repurchase their homes, assuming that those properties are part of the program's inventory and assuming that borrowers qualify for a mortgage

under the new program guidelines. Regarding other vacant and abandoned properties, HUD might rely on or borrow from major successful efforts (such as Chicago's Troubled Buildings Initiative⁴) or institutions with expertise in the field (such as Smart Growth America⁵) (NCRC 2008).

Conclusion

Many economists propose allowing the market to correct itself despite the fact that this approach would allow millions of families to slip into foreclosure. Given the role that unfair and deceptive practices have played in creating the crisis and the reality that *all* Americans are paying the cost of regulatory failure, responsible public policy demands a thoughtful and meaningful response. As Professor Elizabeth Warren of Harvard University Law School points out, families have better consumer protection when they buy a toaster or a microwave oven than they do when they buy a home (2007). Recently, thousands of toys with lead-based paint were found to have been imported into this country. If those toys had been allowed to remain on the market and harm our children, providing compensation to families would not be referred to as a "bailout." Responsibility for failing to protect consumers would have been accepted at the national level, and immediate intervention would have followed. Further, the companies that were negligent in their duty to protect the public would have been held accountable. By the same token, the time has come to help consumers who have been financially damaged by failed regulatory policy in the mortgage arena as well.

Just as it would not have been an acceptable compromise to have removed some, but not all, lead-based toys from the shelves, it should not be acceptable to remove some, but not all, unfair and deceptive practices

⁴Since 2003, the Troubled Buildings Initiative, part of the city of Chicago's Department of Housing, compels landlords to maintain safe and drug-free environments for residents. Primary areas of concern include neighborhood gang and drug activity, residents at risk from having utilities disconnected, and dangerous conditions created by lack of maintenance or repairs. The city partners with nonprofit organizations to strengthen city blocks and neighborhoods by reclaiming foreclosed, vacant, and abandoned properties. During the first three years of the program, over 2,500 units were rehabilitated or repaired (City of Chicago 2008).

⁵The National Vacant Properties Campaign is a joint partnership between Smart Growth America, the Local Initiatives Support Corporation, and the Metropolitan Institute at Virginia Tech. The goal of this campaign is to help communities prevent abandonment, reclaim vacant properties, and once again become vital places to live. The campaign builds a national network of leaders and experts, provides tools to communities, raises awareness through communications, and provides technical assistance and training. According to its Web site, the National Vacant Properties Campaign (2008) has worked with nonprofits, elected officials, and residents in 14 states.

from the mortgage market. The public deserves better. Moreover, additional efforts should be made to ensure that the U.S. financial services system, in general, works for everyone. Financial services in low- and moderate-income and minority working communities are generally high cost and counterproductive to building savings and good credit histories (Carr and Schuetz 2001; Caskey 1994; Stegman 1999). Legislative mandates to ensure more equitable credit availability, such as the Community Reinvestment Act (CRA), the Equal Credit Opportunity Act, the Truth in Lending Act, and the Home Ownership and Equity Protection Act, should be continuously updated to accommodate changes in the financial services marketplace. Moreover, CRA and related acts must be meaningfully enforced. Expansion of CRA coverage to a broader class of financial institutions, for example, could have prevented much of the worst abuses of the subprime market. Most of these unfair and deceptive practices were the work of non-CRA-covered mortgage lending institutions.

Finally, federal investments in financial innovation for disadvantaged communities are also warranted and overdue. Innovative products that could better align the interests of investors and borrowers, such as shared-equity mortgages, have great potential (Caplin et al. 2007). Shared-equity mortgages allow investors to take an equity stake in homes, usually repaid by long-term appreciation in value. Because investors gain when homeowners sustain their homes and housing markets are healthy, investors and homeowners have a common financial interest. In addition, innovative savings and consumer credit programs have been documented or promoted by a range of research and policy institutions such as the Center for Financial Services Innovations, the Center for American Progress, the Brookings Institution, the New America Foundation, United for a Fair Economy, and the Insight Center for Community Economic Development.

Federal support, which could move pilot programs and demonstration initiatives to larger-scale efforts, has unfortunately been lacking. The current crisis demonstrates that one key component of a robust and sound economy is the inclusion and full participation of all households in an efficiently functioning and responsibly regulated financial system. NCRC, under the rubric of the “Financially Inclusive Society,” is examining ways in which the many thoughtful financial innovations that have been developed over the past decade can be better prioritized and organized into a comprehensive legislative proposal that might one day lead to true equality of access to financial services for all Americans.

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