Fostering Opportunity:

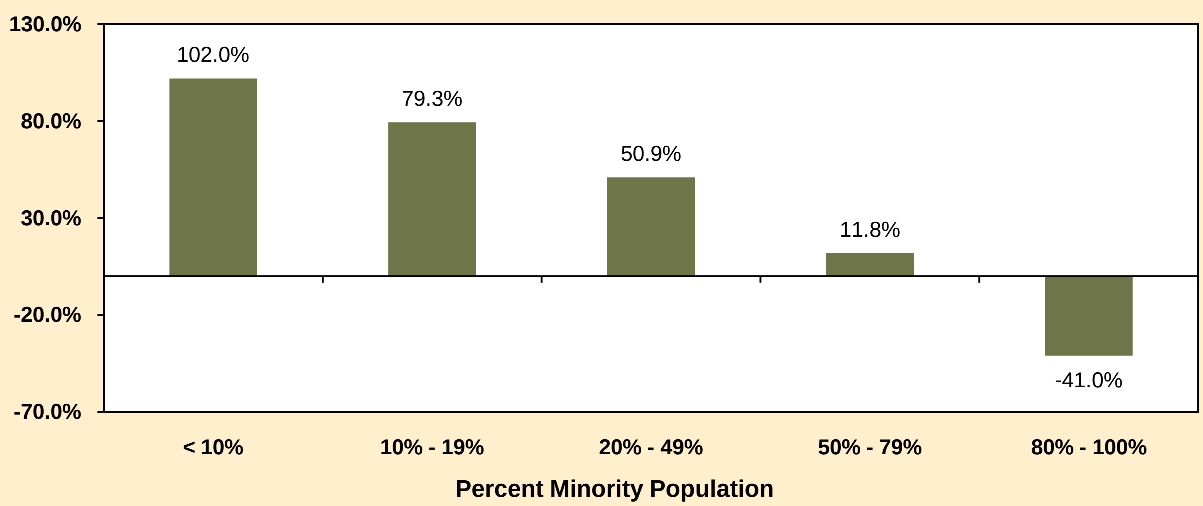
The Impacts of Changes in Housing Finance on Access to Credit and Housing Choices

In response to dramatic proposals to change the housing finance system in Washington, Woodstock Institute convened a panel discussion on May 12, 2011 at the Federal Reserve Bank of Chicago with top housing decision-makers to explore the current challenges to mortgage finance and potential impacts on low-wealth communities and communities of color.

Research from Woodstock Institute and others suggests that communities of color have borne the brunt of the foreclosure crisis. Despite recent foreclosure growth in predominantly white areas, Woodstock Institute research has shown that communities of color were hit hardest earlier in the crisis and have disproportionately high concentrations of foreclosure filings and abandoned foreclosed buildings. For example, African-American communities are 11 times more likely to have an abandoned foreclosed home and three times more likely to have a property in foreclosure than are predominantly white communities. Neighborhoods with high concentrations of foreclosures are often destabilized by plummeting property values, blight, and higher crime.

Access to sustainable credit for residential mortgages is a key ingredient to stabilizing neighborhoods strongly affected by the foreclosure crisis and putting them on the path to recovery. However, the very communities that need stabilization most—communities of color—are not seeing adequate opportunities to borrow affordably. While lenders have been tightening credit everywhere during the recession, prime mortgage credit for home purchase has plummeted sharply in communities of color in Chicago and across the country. Research from Woodstock Institute and partner organizations in other major mortgage markets found that, between 2006 and 2008, prime mortgage lending for home purchase in communities of color declined more than twice as much as it did in predominantly white communities. Borrowers in communities of color also have limited opportunities to refinance their existing mortgages, leaving them unable to take advantage of low interest rates to reduce their payments. Woodstock's collaborative research has shown that conventional refinance loans in communities of color across the country dropped 17 percent between 2008 and 2009, while conventional refinance loans grew by 125 percent in predominantly white communities.

Changes in conventional refinance lending by Chicago area census tract racial/ethnic composition, 2008-2009



Source: Home Mortgage Disclosure Act Data, US Census

In addition to the difficult situation facing communities of color, a number of challenges face the mortgage credit market throughout the country. Reeling from recession-related losses, both lenders and secondary market entities have tightened credit standards. As a result, the federal government has taken on an increasingly important—some say untenable—role in the mortgage market. In 2010, ninety percent of newly originated home mortgages were either insured by the Federal Housing Administration (FHA) or securitized by Fannie Mae and Freddie Mac.

The federal government is looking to restructure the housing finance system in a way that reduces taxpayer risk and encourages prudent investment in the housing market, not the unscrupulous lending practices that presaged the housing crash. At the same time, consumer advocates and community organizations are concerned that, in pursuit of prudence, the government will overcorrect and enact policies that unduly restrict credit to underinvested communities.

Woodstock Institute convened an event, "Fostering Opportunity: The Impacts of Changes in Housing Finance on Access to Credit and Housing Choices," to discuss these difficult questions. The panelists at "Fostering Opportunity" were stakeholders with diverse perspectives on how to best balance the needs of a sound financial system and the community, including representatives from the U.S. Department of the Treasury, National Community Reinvestment Coalition, CitiMortgage, Community Investment Corporation, and Oak Park Regional Housing Center. For more information on the panelists and attendees, please see the Appendix.

Policy Proposals

Sameera Fazili of the U.S. Treasury Department presented the Obama Administration's proposals for restructuring the housing finance system. The plan would involve winding down the current system dominated by the government-sponsored entities (GSEs), Fannie Mae and Freddie Mac, and replacing them with a system more reliant on private investment. Treasury released a white paper outlining three options for what that system could look like.

Option one would be a largely privatized system of housing finance with the government's role in insuring or guaranteeing mortgages limited to the FHA and other programs, such as the USDA and Department of Veterans' Assistance, aimed at providing credit to low- and moderate-income borrowers. This option would not provide government support in the housing market in the event of another credit crisis.

Option two, like option one, would include programs targeted to low- and moderate-income borrowers, but would also allow the government to scale up its guarantees for the market in a situation where private credit dries up during a housing crisis.

Option three would include targeted guarantee programs and the government would also provide catastrophic reinsurance for securities of mortgages that meet stringent underwriting standards.

Another policy proposal discussed, the qualified residential mortgage, is intended to reduce excessive risk-taking behavior in mortgage lending. The "originate-to-distribute" model of mortgage underwriting, in which lenders make loans with the intention of selling them to investors instead of holding loans on their books, demonstrated its weaknesses when the housing bubble burst. Some lenders made excessively risky loans since any risk associated with the loan's performance was passed off to investors. In order to mitigate the dangers of lenders' risk-taking orientation, the Dodd-Frank financial reform bill included a measure that would require lenders to retain five percent of the risk of each loan. Some loans will be exempted from the risk-retention requirements if they are insured or guaranteed by Fannie Mae, Freddie Mac, the FHA, or the VA or fall into the category of "qualified residential mortgages" (QRMs), which are loans that have characteristics shown to be associated with low default rates. Regulators have proposed a QRM definition that requires, among other aspects, a 20 percent down payment and very low debt-to-income ratios. Currently, the vast majority of mortgage loans are backed by the FHA, Fannie Mae or Freddie Mac and would therefore be exempt from the risk retention requirements. However, if the Obama Administration's proposed wind down of Fannie Mae and Freddie Mac occurs, private-sector lenders subject to risk-retention requirements will play an even larger role in mortgage finance for low- and moderate-income people. This will ultimately result in a restriction of credit to otherwise qualified low- and moderate-income borrowers, who will likely be unable to meet the down payment requirements of the QRM guidelines and will be forced to forgo homeownership or pay the increased cost of borrowing a non-QRM loan. The QRM regulation is open for public comment until August 1, 2011.

Discussion

Panelists detailed challenges to mortgage lending in today's climate and responded to the policy proposals on the housing finance system and QRMs. The analysis and recommendations outlined below are the panelists' own and do not necessarily represent Woodstock Institute's position.

Challenges in today's housing market

- Over ninety percent of newly originated mortgages are government-backed by Fannie Mae, Freddie Mac, the FHA, or the VA. Some believe that the situation puts excessive risk on the taxpayers and is not sustainable in the long run.
- Despite some signs of recovery, the recession is still persistent—joblessness is still high particularly in communities of color, and damaged credit and loss of income impacts individuals' ability to access affordable housing. State and local governments are facing unprecedented budget crises and do not have the resources to invest in disinvested communities, negatively impacting property values and neighborhood desirability.
- Financing is scarce for small multifamily buildings (5-100 units), which are crucial sources of affordable housing. The secondary market understands how to package and sell very small buildings (1-4 units) and very large buildings (>100 units), but they don't have a good mechanism for handling mid-sized buildings (between 5 and 100 units); because of this, many lenders are reluctant to finance mid-sized multifamily buildings.
- Refinance lending has plummeted in communities of color, limiting opportunities to take advantage of historically low interest rates that offer lower monthly payments or the opportunity to use accumulated home equity for wealth-building activities.
- In some deeply disinvested communities, there is no market at any price. Access to sustainable credit is not the only—or primary—challenge facing some communities with high levels of blight, crime, and unemployment. Local governments that are in the best position to stabilize these neighborhoods are facing unprecedented revenue shortfalls and record high demands for critical services, while the federal government is focused on deficit reduction and is unlikely to fund key economic security and community development initiatives at the previously higher levels.

Critiques of policy proposals in Washington

Several panelists raised concerns about the potential impacts of proposals to eliminate the GSEs and require a 20 percent down payment for a QRM.

- Any of the Obama Administration's proposals to eliminate the GSEs would eliminate their mandate to advance affordable housing. This would limit access to homeownership, particularly for low-wealth people and people of color. Homeownership has been the primary means of building wealth for communities of color. Without the GSEs, what will supplant homeownership as a means for people of color to build sufficient wealth? Panelists from consumer and advocacy groups believe that there is not a satisfactory answer to the question.
- Like elimination of the GSEs, an overly restrictive definition of the QRM will disproportionately limit access to credit in communities of color since people of color are less likely to have enough assets with which to make a 20 percent down payment. Many believe that it is unlikely that many non-QRM loans will be made at an affordable price, especially if the GSEs are eliminated or their risk retention exemption is removed. While FHA loans would still be available for the low-down-payment market, some panelists point out that the result would be relegating borrowers of color to a separate and unequal mortgage market since FHA loans have limited wealth-building potential compared to conventional loans. Some panelists note that loans with down payments as low as 3.5 percent have been proven to be safe and that other loan characteristics—such as total debt-to-income ratio—are more important to determining risk.

Policy Proposals

Over the course of the discussion, panelists proposed a variety of policy solutions to the challenges in the housing finance system.

- Broaden or eliminate QRM down payment requirements. Data on loan performance based on down payment size should be further examined and the down payment requirement should be lowered to a level—perhaps 3 to 5 percent—that balances safety and soundness with broader access to credit goals.
- Create a Public Mortgage Corporation (PMC) to purchase mortgages and issue securities. Dan Immergluck of Georgia Tech has proposed an alternative to the Obama Administration's GSE reform plan that would create a PMC to purchase mortgages, issue securities, and support affordable homeownership and rental housing. A PMC would provide partial insurance for its securities based on the level of risk of the loans involved and crowd out issuers of dubious securities.
- Improve data disclosure and transparency in the secondary market. Better data is needed to ascertain whether the secondary market is adequately serving the needs of borrowers and investors.
- Expand the Community Reinvestment Act (CRA) to the secondary market and require the CRA to consider whether people of color are adequately served by financial institutions. Currently, the CRA is applicable only to depository banks and thrifts. Since the secondary market strongly influences access to credit, expanding the CRA to the secondary market would help regulators ensure that the credit needs of low-income individuals are being served. Requiring CRA regulators to consider whether the financial needs of people of color are being met—not just low-income individuals—would empower regulators and communities to combat racial discrimination.
- Reexamine the mortgage interest deduction. The mortgage interest deduction is projected to cost $131 billion in 2012, much more than total expenditures for the entire Department of Housing and Urban Development ($48 billion). The expenditures on the deduction primarily benefit the top fifth of income earners. Some panelists argued that we should limit the deduction based on the size of the mortgage or eliminate it completely and instead use those funds to subsidize sustainable homeownership for creditworthy low-income or first-time homebuyers. Other panelists responded that eliminating the deduction is politically difficult, would amount to a tax hike on the middle class, and would delay recovery by raising the cost of homeownership in the middle of a housing crisis.
- Pursue innovative loan products targeted at first-time and low-income homebuyers. Some creative methods for safely expanding access to homeownership are currently being piloted across the country, such as shared equity appreciation mortgages and lease-to-purchase mortgages. These new products should be evaluated and the most successful ones should be promoted widely.
- Create incentives and requirements to get lenders to be active in the small multifamily market. Supporting small- and mid-sized multifamily buildings is key to promoting affordable housing and the GSEs play an important role in facilitating financing for rental buildings. As we reform the housing finance system, we need to maintain and expand incentives and mandated goals for financing small multifamily buildings.
- Support and strengthen Community Development Financial Institutions (CDFIs).CDFIs have expertise in working in underinvested markets, such as small multifamily buildings or first-time homebuyers. CDFIs have a long track record of successfully leveraging public funds for these activities, and adequate funding for the Treasury Department's CDFI Fund is critical to maintaining this important source of capital.
- Restore private market confidence by fully implementing Dodd-Frank, reforming the GSEs, and standing up the Consumer Financial Protection Bureau (CFPB). Part of encouraging private investment in the housing market is creating a regulatory environment that minimizes uncertainty, protects consumers and investors, and increases accountability and transparency. Fully implementing the Dodd-Frank Act, reforming the housing finance market, and appointing a permanent head for the CFPB so it can begin the rulemaking process are important steps to achieving those goals.

More information

For more information on the event, please contact Geoff Smith at gsmith@woodstockinst.org or 312-368-0310.

Appendix

Panelists

Alden Loury, Chicago Reporter (Moderator)
Sameera Fazili, U.S. Department of the Treasury
Jim Carr, National Community Reinvestment Coalition
Bill Dyson, CitiMortgage
Jack Markowski, Community Investment Corporation
Rob Breymaier, Oak Park Regional Housing Center

Attendees

Access Living
ACCION Chicago
Action Now
Asset Building Consultant
Bethel New Life
Center for Economic Progress
Center for Neighborhood Technology
Charter One Foundation
Chicago Community Loan Fund
Chicago Reporter
Chicago Tribune
Citi
CitiMortgage
CKSW Consulting LLC
Coalition for Community Banking
Community Bank of Oak Park-River Forest
Community Investment Corporation
Community Savings Center
Federal Reserve Bank of Chicago
First American Bank
First Eagle Bank
First Midwest Bank
Generations Community Bank
Goodcity
HOPE Fair Housing Center
Housing Action Illinois
Illinois Department of Financial and Professional Regulation
Illinois Service Federal Savings and Loan Association
Jewish Council on Urban Affairs
Lake Forest Bank and Trust
Law Offices of John Ahern
Legal Assistance Foundation of Metropolitan Chicago
Loan Management Solutions
Local Economic and Employment Development Council
Mercy Housing Lakefront
Metropolitan Mayors Caucus
Metropolitan Planning Council
Metropolitan Tenants Organization
Mitchell Development Consultants Inc
National Community Reinvestment Coalition
Neighborhood Housing Services of Chicago
North Side Community Federal Credit Union
Oak Park Regional Housing Center
Office of Illinois Attorney General Lisa Madigan
Office of Illinois Treasurer Dan Rutherford
Office of the Comptroller of the Currency Chicago
Operation HOPE, Inc.
Prudential Starck Realtors of Naperville
Rogers Park Community Development Corp
Sargent Shriver National Center on Poverty Law
South Austin Coalition Community Council
Stillwaters Consultation
Talmer Bank and Trust
The Chicago Community Trust
The PrivateBank
The Renaissance Collaborative
Tru-Source Total Life
United States Department of the Treasury
Urban Partnership Bank
US Bank
Voice of Community Ministerial Association (VOCMA)
West Humboldt Park Family and Community Development Council
West Suburban Bank
WKKC 89.3 FM
Woods Fund of Chicago
Woodstock Institute
WVON-AM
YNB Consulting
Zam's Hope