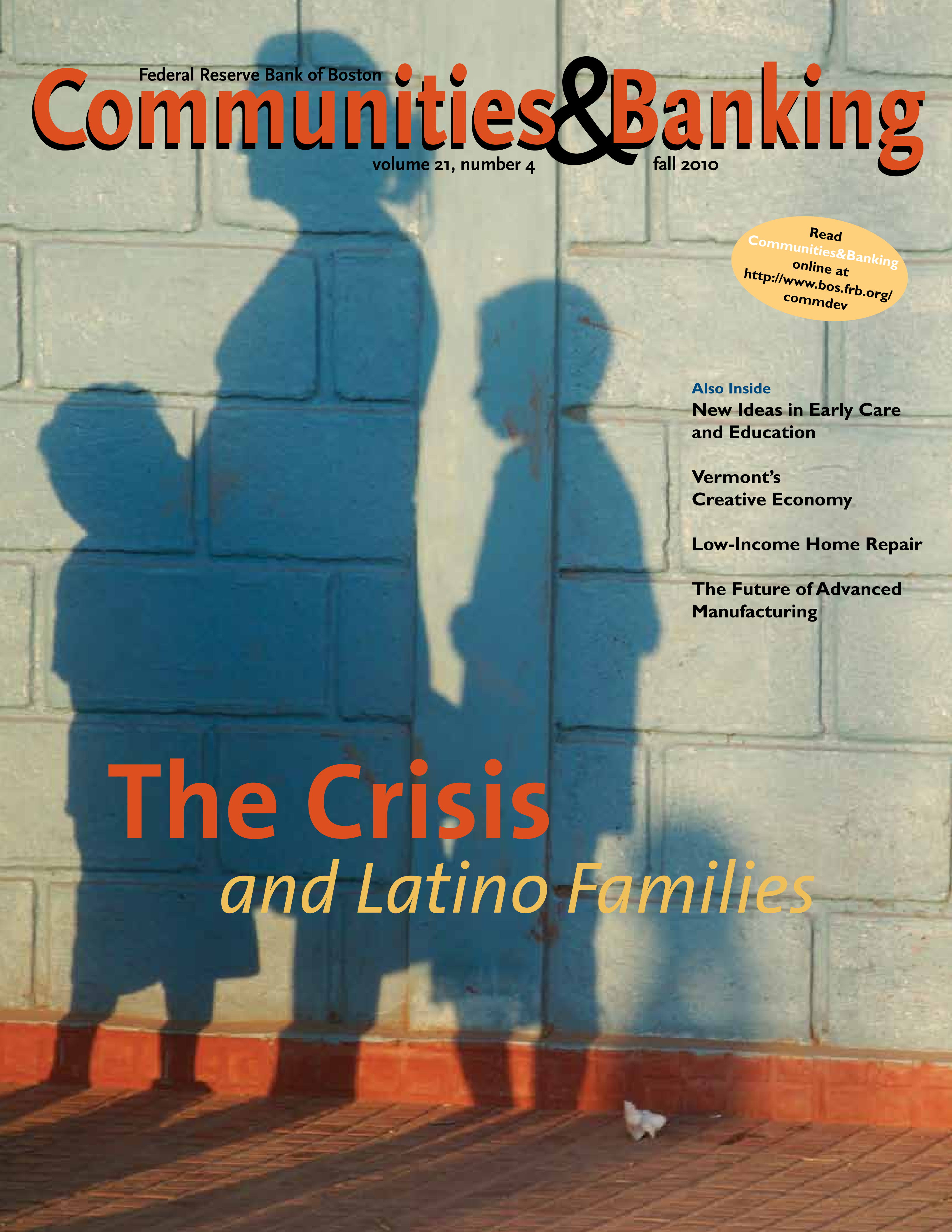

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# The Crisis
## *and Latino Families*

# Contents



*Communities & Banking* magazine aims to be the central forum for the sharing of information about low- and moderate-income issues in New England.

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# The Crisis and Latino Families

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*I put a $56,000 down payment for the house.*
*It was a lot and I lost everything.*
*Everything I made since I've been working here.*

by Janice Bowdler,
Roberto G. Quercia, and
David Andrew Smith

*The financial crisis can be measured in many numerical ways.[1] It can be measured by the 8 million homeowners delinquent on mortgage payments, the $7 trillion in lost household wealth, the 30 percent decline in house prices, the 15 million homeowners underwater, or the doubling of the unemployment rate.[2]*

*But there is another side to consider—the stories of families. With the effects on families in mind, the University of North Carolina's Center for Community Capital and the National Council of La Raza partnered to study Latino families, interviewing members of 25 foreclosed families in Texas, Michigan, Florida, Georgia, and California.*

## Psychological Effects

The study found that both intra- and inter-family relationships were dramatically affected by housing and financial instability. Families often experienced marital difficulties and had to make major changes to plans involving their children. Children who experienced instability in the home had difficulty concentrating in school.

Although little is known about the impact of foreclosure on Latino families specifically, prior studies have identified the psychological harm it does to families in general. And the implications of research on such disruptions as divorce, medical crisis, unemployment, school changes, and housing instability suggest that foreclosure, too, inflicts broad and deep damage on families and children.

*"Grandpa, why didn't you pay the house?" And I'm like, "Well, you don't understand right now, but it's something that happened that I didn't want it to happen but—" And she says, "When I'm older, I'll buy it again for you."*

Numerous causes of foreclosures were identified in the UNC/NCLR study, but loss of income was most often paramount. Most families experienced a "pile on" effect with multiple setbacks, such as health emergencies or resetting of mortgage payments, and the loss of income was the final straw. Families went to great lengths to stave off foreclosure, taking second jobs, borrowing money, and draining savings. Several reached out to their lenders, but none of those interviewed were offered a workable alternative to foreclosure, and many were frustrated by lenders who lost their paperwork or used their payments for new fees rather than for arrears.

## Ways of Coping

*I got the license to drive a truck … thinking that I could save the house … And that was even worse because I wasn't with them …I didn't see them. Imagine that.*

None of the families spent time in a shelter or on the streets, though several admitted to coming close. Instead, they relied on social networks. Moving in with family or friends was the most common first step after leaving the home.

*I'm living with a brother… He has a family of six. Plus us three, it's nine, so we're very crowded there.*

Most turned to family or friends for financial support, too. Public benefits became a lifeline for others. Under stress, parents and children experienced both physical and psychological health problems or the exacerbation of existing conditions. Nevertheless, several parents reported cutting back on medical care.

Signs of depression, increased anxiety and tension, and feelings of guilt and resentment were commonplace. Multiple moves and cramped living conditions frequently led to a sense of instability, which, when combined with financial pressure, led to arguments and resentment among family members—even to divorce and separation. Children's academic performance and behavior at school were also affected.

*[My children can't] get used to a new school. It's too soon.*

Ten of the families said that their children had to change schools, and several parents deemed the new schools inferior to the prior schools. Many parents perceived that their children were becoming withdrawn and were having trouble making new friends. Families also reported that children were not as able to participate in extracurricular activities because of challenges getting to and from school.

Although changing schools was often traumatic for the children, none of the families interviewed accessed the benefits available under McKinney-Vento Homeless Assistance Act. The Act gives children without a permanent address the right to attend the school of their choice. The district is required to provide free transportation. Although McKinney-Vento liaisons reported increases in families served since the start of the crisis, they suspected that former homeowning families were underutilizing their services. School district staff thought such families were less comfortable accessing social services. One liaison said that the goals of advancement and self-sufficiency, powerful drivers in immigrant communities, might have kept former homeowners in the Latino community from seeking help.

For most families, their home represented a financial investment that they expected would pave the way for future security. It was a symbol of economic advancement and achievement. But family finances actually suffered from homeownership. The interviewed families reported an average of $89,155 lost because of buying homes and making improvements. Additionally, they said, their credit had been destroyed. As a result of the setbacks, many made changes in their long-term financial plans, including their plans to help their children with expenses, such as education and major asset purchases.

But despite the financial, social, and psychological effects on families' plans for the future, most still expressed faith in their ability to regain their economic footing and to achieve the "American Dream."

## Quest for Solutions

These stories are just a microcosm of a broader trend. Communities of color are experiencing the effects of the crisis at higher rates than other groups. Minority borrowers were disproportionately likely to receive the kinds of mortgages most at risk of default.[3] Cities and regions with sizeable Latino populations have been among the hardest hit—Nevada, Arizona, Florida, and California—and Latinos have experienced the largest increase in unemployment of any group since the recession began in December 2007.[4] Latino homeowners carry 66 percent of their net worth in their home,

**The interviews are a warning that more foreclosures will have a devastating, long-term impact on the well-being of families, children, and communities.**

making foreclosure particularly devastating.[5] The housing crisis is expected to result in a loss of as much as $98 billion in collective Latino household wealth.[6]

The interviews provide a window on the stories behind the numbers. They are a warning that more foreclosures will have a devastating, long-term impact on the well-being of families, children, and communities. They also lend urgency to the quest for solutions. Three recommendations are most urgent.

First, stabilize families in crisis with more-effective interventions to reduce foreclosures. Those families who cannot sustain homeownership should be allowed to stay in their foreclosed homes as renters where possible or else receive access to good-quality, affordable rental alternatives. Families who have lost their homes should be encouraged to access public benefits. One specific recommendation is to change the narrow Department of Housing and Urban Development definition of homelessness to align with the Department of Education's broader definition, as a number of families who are eligible for education-related supports are ineligible for HUD's federal homeless assistance (shelters, transitional housing, and the like).

Second, work on recovering and rebuilding the economic security that millions of families across the country have seen evaporate. (A credit-scoring amnesty would also help to isolate the negative consequences of the recession.)

Third, in reforming financial services, include protections that promote access to fair lending and have stronger enforcement provisions.

Finally, expand research studies to include a rigorous, quantitative examination of the impact of foreclosures on families and children. We hope that our preliminary investigation will encourage policymakers interested in understanding the true cost of foreclosure to look into the faces of the millions of children affected by the crisis.

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**Endnotes**

[1] This article is based on *The Foreclosure Generation: The Long Term Impact of the Housing Crisis on Latino Children and Families*, http://www.nclr.org/index.php/publications.

[2] Bureau of Labor Statistics, "Economic New Release: Employment Situation Summary," http://www.bls.gov/news.release/empsit.nr0.htm.

[3] Debbie Gruenstein Bocian, Keith Ernst, and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* (Washington, DC: Center for Responsible Lending, 2006).

[4] See "Negative Equity by State," *Negative Equity Report* (San Francisco: Loan Performance HPI Data Libraries, 2009), http://www.loanperformance.com.

[5] *Assets and Opportunity Special Report: Net Worth, Wealth Inequality and Homeownership During the Bubble Years* (Washington, DC: CFED, 2008).

[6] Raul Hinojosa Ojeda, Albert Jacquez, and Paul Cruz Takash, *The End of the American Dream for Blacks and Latinos: How the Home Mortgage Crisis is Destroying Black and Latino Wealth, Jeopardizing America's Future Prosperity and How to Fix It* (San Antonio: The William C. Velazquez Institute, 2009).

# Advanced Manufacturing in New England

# Strategies for Tapping the Potential

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by James Brett and Mike Reopel

**In the 1800s,** when a fledgling United States was beginning to gain its global identity as an economic powerhouse, there was little question as to what was driving that distinction. The New England region was the economic engine of the country, and the exponentially expanding need for manufactured goods fueled that engine. The demand for shoes, textiles, and other mass-produced goods seemed endless, and the manufacturing industry in New England flourished.

Nothing is constant, times change. Even though the high-yield manufacturing industry has shown longevity, very few people believe that the future of manufacturing in New England lies in producing low-tech goods in high volumes. Traditional manufacturing has been on the decline for years, and to remain competitive, a strategic approach is necessary, one that capitalizes on New England's strengths. A mix of highly skilled and educated workers, engineers, business developers, and financiers makes the region uniquely suited to excel in advanced manufacturing.[1]

## A Position of Strength

Advanced manufacturing is characterized by innovative approaches that create complex products and devices with a high standard of operational excellence. Rather than profitability derived from the sheer number of goods produced, advanced manufacturing relies on technical expertise for profit, with production volumes typically quite low when compared with standard manufacturing.

Important to New England's efforts to foster a strong economic outlook, the advanced-manufacturing sector offers not only highly skilled jobs but also well-paying ones. In turn, these jobs in specialized industries strengthen the overall economy and create new employment opportunities across a whole range of social strata.

In New England, it is estimated that nearly 60 percent of manufacturing jobs can be classified as advanced manufacturing, meaning that advanced manufacturing has now outpaced its traditional counterpart. Among the companies that host the jobs are the multinational Raytheon, headquartered in Waltham, Massachusetts. Others are smaller, emerging companies, such as Insight Tech-Gear, which is headquartered in Londonderry, New Hampshire, and is a leading supplier of optical instruments to the military. Between the scope and size of these two businesses lie hundreds of similar companies that contribute mightily to the New England economy.

Perhaps more than any other area in the country, New England has an infrastructure rich in knowledge and talent. Few regions can come close to the depth or diversity. Advanced manufacturing thrives in a network, or "talent cluster," consisting of scientists, researchers, precision machinists, engineers, business developers, and entrepreneurs. That kind of atmosphere results in enhanced innovation and problem solving and reduces learning curves that might otherwise impact the profitability of what is relatively low-volume production. Specific areas ripe with these concentrated talent clusters include Merrimac Valley (Massachusetts)/Southern New Hampshire; the section stretching from New London, Connecticut, to New Bedford, Massachusetts; and the Connecticut River Valley.

Advanced manufacturing relies on a tight learning curve, innovation, and the ability of information and expertise to flow freely among stakeholders. Talent clusters and the centralized expertise in New England enhance that learning curve and capitalize on economies of scale. By collaborating in a network to design the prototype to a lower cost, the innovation clusters also can help solve the "first unit" problem (manufacturing cost is highest for the production of the first unit). Large volumes would not be needed for the product to become cost-competitive because the starting point would be more competitive. Essentially, joint problem solving and shared efficiencies allow advanced-manufacturing players to do less and profit more.

**Perhaps more than any other area in the country, New England has an infrastructure rich in knowledge and talent.**

A recent study commissioned by the New England Council and conducted by Deloitte Consulting LLP, provided strategies for growth within New England's advanced-manufacturing sector. And it projected that, if a concerted effort to promote and support the sector were made, approximately 8,000 new jobs with average salaries of $80,000 could be created in the region each year.

## Challenges

Five major factors have so far kept the advanced-manufacturing industry in New England from reaching its potential.

First, according to the study, is skill level. Many advanced manufacturers report difficulties filling well-paying jobs because of the lack of a qualified and skilled labor force. In fact, the researchers found that approximately 3,000 to 4,000 advanced-manufacturing positions in New England were left unfilled in recent years. Residents' need for employment is there. What is lacking is, in part, the training and tracking of the workforce into these high-paying jobs.

To an unfortunate degree, the shortage of skilled labor in the advanced-manufacturing industry stems from perception. When people hear the word "manufacturing," many immediately think of the "Four Ds"—dirty, dark, dangerous, and declining. Parents and teachers tend not to advocate careers in manufacturing. They fail to emphasize how a solid backing in mathematics and applied sciences can give students a leading edge for the high-paying jobs in advanced manufacturing. Also, most schools do not prioritize hands-on learning, and that reduces opportunities for workforce development in the sector.

Second, advanced manufacturers themselves do not collaborate enough to develop their employment base. They need to partner more extensively with schools to do a

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better job of moving students into dynamic manufacturing careers. Hosting educational site visits and participating more in career seminars would go a long way toward rebranding advanced manufacturing as a vibrant industry with good, challenging jobs. The effort to track students into these jobs will not bear fruit overnight. A shift in mind-set has to come first.

Third, state governments are failing to make even relatively modest investments to spur the advanced-manufacturing sector. Many state manufacturing tax incentives were created in the 1950s and have not kept up with the times. A concerted effort is needed to determine best practices, help leverage targeted financial assistance from the federal government, and identify which tax policies will allow advanced manufacturing to create and retain high-quality jobs.

Fourth, loans can be hard to get for businesses trying to expand. Advanced manufacturers, particularly smaller ones, are often hampered by limited access to capital. Sector-specific small business loan programs could help advanced manufacturers reach their full potential on a faster track, creating job opportunities in a still-struggling economy.

Finally, cross-border collaboration needs strengthening. New England state governments need to do more to work together across state lines. They should have their economic development departments create an inventory of advanced manufacturers to facilitate partnership-building efforts throughout the region. The New England states need to start viewing their neighbors as manufacturing partners, not as competitors. Individual states will be stronger as part of a clearly identified, collaborative, advanced-manufacturing region than if they go it alone.

## A Shared Solution

At a time when many people take a cautious, and sometimes even cynical, view of targeted government investment, the New England Council/Deloitte report is unique in its holistic recommendations. It advocates for involving numerous stakeholders, not just the public sector. A comprehensive solution requires the private sector to undertake proactive educational outreach, an investment of time and resources, and rebranding. Selected tax incentives and a relatively modest loan program are only one part of a larger effort to create a substantial infusion of jobs—advanced-manufacturing jobs and others— into the economy. To the report's authors, that is the essence of "smart government"—a strategic investment in an underutilized industry of high potential and collaboration with the private sector to leverage the greatest number of jobs possible.

**Cross-border collaboration needs strengthening. New England state governments need to do more to work together across state lines.**

In the new economic reality, New England must take a thoughtful and calculated inventory of assets—educational, financial, engineering, and knowledge-based assets—and leverage those assets to achieve a strategic objective. The New England Council plans to continue its work with elected officials and leaders in the advanced-manufacturing industry throughout the region to capitalize on some of the untapped potential in the industry and to advance the shared goal of job creation.

New England must not only protect its base when it comes to advanced manufacturing, but it also must take steps to ensure the industry's enhancement and long-term health. The high-paying regional jobs at stake—both existing and potential—speak to the importance of a concerted effort to ensure that the full viability of the sector can be achieved.

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**James Brett** *is the president and CEO of the New England Council.* **Mike Reopel** *is a principal at Deloitte Consulting LLP. They are based in Boston.*

### Endnote

[1] This article is based on the 2009 study, "Reexamining advanced manufacturing in a networked world: Prospects for a resurgence in New England," http://www.newenglandcouncil.com/reports.php.

RI

# Rhode Island Unemployment


Illustration: Barrie Maguire

**How can a state like Rhode Island have such a high** unemployment rate? This question has been asked often over the past year, especially since at one point, Rhode Island found itself with the dubious distinction of having the highest unemployment rate in the United States. Following that extreme, Rhode Island seemed to settle into a niche where its rank was third nationally.

by Leonard Lardaro
University of Rhode Island

## Multiyear Losses

The underlying causes for Rhode Island's very high unemployment rate are unfortunately not just cyclical. There are a host of structural obstacles within the state's economic environment that also play substantial roles. Taken together, they have produced an array of less than flattering statistics:

- Rhode Island's population began a prolonged period of decline in July 2004;
- Rhode Island was one of the first states to experience budget deficits, well before the start of its current recession;
- payroll employment in Rhode Island peaked in January 2007, a full 11 months before the national employment peak; and
- Rhode Island's economy lapsed into recession in June 2007, six months before the U.S. recession began.

The interaction of Rhode Island's structural negatives and the recent housing bubble produced its most severe economic crisis since the 1991 banking crisis.

A look at payroll employment since 2005—as a percentage of the January 2005 value—for the United States, New England as a whole, and southern New England shows Rhode Island as the clear outlier. (See "Employment since 2005.")

Three observations stand out. First, Rhode Island's employment peak occurred far earlier than any of the others. Second, its employment gain through its peak was less than for the others. Finally, its employment fell faster and by a significantly greater percentage relative to its January 2005 base than did employment in the United States, New England, or the other southern New England states.

Rhode Island's employment behavior over this period is the joint result of both cyclical and longer-term or secular factors. Perhaps the most prominent cyclical factor affecting Rhode Island's labor market over this period was the housing bubble, although national weakness took its toll on manufacturing as well. Construction employment in Rhode Island rose by over 21 percent from 2002 through its peak in January 2007, well above the rates of growth for either the United States or New England for that period. After the January 2007 peak, construction employment in Rhode Island fell by 30 percent, and the combination of declines in construction and manufacturing employment (a loss of 18,400 jobs) accounted for 42 percent of the total decline in Rhode Island employment.

**In addition to taxes, Rhode Island has competitiveness issues with its fees, regulations, electricity costs, and most important, the skills of its workforce.**

What are the secular factors, the things that kept Rhode Island's prerecession employment gains below those of the other entities? Many people cite taxes as the lone culprit, but taxes are only part of the problem.

The problem for Rhode Island is more encompassing. In addition to taxes, Rhode Island has competitiveness issues with its fees, regulations, electricity costs, and most important, the skills of its workforce. Unfortunately, businesses throughout the country know these facts about Rhode Island. In almost any 50-state comparison of business climates, Rhode Island ranks among the worst.

Recently, the Tax Foundation's State Business Tax Climate Index provided rankings going back to 2006. That year, Rhode Island's rank was 50th—dead last. The following year, when Rhode Island's economy peaked, its rank had "improved" to 49th. Since that time, there have been further improvements. The 2010 ranking by the Tax Foundation places Rhode Island at 44th. In a recent comparison published by *Forbes*, "The Best States for Doing Business," Rhode Island's overall ranking was 43rd, New England's second worst (Maine was 46th). Rhode Island's worst category was the Regulatory Environment category, where it came in 50th. Although the state was not close to 50th in any other category, it had no highly favorable rankings, resulting in a poor overall ranking.

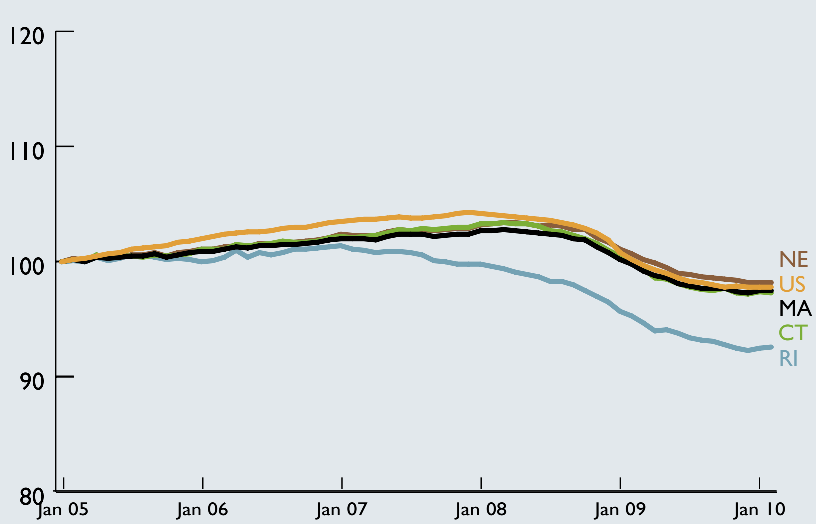
In response to all of this, Rhode Island at long last passed significant reforms to its personal income tax that are scheduled to begin in 2011.

## Education and Other Challenges

Another secular factor with an important contribution to Rhode Island's high jobless rate is its ongoing defunding of public education, in progress for well over a decade. As the state has continued to contribute ever less to its higher education system, tuition, fees, and other costs to students have continued to rise, making higher education less and less affordable to residents.

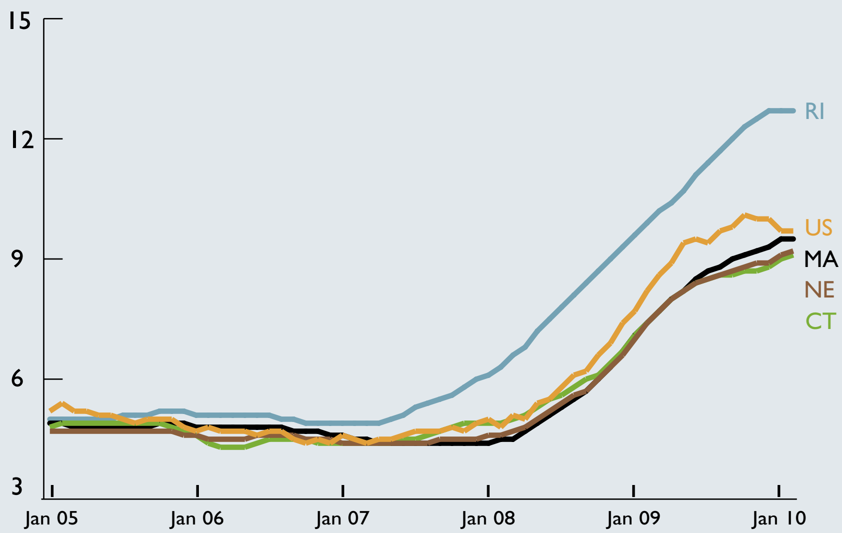
That problem is compounded by Rhode Island's relatively high cost of doing business. Although Rhode Island has high-tech jobs, its nondefense tech sector pays less than jobs available in Massachusetts and Connecticut. In addition, Rhode Island's

**Employment since 2005**




Source: Federal Reserve Bank of Boston's Indicators Interactive.

**Unemployment Rates (Percentage)**




Source: Federal Reserve Bank of Boston's Indicators Interactive.

high-tech jobs often have lesser job ladders than tech jobs in neighboring states. As a result, Rhode Island loses college graduates each year to other states, and because of its size, graduates who remain Rhode Island residents can commute to neighboring states. All of this exacerbates problems with the skills of the state's labor pool (which contributes to Rhode Island's relatively high cost of doing business). Moreover, it restricts the supply of skilled workers available to tech firms, making it difficult for the state to attain a critical mass in technology-oriented and growth industries.

The commuting portion of this phenomenon is a brain drain: It occurs Monday through Friday, 9 a.m. through 5 p.m. In effect, Rhode Island rents out some of its most highly skilled workers to neighboring states. The upside is that those individuals bring home their income, helping to fuel housing demand and retail sales. Still, a healthy portion of Rhode Island's economic momentum through the time of its employment peak was predicated on employment opportunities in other states.

Another area that has contributed to Rhode Island's relatively high joblessness is the performance of its goods-producing sector. There are cyclical elements at work, but longer-term trends exist as well. As in other states, this sector no longer produces the volume of jobs it once did, even in the best of times. Since the 1980s, when new home construction in Rhode Island attained high levels, space limitations, local growth restrictions, and the like have held down new home construction, although construction employment did rise sharply through early 2007. The last time Rhode Island manufacturing employment rose was 1984. So, Rhode Island's goods-producing sector can no longer be counted on to generate the number of jobs it once did. However, as we have seen, it is capable of creating substantial job loss during economic downturns.

One other instance of secular trends interacting with cyclical factors to produce higher joblessness concerns Rhode Island's budget. Even before the housing market collapse and the global recession, Rhode Island had experienced continuing problems balancing its budget. The actions taken to balance those budgets materially sapped the state's economic momentum, further exacerbating the cyclical and secular factors at work. The effects of persistent budget problems, along with deteriorating cyclical performance in the goods-producing sector, were significant factors in raising Rhode Island's unemployment rate.

In sum, Rhode Island's economy had already weakened materially before either its own recession in mid-2007 or the national recession at the end of that year. In effect, Rhode Island had a negative margin for error against such cyclical weakness, the result of the housing collapse and the slowdown in national activity and a host of its own structural deficiencies. Thus Rhode Island's unemployment rate has remained well above that of the United States, New England overall, and the rest of southern New England. (See "Unemployment Rates.")

From 2005 through its employment peak in early 2007, Rhode Island's unemployment rate was comparable to unemployment in the United States, New England overall, and the rest of southern New England. But after the employment peak, the state's unemployment rate rose substantially, reaching almost 13 percent by late 2009.

## An Addendum

The severe flooding of early April 2010 clearly hurt Rhode Island's economy. Fortunately, the floods occurred at a time of building economic momentum. Ironically, Rhode Island's April jobless rate fell from its March level as flood-related job loss was classified as "weather related." Add census hiring and May's rate fell even further. Retail sales also held up well, as persons shifted their purchases to other retail locations, some of which were more "high end."

Ironically, construction expenditures for rebuilding and the federal funds that will flow into Rhode Island for disaster relief will raise its rate of growth above what it otherwise would have been had the flooding not occurred. So in 2011, we may expect Rhode Island's unemployment rate to decline faster than it would have otherwise, the result of Rhode Islanders exhausting all federal unemployment insurance benefit entitlement and the enhanced growth effects of post-flood activity.

To conclude, the most significant long-run reconstruction for Rhode Island will occur only when the skills of its labor force are substantially enhanced. And that will require continued progress in primary and secondary educational attainment and an end to the state's decade-long defunding of public higher education.

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by Spencer M. Cowan
and William M. Rohe
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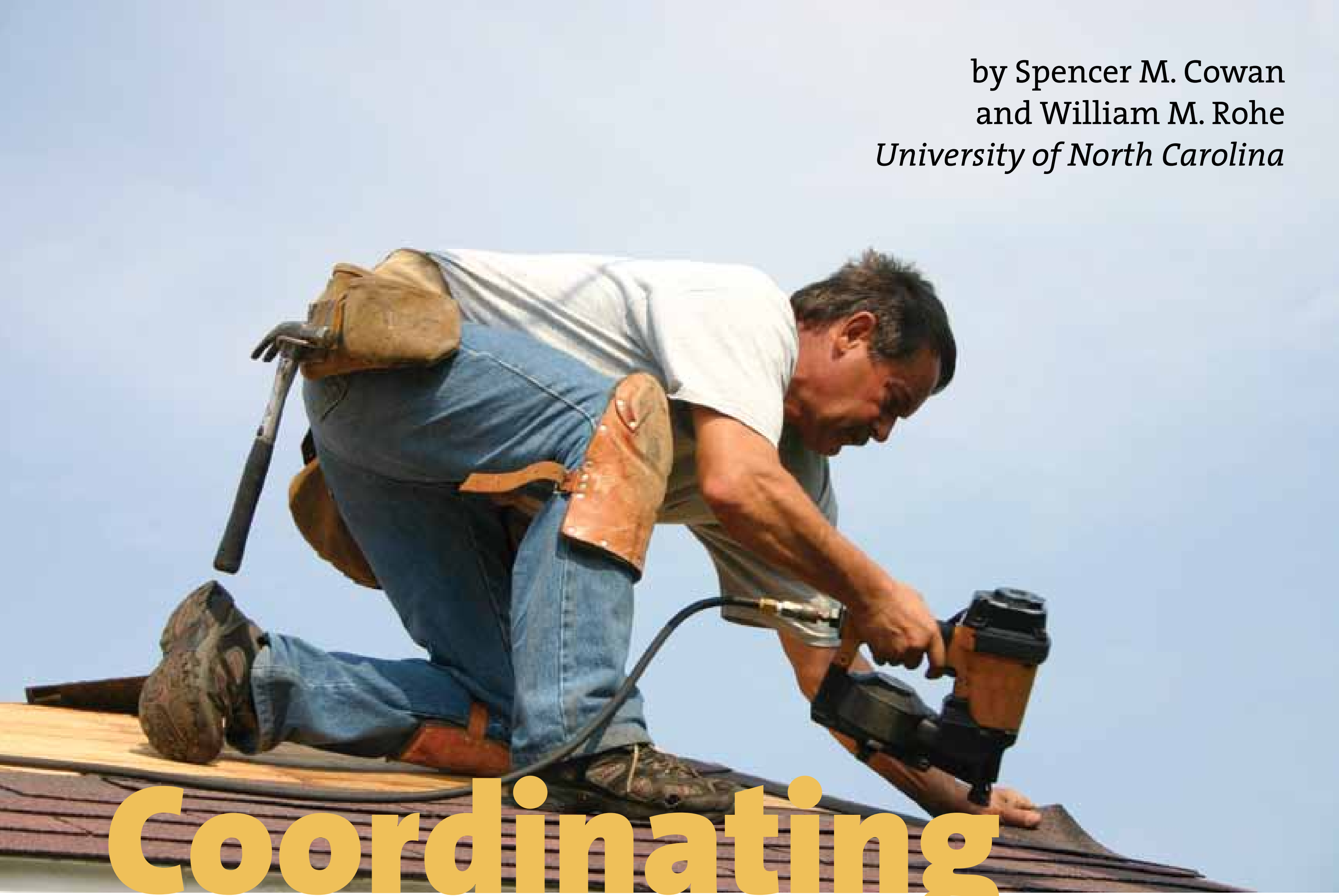

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# Coordinating Homeowner Assistance

## *Weatherization and Housing Rehabilitation*

Low-income homeowners face challenges balancing the financial demands of homeownership. First, they are more apt to have higher-cost subprime or adjustable-rate mortgages. Second, they are more likely to own older, poorly insulated homes with less efficient HVAC systems and appliances. Finally, their homes tend to have more urgent repair and maintenance needs.[1]

Policymakers have responded with two separate, complementary programs: weatherization and housing rehabilitation. Weatherization programs fund upgrades that reduce energy consumption, such as adding insulation or replacing old HVAC systems. Rehab programs help low-income homeowners maintain their homes and eliminate safety hazards. According to a recent study, however, differences between the two types of programs make coordinating the assistance they provide difficult.

## How the Programs Work

The three major funding sources for weatherization are the Department of Energy's Weatherization Assistance Program (WAP), the Low-Income Home Energy Assistance Program (LIHEAP) of the Department of Health and Human Services, and public benefit funds established in 30 states. The American Recovery and Reinvestment Act of 2009 (ARRA) increased funding for WAP from about $227 million in 2008 to $5 billion over the next three years. Annually, LIHEAP adds about $213 million to weatherization initiatives, and public benefit funds contribute $330 million. Before ARRA, the income eligibility threshold for weatherization programs was 150 percent of the poverty level or 60 percent of state median income (whichever was lower). ARRA increased the limit to 200 percent of the poverty level or 60 percent of state median income. Most weatherization assistance comes in the form of grants.

Rehab programs are usually funded through the Department of Housing and Urban Development (HUD) Community Development Block Grant and HOME programs. HUD distributes funds directly to larger cities and counties, as well as to state governments, which pass them on to smaller communities. About $548 million of CDBG and about $275 million of HOME funds are spent on single-family or owner-occupied housing rehab programs annually. The income eligibility threshold for rehab programs is generally 80 percent of area median income (AMI). Rehab assistance is provided to homeowners mainly in the form of subsidized loans, less often as grants.

One impediment to coordination is the different income-eligibility thresholds. In 2006, for example, the income limit for rehab assistance for a family of four in Boston was $60,550, which was 80 percent of AMI—for weatherization the limit was $49,537, which was 60 percent of state median income.

Another impediment is the different timing of funding and expenditures. Weatherization agencies usually receive funding annually, through an established formula, and must spend the money within a single fiscal year. Rehab organizations apply for funds and then have to wait for approval and disbursement of funds, which can take more than a year. Rehab funds can be spent over three or four years.[2]

In addition, the programs normally work through different types of organizations. Weatherization funding generally goes to community action agencies, whereas rehab funding is likely to be distributed through local government agencies or community development corporations. The two types of agencies do not have a history of collaboration, and typical impediments to interagency collaboration—including turf issues and conflicting program regulations and mandates—further hinder coordination efforts.

The lack of coordination creates problems for both clients and administering agencies. Clients may take loans to pay for work that could have been funded by grants, and separate agencies conduct intake interviews and income certifications for the same households.

## Evaluation Project

In 2002 the Ford Foundation and the Energy Programs Consortium (EPC) developed a demonstration program, the Weatherization, Rehab, and Asset Preservation (WRAP) program, to test the feasibility of having local agencies coordinate weatherization and rehab assistance. The Center for Urban and Regional Studies at the University of North Carolina at Chapel Hill evaluated that program between 2002 and 2007.

Ford and EPC selected 11 highly successful nonprofits in nine states to participate in the program. Two, the Massachusetts Affordable Housing Alliance in Dorchester and Action Energy in Gloucester, Massachusetts, worked in collaboration with Action for Boston Community Development and assisted 117 clients, completing work on 108 homes. Of the other nine organizations, only four were able to enroll more than 100 clients and complete work on more than 80 homes during the evaluation period: the Community Development Corporation of Long Island, the Community Action Council of South Texas, Philadelphia's Energy Coordinating Agency, and Milwaukee's Social Development Commission.[3]

**Homeowners with extremely low incomes may not qualify for loans, even subsidized ones. For them, grants are essential.**

The evaluation revealed three lessons

### Sources of WRAP Funding, by Site

| | Rehab | | Weatherization | | Percentage of Funding as Grants |
|---|---|---|---|---|---|
| Site | Grants | Loans | Grants | Loans | |
| Freeport, NY | $48,295 | $1,519,323 | $748,113 | $0 | 34 |
| Massachusetts | $178,345 | $1,979,537 | $422,799 | $25,680 | 23 |
| Milwaukee | $463,437 | $51,660 | $527,932 | $0 | 95 |
| Philadelphia | $396,058 | $202,200 | $333,834 | $0 | 78 |
| Rio Grand City | $636,783 | $161,390 | $244,983 | $0 | 85 |
| TOTAL | $1,722,918 | $3,914,110 | $2,277,661 | $25,680 | 50 |

Source: Weatherization, Rehab, and Asset Preservation (WRAP) agencies' quarterly reports, authors' calculations.

for policymakers: low-income homeowners need different forms of assistance; existing programs do not offer the full range of assistance needed; and differing program regulations and systems for distributing funds hinder efforts to coordinate weatherization and rehab work.

Whether low-income homeowners need grants or loans depends on their incomes. Homeowners with extremely low incomes may not qualify for loans, even subsidized ones.[4] For them, grants are essential. More than half of the clients in three WRAP programs (Milwaukee, Philadelphia, and Rio Grande City) had incomes below 30 percent of AMI. Those sites also had the highest percentage of grants. The Massachusetts programs had the highest percentage of households with incomes between 50 percent and 80 percent of AMI and the lowest percentage of grants. (See "Sources of WRAP Funding, by Site.")

The five largest WRAP programs provided about $7.9 million in assistance. Of that, $1.7 million was in rehab grants, $3.9 million in rehab loans, $2.3 million were weatherization grants, and only $26,000 were weatherization loans.

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Although WRAP agencies secured both weatherization and rehab funding, WRAP staff members in seven of the 11 local agencies cited differences in the income eligibility criteria as a significant obstacle to coordination. The agencies in Freeport and Massachusetts were granted waivers to use state or local public benefit funds to provide weatherization services for homeowners with incomes over the usual WRAP income limit. Those waivers allowed the sites to bridge the gap at the upper levels of eligibility. For homeowners with incomes below the weatherization threshold, they used subsidized loans (zero interest, deferred payment, or forgivable) to fund rehab work. None of the other WRAP sites, however, were able to standardize their income eligibility criteria.

Program staff in both Freeport and Rio Grande City noted that the difference in the timing of funding and expenditures between programs caused problems. During the first year of the program, both sites received significant weatherization funding but could not secure rehab funding before the deadline for spending those funds. Both agencies decided to perform the weatherization work and return later to finish other needed repairs. This decision frustrated both program staff and clients and resulted in an inefficient rehabilitation process. As staff in Rio Grande City noted, the decision meant that "some of the neediest people in the *colonias* [neighborhoods] had to be passed over since their homes could not be weatherized without extensive rehab work."

Low-income homeowners need assistance to meet the challenges of balancing their budgets while facing rising operating and maintenance costs. Government agencies have recognized those needs and have established programs to help. Unfortunately, the programs are structured in ways that prevent local agencies from achieving greater efficiencies and providing better, more comprehensive services by coordinating funding from the separate programs. Program regulations that interfere with coordinating assistance need to be reconsidered to maximize the benefits to homeowners and increase the efficiency of the agencies trying to help them.

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4 Extremely low income is below 30 percent of AMI.

# *Mapping* New England

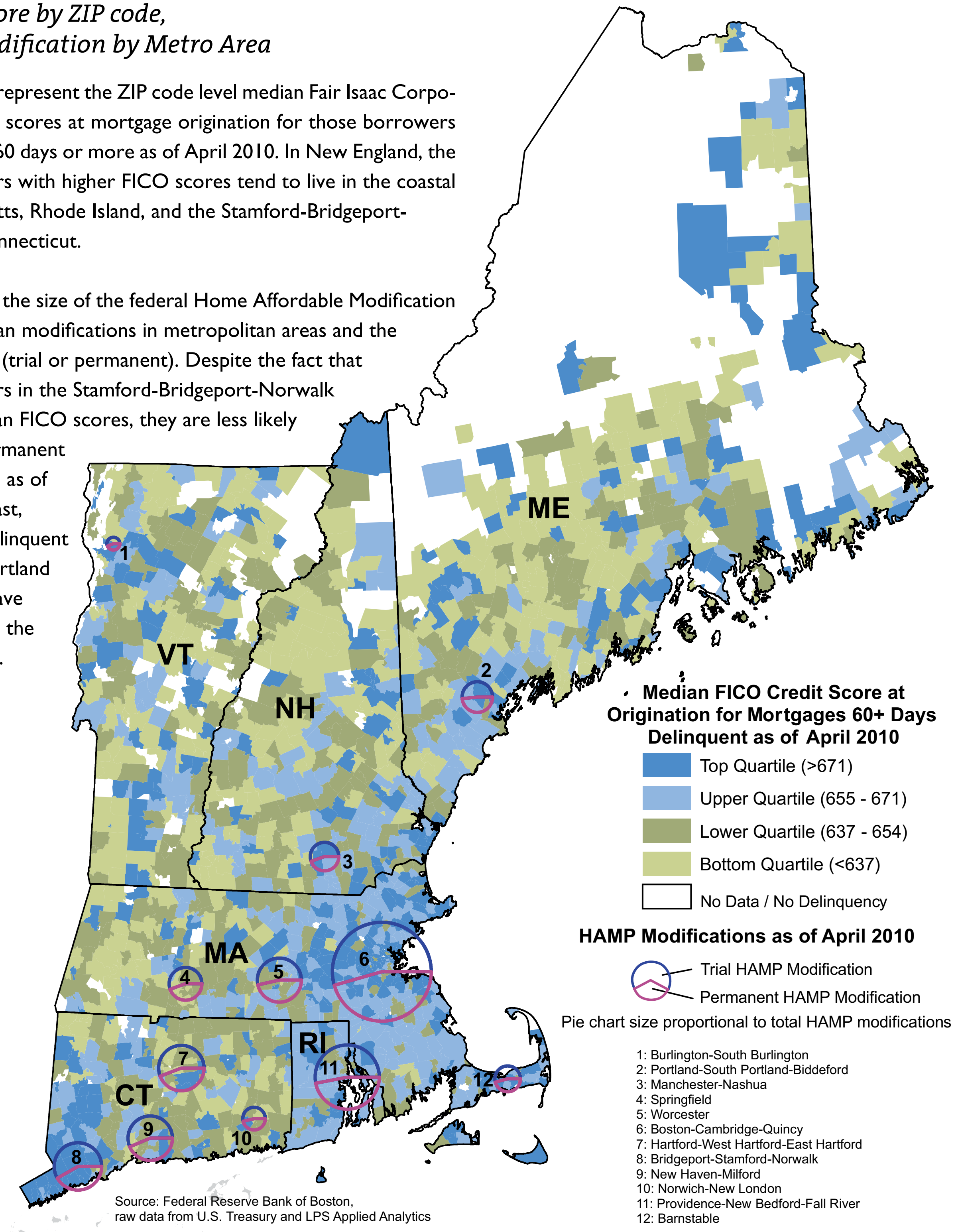
*Mortgage Holders in Trouble*

## *Median FICO Score by ZIP code, HAMP Loan Modification by Metro Area*

The shades of color represent the ZIP code level median Fair Isaac Corporation (FICO) credit scores at mortgage origination for those borrowers who are delinquent 60 days or more as of April 2010. In New England, the delinquent borrowers with higher FICO scores tend to live in the coastal areas of Massachusetts, Rhode Island, and the Stamford-Bridgeport-Norwalk area of Connecticut.

The pie charts show the size of the federal Home Affordable Modification Program (HAMP) loan modifications in metropolitan areas and the type of modification (trial or permanent). Despite the fact that delinquent borrowers in the Stamford-Bridgeport-Norwalk area have high median FICO scores, they are less likely to have received permanent HAMP modifications as of April 2010. In contrast, almost half of the delinquent borrowers in the Portland metropolitan area have received such offers, the highest in the region.

Map: Kai-yan Lee
Federal Reserve
Bank of Boston




# The Subprime melt

Today there is a frequent refrain that the subprime collapse came as a surprise. We contend that, on the contrary, many saw it coming.[1] Starting in the 1990s, there were white papers by consumer organizations and articles in newspapers about abuses in the subprime market. Consumer advocates repeatedly testified before House and Senate committees, citing evidence that, for example, home foreclosures had tripled between 1982 and 1997, high-cost subprime loans accounted for 22 percent of all foreclosures in 1998, and many subprime loans were simply unaffordable.

Illustration: Barrie Maguire

by Kathleen C. Engel
and Patricia A. McCoy

# down: *Who Knew What When?*

These issues, flagged by consumer groups and reporters during the 1990s, were a harbinger of things to come. Risky adjustable-rate mortgages (ARMs) and interest-only ARMs made up less than 5 percent of nonprime mortgages in 2001; by 2006, that percentage was more than 50 percent. Loan-to-value ratios climbed for subprime and so-called Alt-A loans (considered less risky than subprime but more risky than prime); low- and no-documentation loans proliferated. To compound matters, borrowers who could not afford old-fashioned, fixed-rate loans ended up with loans offering teaser rates that would eventually become unaffordable.[2]

## Warning Signs

As the subprime market grew, so did consumer protection lawsuits charging lenders with predatory lending. In 2002, Citigroup Inc. settled a Federal Trade Commission predatory-lending claim for $215 million. In 2004, the Federal Reserve Board issued a $70 million civil money penalty against Citigroup and its nonbank subprime arm, CitiFinancial Credit Company, for abusive loans. Household Finance, owned by HSBC, paid $484 million to settle state consumer protection claims. In 2006 Ameriquest paid $325 million to resolve lending claims brought by state attorneys general.

Federal agencies were already tracking lending abuses before the mortgage market collapsed. Between 1998 and 2001, banking regulators grappled with the failure of several insured depository institutions, including BestBank, Pacific Thrift and Loan Company, First National Bank of Keystone, and Superior Bank FSB, which were brought down, in part, by bad subprime loans. In 1998, the Department of Housing and Urban Development (HUD)—together with the Federal Reserve Board—produced a report pointing out deficiencies in subprime mortgage disclosures.[3] In 2000, Treasury and HUD issued a joint report on subprime abuses.[4]

**The private mortgage industry also knew of the issues. Investment banks had data showing that highly leveraged borrowing went hand-in-hand with higher defaults.**

The states also were aware of troubling practices in the subprime market. Starting in 1999, states enacted a succession of anti-predatory lending laws in response to the proliferation of problem loans. By 2005, more than half the states had adopted such statutes.

The private mortgage industry also knew of the issues. Behind the scenes, investment banks and other securitization actors had proof that many subprime lenders were up to no good. Investment banks had years of data showing that highly leveraged borrowing went hand-in-hand with higher defaults. Despite that, they financed and bought loans even when borrowers had no equity in their homes. The big banks knew that private-label mortgage-backed securities and related derivatives were spawning increased risk. As a former risk manager at Morgan Stanley told a *New York Times* reporter, “You absolutely could see it coming.”[5] Nevertheless, Wall Street generally failed to impose greater controls on the loans it securitized.

Then there were Fannie Mae and Freddie Mac. According to the *Wall Street Journal*, Fannie Mae's chief risk officer wrote a memo in 2005 warning that the loans backing Fannie's subprime bonds would lose value if housing prices dropped. He expressed concern that the rating agencies had not adequately assessed the risk in subprime and Alt-A loans.[6] Similarly, according to an article in the *New York Times*, Freddie Mac's chief risk officer advised his higher-ups in 2004 that subprime loans "would likely pose an enormous financial and reputational risk to the company and the country." But as the head of Freddie Mac told the *Times* reporter, the company "couldn't afford to say no to anyone."[7] The same sentiment reigned at Citigroup, where Charles Prince, then CEO, opined that as long as "the music is playing, you've got to get up and dance."[8]

Rating agencies were aware of the looming crisis, too. In 2003, a director at Fitch Ratings told *Investment Dealers' Digest*, "One of the things we will be watching closely for is a loosening in underwriting guidelines. ... If we start to see changes for the worse, moving down the credit scale, that would raise red flags."[9] By 2005, the rating agencies were fielding complaints that ratings on mortgage-backed securities were too high and did not accurately reflect default risk.[10]

## The Lessons of History

Perhaps the strongest evidence that players knew of the risks associated with subprime lending comes from history. The subprime crisis that began in 2007 was not the first. During the 1990s, companies like Green Tree Financial were financing the purchase of manufactured homes—trailers and double-wide homes. Like many types of subprime mortgages, these loans frequently had terms that borrowers could not afford. To keep volume high, Green Tree began making loans to people who did not meet the company's underwriting guidelines. Every month, the underwriting deteriorated further as Green Tree salespeople tried to meet quotas. Green Tree, later part of Conseco, sold the loans for securitization on Wall Street. By 2002, Green Tree's improvident loans had brought Conseco down and forced it into bankruptcy.

At the same time, several good-sized subprime mortgage lenders also were promoting high-risk loans. In 1998 and 1999, some of these firms failed. Investors in securities backed by the failed institutions' loans accused the investment banks of lax underwriting and charged the rating agencies with incompetence.[11] Similarly, in the late 1990s, risky subprime car loans prompted a spate of bankruptcies among auto finance companies.

**Too many actors, from mortgage brokers to investment banks and beyond, believed they could make money on subprime and pass the risk along the food chain.**

This should sound familiar. What is hard to understand is why it was mainly consumers, their advocates, outside researchers, and a handful of politicians and state officials who yelled "fire" when the flames were at the door. One would think that if lenders were making loans to borrowers who could not afford to pay them unless home values rose forever, the market would have shut them down.

Why didn't that happen? The answer is that so many actors, from mortgage brokers to investment banks and beyond, believed they could make money on subprime and pass the risk along the food chain.

Market participants believed they could extract themselves by selling any risky holdings if the market started to tank. With scant concern about borrowers, society, or even the survival of the industry, subprime lending and subprime securitization descended into a Hobbesian nightmare. Mortgage brokers originated high-risk subprime loans because they collected their fees at closing and did not bear any credit risk. Lenders made reckless loans because they earned up-front fees and could pass the loans to investors by way of investment banks and other entities that converted loans into securities. Investment banks glossed over the risks because they made money from securitizing the loans—and curtailing abusive lending would have been bad for quarterly earnings reports.

Investors, at least, should have cared about loans that might not be repaid, even if the people in the middle didn't. After all, next to borrowers, investors had the most to lose from bad subprime lending. In reality, investors also threw caution to the wind. They believed that they were insulated from credit risk. Credit rating agencies had awarded high ratings, and investors had received their high-yield interest payments on time for years, so they did not question the performance of the underlying loans. They also hedged their risk by buying protection on the underlying securities.

All told, the saga of subprime mortgage lending was a game of hot potato, and few of the players can legitimately deny that they knew the potato was hot.

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by Louise Stoney
and Libbie Naman Poppick

# Shared Services

## Strengthening Early Care and Education

Early learning lasts a lifetime. We now have a strong body of evidence that learning is especially significant in the first five years of life and affects brain architecture for years to come.[1] That's why high-quality early care and education (ECE) is vital for children's academic and social success.[2] And given that more than 60 percent of U.S. mothers of children younger than 5 years old are working and that 73 percent of those children are regularly in child care, making sure that ECE is a healthy, sustainable industry delivering high-quality services is critical for the nation.

But delivering a high-quality program is expensive. Programs must offer competitive salaries to attract and retain teachers with the education and experience needed to foster positive child development. Employees need ample opportunities for supervision, mentoring, and other professional-development activities. Bilingual services, mental health services, developmental screening, and links to health insurance may be needed.[3] Few market-based ECE programs can secure the stable revenue required for such costs. Many already suffer from poor teacher quality and high turnover.

## The Business Challenges

Although vital, the ECE industry is fragile. Most ECE businesses are small and headed by professionals whose expertise is not business expertise. Tuition may be the sole revenue source. In fact, the average child-care center generates about 87 percent of its revenue from parent fees.[4] Compare that with public colleges and universities, which rely on tuition fees for only 36 percent of revenue. Although there is some government support for ECE programs, it represents only a small percentage of ECE expenditures.[5]

Generating the dollars needed to establish and sustain high-quality early care and education programs has never been easy, and it is harder in a recession. For parents in many communities, especially low-income ones, price sensitivity is high, which means that programs often cannot charge fees high enough to cover costs and still attract enough enrollees.[6] Because licensing and good practice require high staff-to-child ratios, good programs are expensive, and full enrollment is needed to pay for them. In attempting to remain economically viable, early care and education programs face what we term the "iron triangle": setting fees high enough to cover costs, collecting fees (or publicly funded vouchers) in full and on time, and maintaining full enrollment. The need to simultaneously meet all three requirements makes programs especially vulnerable to market conditions.

ECE programs are usually small businesses. Nationwide, the average child-care center serves fewer than 70 children. More than 80 percent employ 20 workers or fewer.[7] At many centers, managing finances is just one of numerous tasks that directors or assistant directors handle. They must react to scores of demands every day (staff needing supervision, a child who won't stop biting, an anxious new parent, a clogged toilet, an ill cook). Fiscal management often gets pushed to the bottom of the list.

Also, to ensure sustainability, ECE managers must tap many funding streams, interact with multiple public and private agencies, and market their services. To keep dollars flowing, they need to comply with a dizzying array of funding requirements while meeting complex quality standards. Without careful, consistent attention to the business side, revenues decline and programs falter.

## Shared Services Alliances

To address the issue, a growing group of ECE leaders are developing a management approach called *shared services*. The idea is that a shared infrastructure can give programs access to professional business support that functions at an efficient scale but lets programs maintain their status as independent providers.

Shared services alliances have been formed that include both center- and home-based providers and numerous services, business models, and sponsoring agencies. (See "Potential Shared Services.")

### Potential Shared Services

- Quality support (classroom and child assessment, curriculum support)
- Management/administration (team of directors/supervisors)
- Fiscal (billing and fee collection)
- Marketing and enrollment
- Fund development
- Human resources and staffing
- Health/mental health/ family support
- Food services
- Purchasing goods and services

In Chattanooga, Tennessee, the Children's Home, a large child-development center, leads the effort. Before offering management services to the 10 community-based programs in its network, the Children's Home had its own staff managing money and supporting program quality. Creating the network involved restructuring and expanding the staff to reach an additional 370 offsite children.

In other communities, similar economies of scale can be found in a range of intermediary organizations both inside and outside early care and education, including child-care resource and referral agencies, family child-care networks, and nonprofit umbrella organizations. Some ECE programs join forces and create collectively run shared services entities.

As the organizations engaged in shared services create new business models, they also are developing new management tools, including information technology to support fiscal and management tasks and better data collection to guide marketing and enrollment. Additionally, leading shared services organizations are collaborating with other industries to reach scale nationally in functions such as human resources and purchasing.

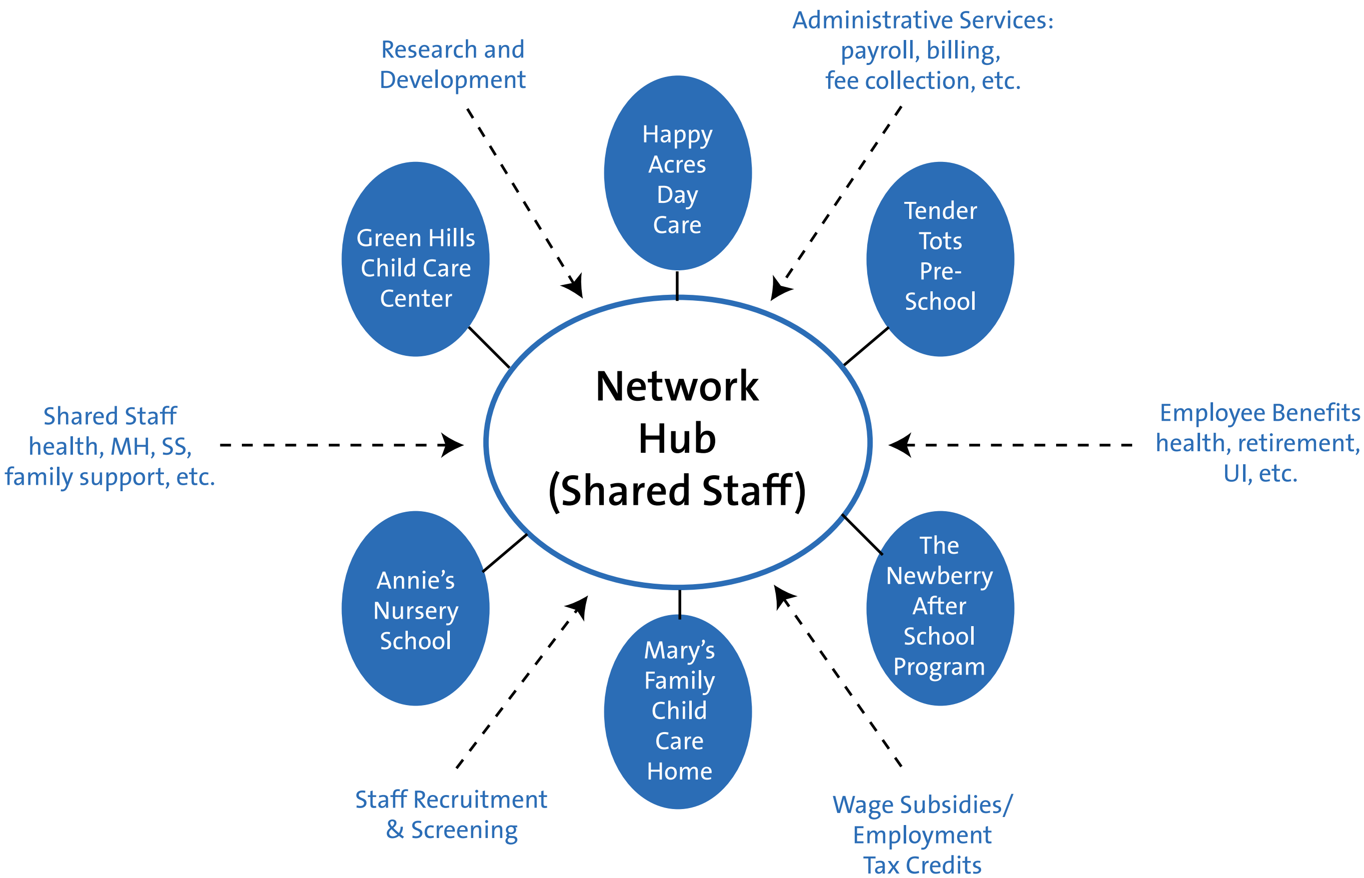
Alliances can make ECE programs financially and programmatically stronger. The small child-care programs that joined up with the Children's Home had previously been struggling financially and were unable to provide high-quality services. Today they not only offer top-quality early learning but are able to link the low-income children and families they serve to comprehensive health, mental health, and social services. Staff members have higher wages and paid health and dental coverage, a pension plan, and a host of other benefits and career opportunities not available to them in the past.[8]

Infant-Toddler Family Day Care (IFDC), an alliance of home-based providers in Fairfax, Virginia, boasts similar results. IFDC includes about 130 family child-care providers, most speaking a primary language other than English. Thanks to a steady income in the alliance, they earn more than their unaffiliated peers. The alliance manages fee collection and helps providers stay fully enrolled. It has strong standards for professional development and specialized training and internship opportunities for non-English speakers. Its home-based providers stay in the child-care field 2.6 times longer than the national average. Among other benefits, the alliance offers parent services such as support groups, parenting education, and substitute care when an alliance provider is ill. (See "Network Hub.")

## Small with Scale Advantages

In creating an administrative structure large enough to employ staff with the skills and time to focus on the business side, alliances actually support the small settings that foster good child development. The whole is greater than the sum of its parts. Consider the following:

- the fiscal management and economic strength of a larger organization make it easier for very small businesses to weather economic storms;
- costs in areas such as payroll, benefits management, banking, janitorial, food services, and purchasing are lower;




- the more stable financial and organizational structure, improved compensation, and comprehensive professional-development approach translates into higher-quality education and more family support services; and
- outcomes are better and more easily tracked.

Increased government support and consistent policy direction for early care and education is needed. But the ECE industry also needs to reinvent itself by investing in stronger management models. With careful attention to the business side, market-based early care and education services can build a better future for the nation's children.

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# The Creative *Economy*, Public Policy, and *Community* Development

by Mollie S. Burke
Vermont State Representative

On the first Friday evening of every month, residents and visitors fill the streets of Brattleboro, a 12,000-person community located on the Connecticut River in Vermont. Considered one of the top 10 small "Art Towns" in America, Brattleboro shows how the arts can boost a region's economic vitality.[1]

The Gallery Walk's 40 stores and galleries sit in a three-block historic downtown district. This architecturally intact 19th century streetscape forms an aesthetic backdrop for the crowds weaving their way in and out of storefronts during the event. It is one large community block party. Neighbors and friends stop to greet and linger to chat. Musical groups serenade the crowds. It is possible to hear nationally known but locally based musicians or members of the Brattleboro High School Band (who performed in the Obama inaugural parade), all playing for joy. Nonprofits sell baked goods or raffle tickets from tables set up on the sidewalk.

Residents and visitors in Brattleboro, Vermont, turn out for the annual Strolling of the Heifers parade. Photograph: Greg Worden

## Building on a Strength

Gallery Walk was founded in 1995 amid concerns about the way online shopping and big-box stores in nearby New Hampshire were contributing to declining revenues "downstreet." The idea was that capitalizing on Brattleboro's artistic wealth could help to preserve the fragile downtown economy.

As Gallery Walk has evolved, so has the town's sense of itself as an arts community. In 2001, a citizens group called the Brattleboro Arts Initiative purchased the historic art deco Latchis hotel and theater to procure a performing arts space and hotel for downtown economic development and architectural preservation.

These are only two of the many arts institutions that define Brattleboro. A short skip down the street from the Latchis are the Brattleboro Museum and Art Center and the dynamic New England Youth Theater. Scattered nearby are a music school, a dance school, and a visual arts school. About a mile south, an old mill building houses the Vermont Jazz Center, the New England Center for Circus Arts, and several incubating businesses, including a pottery studio and a cabinet-design company.

**A nationwide study, "Arts and Economic Prosperity III," confirmed that investment in the arts promotes community and economic development.**

Annual arts festivals add to the tapestry. A Women's Film Festival occurs in March and the Brattleboro Literary Festival in October. The arts are even a component of the June Heifer Stroll, which draws in thousands to celebrate Vermont agriculture.

In 2005, Americans for the Arts, a nonprofit organization that promotes the arts in the United States, conducted a nationwide study, "Arts and Economic Prosperity III."[2] It confirmed that investment in the arts promotes community and economic development. It also revealed that although less than $4 billion is spent on the arts annually by local, state, and federal governments, there is a $30 billion return on investment.

Americans for the Arts collected data from 6,080 nonprofit arts and culture organizations across the country, including those in Brattleboro. The Arts Council of Windham County, Vermont, along with two other arts organizations, administered the Brattleboro part of the study. The Economic Impact of the Nonprofit Arts Sector of Greater Brattleboro found that local nonprofit arts organizations produced $11 million in economic activity in 2005, almost as much as the entire town budget. In addition, the arts generated $270,000 in local taxes and $600,000 in state revenue. And that doesn't include the for-profit arts sector of self-employed artists and retail galleries.

The figures for jobs generated are equally significant. Nonprofit arts organizations in Brattleboro create 200 full-time-equivalent jobs, representing a total of $6.2 million in salaries, wages, and self-employment income. These jobs are community based and not the sort that can be outsourced. Further, the money is likely to be spent within the community.[3]

Arts events leverage spending at restaurants and stores, while a vital arts community attracts cultural tourists, who often spend twice as much as local audiences and are apt to return or spread the word to friends.

## Beyond the Numbers

Armed with the compelling numbers, arts organizations across the country are stating the case for continued and increased investment in the arts at the level of public policy. Alex Aldrich, head of the Vermont Arts Council, used Vermont's strong numbers in February 2010 to defend his organization's funding request before the appropriations committee of the Vermont House of Representatives. Over the past five years, he stated, 30,000 employment opportunities for Vermont artists and arts educators had been provided, and $4.6 million had been contributed to the Vermont economy. That's impressive for a state with a population of 600,000 people and a total budget of about $4 billion.

However, the economic numbers do not tell the entire story. At a recent meeting at the Vermont State House billed as "Tourism and the Arts," representatives from arts organizations noted that the state needs to improve its use of the arts as a tourist draw to benefit both itself and the artists. Greg Worden, chair of the Arts Council of Windham County, expressed concern that Brattleboro may be at a critical point and that the growing and flourishing arts scene could start to decline without sufficient support. He called for judicious spending of both state and private advertising dollars to attract new audiences.

The problem is that on Brattleboro's Main Street, even though the performing events and restaurants are full, the art galleries have been hit hard by the recession and are struggling. One gallery owner observed recently that tourists are coming to look but not to buy. The Windham Arts Gallery, a longstanding cooperative, closed last year.

Moreover, the artists themselves, the people whose talent and vision create a thriving arts community, have often missed out on the creative-economy benefits. In April 2007, an Artist Town Meeting took place in Brattleboro to identify concerns. The needs that emerged—affordable living and work space, jobs and funding, health care—remain needs today. Many artists and writers struggle to make a living, often working at low-paying, part-time jobs to eke out enough time and money to practice their art. Others find teaching jobs that offer health insurance and a decent salary but drain time and energy from creative endeavors.

Historical precedents for recognizing artists as a community resource and backing that up with financial assistance do exist. The Federal Art Project and Federal Writers Project of the New Deal put artists and writers to work in community settings. Forty years later, the Comprehensive Employment and Training Act of 1973 (CETA) funded artists along with other occupations. The primary goal of these programs was employment, but they also added to our cultural heritage and community well-being. They were a good economic investment, giving a leg up to many at the beginning of their careers who later achieved economic success on their own.

**Armed with the compelling numbers, arts organizations across the country are stating the case for continued and increased investment in the arts at the level of public policy.**

The American Recovery and Reinvestment Act of 2009 (the "stimulus") attempted to address the issue of arts jobs by allocating $50 million nationwide. The Vermont Arts Council received $250,000 for distribution to nonprofit organizations to retain employees. Although that amount was welcomed by recipients, it represented a small fraction of the $789 billion of total federal stimulus money. As Aldrich testified, it was a missed opportunity for job creation, given the economic potential of the arts.

A strong case can be made for public arts funding, but there are also visionary private philanthropists who see the economic and cultural advantages. The founder of the Vermont-based Orton Family Foundation, which engages citizens in articulating community values and planning for the future, saw the potential for artists to participate in the process. Lyman Orton provided $25,000 in 2009 for each of 10 selected Vermont visual artists to create work envisioning the future of the state. The work is touring Vermont towns for one year, provoking conversations and communicating visions and challenges.

This gets to the heart of the issue. Investing in the arts and artists pays economic and cultural dividends and enhances a community's quality of life. But beyond that, there is value in the kind of thinking that artists are known for, and the more that business organizations, community leaders, and policymakers recognize that, the better off the state will be. By definition, artists are creative, and they engage in the innovative and adaptive thinking that communities need in order to flourish.

We need an abundance of both innovation and adaptability to reenvision our communities and our world. We can start by engaging artists in planning, in community decision making, and in the articulation of values and visions.

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**Mollie S. Burke** *is a member of the Vermont House of Representatives. She is also a visual artist and director of Art in the Neighborhood, a nonprofit organization that provides arts classes to economically disadvantaged children.*

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# How Loan Modifications *Affect Credit Scores*

by Prabal Chakrabarti, Federal Reserve Bank of Boston

Homeowners who receive loan modifications and successfully avoid foreclosure may face another issue, one that is not well understood. It turns out that participation in loan-modification programs may adversely affect credit scores. [1] The magnitude of the impact is unclear because many factors affect what lenders will report about borrowers who seek modifications, and other factors affect how much the credit-reporting agencies, credit-score providers, and lenders will penalize borrowers who have loan modifications on their credit reports. Although both the U.S. Treasury and credit-scoring agencies have tried to clarify the issue, the outcome is still murky.

Department, the credit-score penalties for those who sought loan modifications varied, ranging from 30 points to 100 points.

According to Fair Isaac Corporation (FICO), the company behind the FICO credit score, the penalty varied depending on the borrower's previous credit history.[3] The main purpose of scoring agencies' and lenders' credit modeling is to predict an applicant's repayment behavior. Lenders use credit scores to gauge the risk of lending to a borrower and to price that risk appropriately.

Surprisingly, the penalty tended to be *larger* for a borrower who had never been delinquent with a payment. If the borrower was delinquent prior to receiving a trial modification, the credit score would already have dropped considerably (for example, if the borrower was being reported as "pays more than 60 days late"), and the additional effect of making partial payment would be moderate.

The negative impact of loan modifications first received attention in summer 2009, several months after the start of a Making Home Affordable initiative called the Home Affordable Modification Program (HAMP). Some borrowers who received three-month trial modifications subsequently reported decreases in their credit card limit and increases in credit card interest rates. Others reported being denied car loans. The borrowers speculated that their credit history and credit scores had been negatively affected by participation in the HAMP program.

Borrowers need not be late in their loan payments to qualify for a modification but are eligible if default is reasonably foreseeable. If they have been making mortgage payments on time but are approved for a HAMP modification based on evidence of future distress, they may see an impact on their credit score. In fact, borrowers with credit scores of 720 or above with no history of late payments could see a substantial drop in their credit score—a drop of roughly 70 points.

## A Borrower Gets a Shock

One borrower reported that after being unemployed for six months, he took a new job at about one-third less pay. As a result, he and his wife were in poor financial shape. Moreover, they had been struggling since taking out a second mortgage to pay off debt and medical bills. Late in 2009, he went searching for a used vehicle and was approved for 30 days for a $2,000 loan if he found something. The 30-day period ran out before he found a suitable car. When he went to reapply, he was stunned to learn that he was denied as a result of the new information reported about his participation in the HAMP.[2] What happened?

**Borrowers with credit scores of 720 or above with no history of late payments could see a substantial drop in their credit score.**

Prior to November 2009, most lenders were telling the credit-reporting agencies (Equifax, Experian, and TransUnion) that borrowers in the HAMP were being coded as "making partial payment," a standard set by the Consumer Data Industry Association. According to the U.S. Treasury

## A New Code

After the U.S. Treasury recommended that the industry address the issue, the Consumer Data Industry Association created a new code designed to signify participation in the Making Home Affordable program. It is too soon to know whether the code "making payments under government modification plan" causes a negative prediction of repayment in the scoring models. It is meant to be retroactive and replace partial-payment codes for borrowers in loan-modification programs. The change should keep borrowers in good standing from being penalized for entering the modification program, but there is no guarantee. As of this writing, the FICO scoring model ignores the new code, so the overall effect of participating in the program is neutral.

Moreover, although it may be the most well known, the Fair Isaac model is not the sole credit-scoring model. Other models exist, including the VantageScore by VantageScore Solutions LLC, a joint venture of the three credit-reporting agencies. The

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loan-modification program may have different impacts on different models.[4]

Lenders such as credit card companies and auto finance companies also may have their own scoring models and may use the FICO-derived score only as one input into their process. Hence no one should assume that the new code solves the issue. Entrants into a modification program may still see their credit limits lowered or confront a rise in their short-term rates. And although several banks have agreed to use the new code, it is not known whether all servicers are complying.

HAMP revisions issued in March 2010 included two significant new elements: first, a principal-forgiveness option, and second, a temporary payment reduction for the unemployed. The former may be treated differently from the "making payments under government modification plan" code because it represents a true and permanent debt forgiveness. The latter, according to some commentators, is likely to trigger a credit-report penalty.[5]

## Other Debts

The treatment of other debts is of special importance. Loan modifications under the HAMP use a formula to compute desirable debt-to-income ratios for mortgage payments. Monthly debt payments are brought down to 31 percent of monthly income. But so called "back-end" debt (monthly payments for car loans, credit cards, and the like) is excluded from the computation. That is true even though there is a requirement to see a housing counselor certified by the Department of Housing and Urban Development if back-end debt exceeds 55 percent of debt-to-income. This means that borrowers under the HAMP plan may still have many other payments that are not adjusted or modified. Second liens are also not modified except under certain limited circumstances. The value of this element of the plan is debatable, as one could view it as a requirement falling upon senior mortgage-lien holders that is not falling upon second-lien holders, car loan finance companies, or credit card companies. But from a practical perspective, the borrower must maintain all payments or face consequences from lenders.

## Borrower Beware

The possibility of credit score problems should not deter most borrowers from participating in the HAMP program if they face financial distress. According to the Vantage model, a foreclosure can result in a 140-point decline for a borrower with good credit. Bankruptcy can result in a decline of more than 300 points.

But given the prominence that credit scores have taken on, including with employers conducting credit checks or landlords evaluating a tenant, borrowers should be aware that in the future, even if they make every payment on time and follow all the rules of the program, they may be punished by lenders for their participation.

It is understandable that lenders use credit histories and relevant information to assess a borrower's ability to repay and that a change in financial circumstances that manifests itself through modified payments may be taken into account. But one can also argue that the public policy goals of the HAMP should not be compromised by an industry practice if it can be reasonably avoided when borrowers act in good faith in a government-sponsored program. Lender compliance with standard industry reporting must be monitored to ensure that proper reporting is being done.

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### Endnotes

1 As of February 2010, more than 1 million borrowers had lowered their payments (168,000 permanently) through the Making Home Affordable modification program. Some, especially those with job losses and significantly reduced incomes, were not eligible according to the initial criteria, and as of this writing, it was unclear how many more would qualify after the March 2010 program changes. See www.makinghomeaffordable.gov for program details and eligibility.

2 Alan Zibel, "Credit Scores Can Drop After Getting Loan Help," Associated Press, March 19, 2010, abcnews.go.com/Business/wireStory?id=10147330.

3 The FICO score is on a 300 to 850 scale.

4 According to the Vantage Scoring Model, a charge-off of principal can reduce the score by 100 points (on a 501 to 990 scale). See Ken Harney, "Loan Modifications Can Be Gained without Ruining Your Credit Score," *Daily Herald*, April 16, 2010, http://www.dailyherald.com/story/?id=373263&src=118.

5 See Ron Lieber and Jennifer Saranow Schultz, "Answers to Questions about New Mortgage Modification Program," *New York Times*, March 5, 2009; and Jennifer Schultz, "Mortgage Modifications Affect Credit Scores," *New York Times*, January 5, 2010.

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