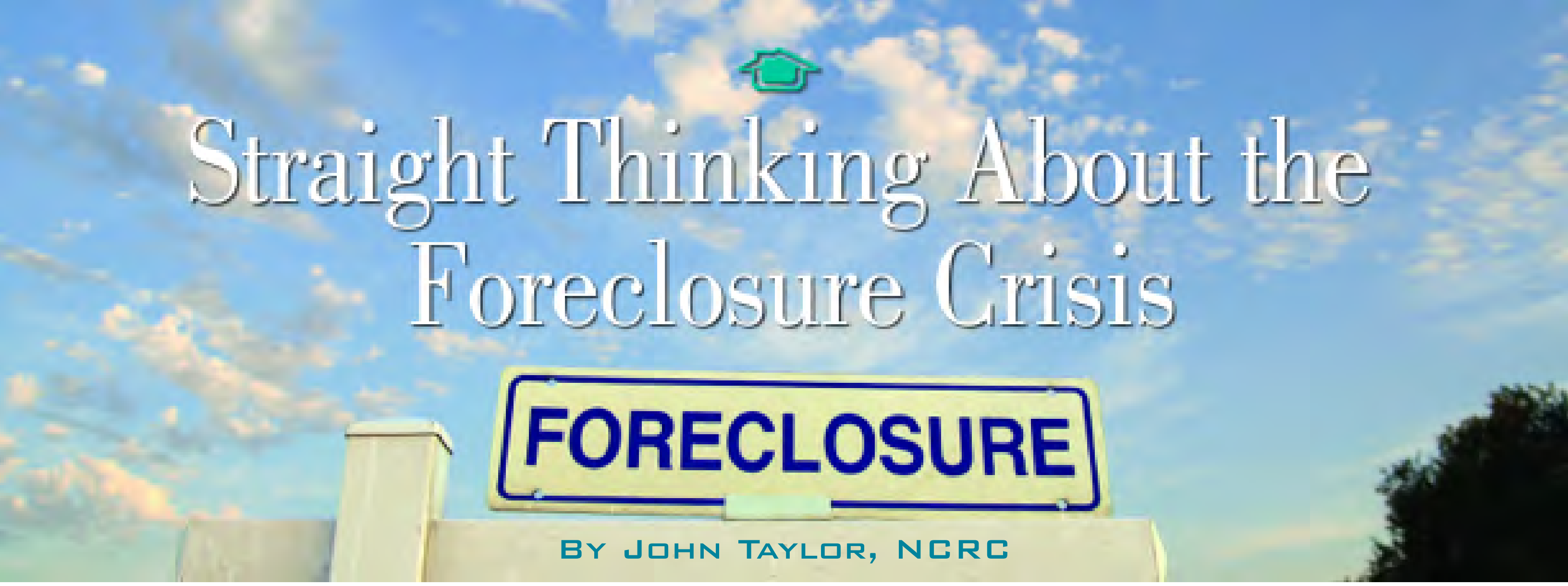
Straight Thinking About the Foreclosure Crisis



By John Taylor, NCRC

There will be plenty of time to sort out what caused our nation's economic crisis and who is to blame. Just a few years ago, consumer confidence and liquidity were strong throughout our entire financial services system. Money was plentiful; banks and investors were searching for opportunities in which to put money. Yet this scenario changed overnight. After over five years of deregulation and regulatory enforcement failure, the mortgage lending industry, from top to bottom, was able to engage in an unprecedented period of greed and malfeasance.

Today, the American system of mortgage finance, once the envy of the world, has produced over six million "toxic mortgages." These mortgages have directly resulted in over two million American families going into foreclosure. Four to five million more foreclosures loom on the horizon.

Silly and indefensible allegations that the poor, or federal government's fair lending and housing laws, caused this problem serve to distract attention from the massive regulatory failure that allowed for this widespread unethical lending. Investors don't lack confidence in America, they lack confidence in the integrity of the American finance system. From real estate appraisers that lack any independence, to malfeasant lenders and brokers, to compliant bond rating agencies and finally to investment banks that operate with little or no accountability, investors simply have lost trust.

Solution Proposed by NCRC- "HELP Now"

Over a year ago the NCRC offered a workable solution to ending the foreclosure crisis. Under *"HELP Now,"* the federal government would purchase these troubled loans from Wall Street, at a substantial discount (a loss already on the books of Wall Street). Existing banks would then refinance these mortgages, pay the government in full, and utilizing the substantial discount from Wall Street, reduce the mortgage principle, and in turn provide homeowners with the appropriate, traditional mortgages that they should have received in the first place.

HELP Now will reverse the foreclosure crisis, but investor confidence and liquidity will not occur without two additional steps. First, Congress must now, finally, pass an anti-predatory lending law that would make illegal the malfeasant lending practices that have brought our economy to its knees. Second, those regulatory institutions that failed to protect the interests of the American consumer and investor should be studied, assessed, overhauled and held accountable. These efforts will signal to investors that it is safe to return to the American market.

In *The Wealth of Nations*, Adam Smith tackled the question: What makes an economy grow? He spoke to the need of a free market, with liquidity and free trade, but he was also emphatic that the Rule of Law must also be present to ensure the fairness and integrity of the market. In Alan Greenspan's *Age of Turbulence* he said: "Reputation and the trust it fosters have always appeared to me to be the core required attributes of market capitalism." Take their word for it; our economic growth is dependent upon our returning integrity to our system of finance. Do that, stop the foreclosures, enforce the Rule of Law to ensure fairness, and we will witness the resurrection of consumer/investor confidence, liquidity and of our nation's economy.

Separating CRA Fact from Fiction

In *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models by Lei Ding, Roberto Quercia, Wei Li, and Janneke Ratcliffe,*[1] the authors use a propensity score model to identify comparable borrowers

MYTH AND FACTS

Myth: The Community Reinvestment Act (CRA) caused the foreclosure crisis.

Facts:

The majority of subprime loans were originated by non-CRA covered financial institutions. In fact, about 75 percent of sub-prime loans were not covered by CRA.[2]

CRA was passed in 1977. The explosive growth in subprime lending occurred more than two decades later, nearly doubling from 2001-2006 alone. No major changes to CRA were enacted during this time.

CRA does not mandate banks to make only home loans. Banks are encouraged to examine credit needs and lend appropriately based on these needs (for small business, home, and other types of loans).

CRA penalizes banks for reckless, irresponsible and otherwise predatory lending.

Myth: Rapid growth of subprime loans was a direct response to financial institutions' efforts to expand homeownership for low, moderate and minority households.

Facts:

Between 1998-2006 over half of subprime mortgage originations were for refinancing.[3]

In that same time, less than 10% of subprime mortgage originations went to first time homebuyers.[4]

Significant gains in homeownership occurred in the 1990s when prime lending was offered to low and moderate income and minority borrowers.

Myth: Federal banking agencies encouraged banks to engage in risky lending practices. In particular, a 1992 Boston Federal Reserve Bank publication, *Closing the Credit Gap: A Guide to Equal Opportunity Lending,* provided unsound advice to banks.

Facts:

Federal Reserve Guidance: Lack of credit history should not be seen as a negative factor for potential homebuyers.

Justification: Willingness to pay debt promptly can be determined through alternative sources of information including timely rent, utility bills, and other scheduled payments.

Foreclosure Reality: Foreclosures are not a result of alternative credit scoring, but rather the product of excessive interest rates and unearned fees making loans unaffordable.

Federal Reserve Guidance: Valid income sources may include social security, second jobs, and other sources.

Justification: Many low to moderate-income households have varying sources but consistent or rising income levels throughout the year.

***Foreclosure Reality:* Subprime loans are not failing as a result of the use of alternative sources of income. Rather, problematic subprime loans are characterized by a lack of income verification, not source of income.**

("subprime like" borrowers) and compares their experience receiving subprime loans as opposed to CRA-related loans. The CRA-related loans in the sample are offered through a program called the Community Advantage Program (CAP) administered by the Self-Help Ventures Fund. CAP loans were generally held in bank portfolios as they had relatively high debt-to-income ratios and loan-to-value ratios. They were offered at prime rates, were fixed for 30 years, and had no prepayment penalties or balloon payments.

The study compared CAP and subprime loans that were first lien, single family, home purchase, owner-occupied and had full income documentation. With these controls, the study found that CAP loans were 70 percent less likely to default than subprime loans. When considering subprime loans made through brokers, the subprime loans were 3 to 5 times more likely to default than CAP loans. Other terms that increased the subprime default rates were adjustable rates and prepayment penalties. Further, the authors suggest that the subprime default rates may have been even higher had they considered low- or no-income documentation loans or loans made to non-occupant owners (that is, investors).

The authors conclude lenders can serve minority and low- and moderate-income borrowers responsibly. Prudent loan terms and conditions can result in sustainable homeownership for these populations. "Special lending programs stimulated by CRA…or the GSE affordable lending goals provide LMI and minority households more sustainable homeownership, compared to subprime loans."

See ***www.ccc.unc.edu/documents/RiskyBorrowers_RiskyMortgages_1008.pdf*** for a copy of the paper.

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1 Center for Community Capital, University of North Carolina – September 2008
2 Testimony before the House Financial Services Committee, Michael Barr, February 13, 2008.
3 Subprime Lending is a Drain on Homeownership, Center for Responsible Lending March 27, 2007
4 Subprime Lending is a Drain on Homeownership, Center for Responsible Lending March 27, 2007