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Keeping the Baby, If Not the Bathwater

Learning the Right Lessons from the Subprime Crisis

The 2008 financial collapse reached sectors of the mortgage market that had performed well and were not involved in the practices that caused soaring foreclosure rates. One corner of that market was home lending by state housing finance agencies. HFAs administer affordable housing programs, including federal and state initiatives that help families who lack significant resources become first-time homeowners.

Affordable Advantage

The bond markets that allow state HFAs to make such loans collapsed in late 2008. In response, Fannie Mae injected capital into state HFA programs. As part of its effort, it created the Affordable Advantage program in cooperation with the National Council of State Housing Agencies. Under it, Fannie Mae bought low-down-payment—$1,000 would qualify—single-family residential loans from state HFAs. The loans were to be strictly underwritten. A good credit profile and sufficient income to repay the loan were essential.[1] In 2010, Massachusetts, Minnesota, Idaho, and Wisconsin agreed to pilot the program.

But a few months later it was all over. Critics of government involvement in the mortgage market seized on Affordable Advantage as a symbol for the type of lending that caused the crisis. The Federal Housing Finance Agency, the oversight agency for Fannie Mae, concluded the program was a mistake.[2]

Affordable Advantage had run into public officials' confusion of over the causes of the crisis. It is important to learn the *right* lesson from catastrophes, and the learning curve from the mortgage meltdown has been abysmal. One would not stop using a stove to cook food in response to a neighbor's house burning down. Neither should we stop all mortgage lending that has a feature in common with the reckless loans that defaulted.

Two misconceptions from the crisis seem to underlie the demise of Affordable Advantage: (1) mortgage lenders should avoid any home loan that has a risk characteristic typical of the nonprime home loans that defaulted; and (2) government home-ownership programs caused the mortgage crisis.

Refuting Misconceptions

Affordable Advantage critics suggest that no government mortgage program should allow a low-down-payment loan, given the problems during the meltdown. The argument for prohibiting all such loans overlooks the context in which many of the problem loans were originated. The private market loans that massively defaulted combined multiple risk characteristics, such as unverified income, low credit scores, and negative amortization. The risk-laden loans were originated in an almost unregulated environment rife with inflated appraisals, forged documents, and hard-sell tactics.

The prudent reaction to excessively risky and unsupervised lending is to require appropriate and long-term risk management. Making home loans with a low down payment does increase risk, especially if the borrower puts *no* money down.[3] But the proper question is whether the public benefits from creating home ownership opportunities outweigh the added default risk when lending occurs in a well-managed underwriting environment.

The other fallacy is that government programs encouraging home ownership were the prime culprit for mortgage market problems. The argument that Community Reinvestment Act lending requirements caused the crisis has been thoroughly discredited.[4] Many critics have tried to blame Fannie Mae and Freddie Mac, but no fact-based analysis has linked any specific Fannie or Freddie affordable-housing initiative to the meltdown. Even the primary Fannie and Freddie role of securitizing mortgages likely did not cause the distress in real estate and mortgage markets—a conclusion reached even by staunch critics of the agencies.[5]

The experience of state HFAs belies the misconceptions. State FHAs make or guarantee single-family home loans to higher-risk borrowers who generally lack access to private mortgage financing but nevertheless repay loans. The typical HFA borrower is a first-time homebuyer with modest income who buys a modest house. In 2008, the average income for state FHA home loans backed by mortgage revenue bonds was $46,518, and the average mortgage loan was about $130,000.[6] Borrowers are disproportionately young and female.[7] About 46 percent obtain down-payment assistance from their HFA.

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Unlike the private subprime mortgage-loan industry, state HFAs have a long history of careful underwriting and support for borrowers. For example, almost every state requires homeownership counseling as part of the lending process.

These agencies have an excellent record of loan performance relative to the borrower's risk profile. Consider two of the four states that participated in Affordable Advantage. Despite being only for lower-income borrowers, loans originated through the Minnesota Housing Finance Agency had a lower rate of foreclosure than the overall foreclosure percentage for Minnesota.[8] And a second-lien loan program for higher-risk borrowers in Massachusetts has operated successfully for 20 years. (See "SoftSecond Success.")

The quiet and successful work of state HFAs is an enduring lesson for both the public and private sectors in how to effectively manage higher-risk mortgage-lending programs. We do not know if Affordable Advantage would have been a successful program had it continued. It is disappointing, however, that the program's premature end probably was the result of public officials misreading the mortgage crisis.

SoftSecond Success

Twenty years ago, a grassroots group of lower-income Boston homebuyers worked with public officials and bankers to design an affordable, sustainable mortgage product to address urban redlining patterns. Thanks to members of the Massachusetts Affordable Housing Alliance's Homebuyers Union, the first SoftSecond program loan, funded by banks and administered by the quasipublic Massachusetts Housing Partnership (MHP), closed in 1991. The SoftSecond program features a conventional first and a "softer" second mortgage—both funded by the bank—that combine with a shallow public subsidy to help lower-income buyers qualify for a mortgage. As of this writing, another 15,074 homebuyers have purchased their first home using the SoftSecond program.

The experiment worked. Bankers still lend (the program had a record year in 2009); state officials have expanded the program even when public funds have been scarce; and SoftSecond loans still serve a need in the marketplace. (More than 40 percent of all loans in recent years have been in the 10 communities with the highest percentage of foreclosed homes.) The program's delinquency and foreclosure statistics also tell a compelling story—and one that policymakers should note as they tackle reform of secondary-market agencies and the future of the Community Reinvestment Act. The SoftSecond foreclosure rate is at 1.01 percent whereas, overall, Massachusetts loans have a 3.18 percent rate. The SoftSecond delinquency rate is also lower than statewide averages, even though the SoftSecond serves borrowers making below area median income—60 percent of the area median on average.

What is the source of SoftSecond's success? Simplicity. MHP's SoftSecond features pre- and post-purchase counseling by community-based organizations, low down payments and low monthly payments (thanks to aggressive pricing and targeted public support), and sensible underwriting that manages risk without shutting out the underserved populations it seeks to serve. Banks that are SoftSecond lenders, public officials, homebuyers, and community organizations all have a stake in creating successful outcomes. Indeed, the long-term retained risk to lenders is a model that should guide regulators and lawmakers in the coming debates. "Homeownership done right" is not just an aspirational slogan, it is a reality from our most recent past.

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Endnotes

1 Minnesota's Affordable Advantage required a $1,000 minimum down payment, a credit score of 680 or greater, total housing expenses of 45 percent of income or less, and a mandatory homebuyer education class. See http://www.mnhousing.gov/idc/groups/homes/documents/webcontent/mhfa_010016.pdf.

2 See "The Weekly Financial Services Republican Roundup," http://republicans.financialservices.house.gov/index2.php?option=com_content&do_pdf=1&id=1386. Moreover, legislative critics misunderstood the program, stating that it "required no . . . good credit history."

3 See Austin Kelly, *Skin in the Game: Zero Down Payment Mortgage Default,* http://mpra.ub.uni-muenchen.de/12478/1/MPRA_paper_4318.pdf, which cites studies showing modest risk for low-down-payment loans and finds higher risks on no-down-payment loans.

4 Letter from Ben S. Bernanke to Sen. Robert Menendez, http://menendez.senate.gov/pdf/112508ResponsefromBernankeonCRA.pdf.

5 Karl Smith, an economics professor critical of core Fannie and Freddie functions, analyzed data on the reasons for Fannie and Freddie losses and concluded: "attempting to subsidize the American dream for low and moderate income families may be a fundamentally bad policy. However, it does not appear to be either the origin of the housing bubble or the source of Fannie and Freddie's trouble." See Karl Smith, *Fannie/Freddie Acquitted,* http://www.ritholtz.com/blog/2010/09/.

6 *State FHA Fact Book: 2008* (Washington, DC: National Council of State Housing Agencies, 2010). The median borrower income was under $40,000.

7 Female-headed households accounted for 30 percent of the loans, and the average borrower's age was under 30.

8 The foreclosure rate for MHFA loans was 1.38 percent as compared with 2.12 percent for Minnesota loans generally. See http://www.mnhousing.gov/idc/groups/public/documents/investors/mhfa_010392.pdf. The report provides data as of June 30, 2010, and compares loans in foreclosure up to the date of sheriff's sale with comparable data from the Mortgage Bankers Association for all Minnesota loans.

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