<u>REBUILDING THE RESIDENTIAL PURCHASE MARKET</u>

<u>Home Ready Buyers: *Creating a Low Foreclosure Pipeline of Low Down Payment Borrowers*</u>

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<u>INTRODUCTION</u>

There are many signs that our battered economy is slowly recovering. But the nation's housing purchase market slowly limps along. Without fundamental changes, it will not return as millions of potential and deserving homeowners will continue to be shut out of the market. Devastated neighborhoods will not heal, local governments' ability to pay for needed public services will be jeopardized and dark shadows will cloud community business and economic health.

This pessimistic scenario is not set in stone. There must be a concerted effort to improve this system, open the way to successful homeownership to more Americans and provide it through a functioning housing finance system that properly balances access to credit and borrowers' abilities to manage that credit.

The route that brought us to this state is now obvious and well documented. The lending community, encouraged by federal policy, abandoned conventional underwriting principles by deciding they could accept ever increasing risks as long as they priced for it. Borrowers and lenders embraced an environment of expanding credit options with lower standards.

Housing market participants cannot ignore the self-evident: A housing finance system that generates near double-digit foreclosure rates fails individuals, neighborhoods and communities regardless of how it was priced. Our economy cannot wait for seven to 10 years on the hope that underwater borrowers to rehabilitate themselves. For a housing market recovery to be self-sustained there must be a supply of capable, credit-worthy borrowers.

What needs to be done to reestablish a low-foreclosure mortgage market that provides appropriate and responsible access to individuals and families? The *Home Ready Buyer* program will establish an infrastructure so borrowers and lenders can be responsible and succeed.

Homeownership is not an unreasonable or unattainable goal for hard working Americans. A simple and focused program, *Home Ready Buyer,* brings together state housing agencies, lenders, private mortgage insurance companies, credit counseling agencies and home buyers to provide a responsible way for first-time homebuyers to enter the market. It will also provide an opportunity for lending institutions to reconnect with the communities where they do business.

The *Home Ready Buyer* program targets those who were most challenged under the old system: first-time homebuyers; those who want to purchase homes but have impaired credit; and those who need time to save for a 3 percent down payment.

State housing finance agencies will set up the *Home Ready Buyer* programs. A modest fee on purchase mortgages will provide the funding for the program's activities which will include credit counseling. It will also incorporate a disclosure requirement highlighting the financial benefits of shorter-term mortgages, such as establishing equity more quickly and reducing financing costs.

The process starts with borrowers -- who are committed to saving and credit improvement -- working with state housing agencies to enter into a "*Home Ready Loan Agreement*" with a lender and mortgage insurer to establish a down payment goal of at least 3 percent plus appropriate closing costs, enter into a credit improvement plan to increase the borrowers' credit score to at least 680, participate in a credit/financial counseling program and participate in a home maintenance and repair class.

Preparing first-time homebuyers with the tools to succeed as homeowners requires an investment. But, as the recent economic downturn has too clearly shown, that cost pales when compared to the tremendous social costs associated with putting people into homes they cannot afford with payments they cannot sustain.

Overview
Mortgage Credit, unlike other forms of credit, has the potential have an impact beyond those directly involved in a specific mortgage. The fixed nature of real estate and the reality that most municipalities' finances depend on real estate activity mean that poor decisions by borrowers and lenders can devastate neighbors, communities and, as we've seen, to the economy as a whole. Since the start of the mortgage meltdown in 2007, we've seen millions home foreclosures,yet there are still an additional 2.7 million seriously delinquent mortgages awaiting final resolution.[1] The consequence -- Americans are seeing the value of their homes and personal net worth plummet even though they remain in their homes, work hard and stay current on their mortgages.

Despite signs that the worst is behind us, a chastened lending community dealing with both an uncertain regulatory environment and seemingly unending litigation related to past mortgage failures has resulted in an overly restrictive mortgage credit environment. Additionally, as highlighted in the October 2012 Federal Reserve Bank of San Francisco Economic Newsletter ("Credit Access Following a Mortgage Default" by William Hedberg and John Krainer), a significant number of potential homebuyers may, unlike in past housing cycles, be unable to participate in any housing recovery due to damaged credit.[2]

Just how broken the housing finance model is can be best revealed by the fact that despite mortgage rates sitting at historic lows, home purchases amount to only about 30 percent of all mortgage activity.[3] To fully heal the housing market, we must deal with both the supply and demand problems in the mortgage *credit* market. This paper will set forth a program, the *Home Ready Buyer* (HRB) program, designed to do just that.

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[1] Seriously Delinquent Mortgages Fall 12%" by Housingwire (12/12/2012) (www.housingwire.com/fastnews/2012/12/12/seriously-delinquent-mortgages-fall-12)
[2] www.frbsf.org/publications/economics/letter/2012/el2012-32.html
[3] www.mortgagebankers.org/ResearchandForecasts/ForecastsandCommentary

Building a Home Ready Credit Program

The *Home Ready Buyer* program will establish a home ownership infrastructure using existing parties to work with borrowers and provide a financing arrangement that they can successfully complete. These parties include, among others: state housing finance agencies; credit unions and community banks; private mortgage insurance companies; and housing and credit counseling organizations. Borrowers, in return for being offered mortgages that they would not normally be able to obtain under conventional circumstances, will be expected to save for a down payment, complete a credit counseling program and accept mortgage terms designed to reduce the frequency of foreclosure.

These features insure that the mortgages will be attractive to investors and private mortgage insurers who will be asked to bear the credit risk. Importantly, as additional support for the program, Regulators must agree that *Home Ready Buyer* loans meet all the various mortgage regulatory standards and tests. The result will be a program that restores a balance between individuals access to credit, while reducing the chances that neighbors and neighborhoods will suffer from putting families into homes they cannot afford to keep. The goal is clear: create access to credit and build a pipeline of home-ready borrowers that have a low likelihood (frequency) of foreclosure.

Who is the target of HRB?

- First-time homebuyers
- Individuals who want to purchase a home but have impaired credit
- Individuals who need time to save for a 3% down payment.

These are the traditional groups targeted by housing policy. The difference with this program is that rather than simply focusing on giving borrowers access to mortgages, the *Home Ready Buyer* program focuses on preparing borrowers for their obligation while also applying underwriting standards that will result in a reduced likelihood of default.

Underwriting Low Foreclosure Mortgages

The primary cause of the mortgage finance crisis that preceded the recent financial meltdown was a lending community, encouraged by Federal housing policy that largely abandoned conventional underwriting principles. This was supported by a notion that lenders/investors could accept ever increasing risk as long as they priced for it accompanied by financing arrangements that boosted short-term profits. Effectively, risk management was supplanted by untested pricing models. Government policy makers, borrowers and lenders enthusiastically embraced an environment of expanded credit options with lower standards as, for a time; everyone seemed to come out ahead. Borrowers were able to purchase larger, more opulent homes, lenders/investors enjoyed higher profits/returns and government policy makers could point to higher consumer spending and home ownership rates.

There was a serious problem lurking in the shadows. An industry whose shared credit disciplines had produced consistent 2 percent to 3 percent aggregate annual default rates for decades had morphed into an industry that would push defaults to three times that level.[4] The mechanisms in place to manage risk in the system (Capital cushions, regulatory oversight, etc.) proved woefully inadequate in the face of this new reality and The Great Recession ensued. The critical flaw was that merely pricing a discrete mortgage for its obvious underwriting deficiencies failed to account for the massive social costs associated with the aggregate increase in mortgage defaults -- costs that the economy as a whole is still laboring to pay for.

The critical question for policy makers: What is an acceptable default/foreclosure rate for both conventional low down payment and government low down payment (FHA/VA) loans?

We don't seek to answer the question specifically; rather, the Home Ready Buyer Program we propose recognizes that high single digit annual default rates do terrible harm to individuals and neighborhoods. The program seeks to re-establish underwriting standards that cut default rates and produce a less volatile foreclosure environment. In addition to instituting a baseline of traditional underwriting principles, *Home Ready Buyer* will also incorporate requirements on the borrower intended to improve their ability to pay back the mortgage.

The Program's underwriting features require standards have a demonstrated capacity to reduce the frequency of default:

- Fully documented loans
- Verification of income and assets
- Cash contribution from the borrower of at least a 3 percent down payment
- Reasonable debt to income ratio.

Additionally, the Program includes borrower requirements intended to better prepare them for the obligations associated with home ownership:

- Credit counseling and a basic financial literacy class (over about 36 months)
- Establishment of savings and checking accounts
- Maintenance of a budget along with records indicating they are paying their bills on time
- Incorporate a disclosure requirement highlighting the financial benefits of shorter term mortgages in terms of equity accumulation and cost of financing.

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[4] Credit Access Following a Mortgage Default" by William Hedberg & John Krainer (10/29/2012) (www.frbsf.org/publications/economics/letter/2012/el2012-32.html)

The Benefits of Building Equity

Historically, homeownership had been the vehicle by which millions of Americans had built equity and wealth while contributing to the growth and development of strong, stable communities. Regrettably, over the last 20-some years housing has become less of a wealth builder and more of a consumer ATM. This fundamental shift in consumer behavior contributed to the severity of the financial crisis we have just weathered. The *Home Ready Buyer* program will educate borrowers about the benefits of building equity both in terms of the impact on their personal net worth and on the impact it has on their cost of borrowing. The program will show borrowers how low mortgage rates and a shorter amortization can be used to accelerate the equity build up in their home. The following table highlights this dramatic impact by comparing a 30 year fixed rate loan versus a 20 year fixed rate loan at approximately the same monthly payment:

COMPARING BENEFITS: 30-YEAR VS. 20-YEAR TERM MORTGAGES

	30 Year Term	20 Year Term
Home Price:	$181,500	$150,000
Down Payment (3%):	$5,445	$4,500
Mortgage Rate:	4.25%	4.00%
Monthly Payment:	$866	$882
LTV at Year 5:	88.1%	79.5%
Equity at Year 5:	$21,629 (11.9%)	$30,801 (20.5%)
Cumulative Interest Over Stated Term:	$135,734	$66,108

While qualifying for a 20 year mortgage might mean the borrower purchases a less expensive home, the 20 year fixed rate loan produces substantial long term financial benefits. The lower down payment, the rapid accumulation of equity in the home (after only 5 years the Borrower already has an additional $9,172 in equity), the elimination of the mortgage insurance premium in under 5 years and $69,626 in interest savings over the life of the loan put the borrower on a dramatically better financial footing. In addition to both the credit counselor and the lender being required to disclose this information to the borrower, the credit counselor will be required to develop a budget with the borrower that demonstrates their capacity to manage a 20 year amortizing mortgage. By educating the borrower on the benefits of accelerated equity growth in their home, the *Home Ready Buyer* program is supporting a better economic outcome for the borrower, an attractive credit risk for the lender/investor and neighborhoods insulated from rapid home price depreciation.

<u>The *Home Ready Buyer* Framework and Guidelines</u>

State Housing Finance Agencies

The administrators of the *Home Ready Buyer* program.

- Set up a segregated account to receive the *Home Ready Buyer* Assessment that will be generated from newly originated loans within the state.
- Using *Home Ready Buyer* Assessment proceeds, pay for borrowers' credit counseling and financial education requirements under *Home Ready Buyer* (with particular emphasis on the positive financial impact of a mortgage that fully amortizes in less than 30 years).
- Provide a list of qualified housing and credit counseling agencies to participate in the program.
- Define and measure the effectiveness of the credit counseling agencies.
- Provide borrowers a "Benefits of Building Equity" disclosure statement.
- Coordinate with other state down-payment assistance programs within the *Home Ready Buyer* program.

Borrowers

Enter into a *Home Ready Loan Agreement* ("*The Home Ready Buyer Agreement*") with the Lender and Mortgage Insurer which would last up to 36 months and require the following:

- Commit to a down-payment savings goal of 3 percent plus appropriate closing costs for the state of domicile.
- Commit to a credit improvement plan with the goal of increasing the borrower's credit score to at least 680.
- Enter into a credit/financial counseling program with the goal of educating the borrower on foundational finance concepts relating to savings spending and budgeting.
- During the program duration, the homebuyer would also take a home maintenance and repair class.

Financial Institutions, the GSEs and Mortgage Insurers

Checking accounts, savings accounts and mortgage underwriting.

- The depository financial institution would provide a low cost checking and/or savings account (such as North Carolina's Citizens Bank "Green Checking" account) required under the *Home Ready Buyer Agreement*.
- Upon the borrowers' successful completion of the *Home Ready Buyer Agreement* the depository financial institution will agree to offer a *Home Ready Mortgage*.
- Upon the borrowers' successful completion of the *Home Ready Buyer* Agreement the private mortgage insurer will agree to insure the *Home Ready Mortgage*.
- *Home Ready Mortgages* must be eligible for GSE purchase and should be <u>a core</u> means by which the GSEs serve the conventional low down payment market.

- *Home Ready* Mortgage terms must include the following:
  1. A first lien mortgage
  2. No more than a 97% LTV
  3. The down payment must come from the borrower (the closing costs could come from the HFA or a as gift from immediate family)
  4. Full documentation of income and assets
  5. A Debt-to-Income Ratio (back-end) not to exceed 42% (or 46% if including utilities and maintenance)
  6. Fixed rate
  7. A "Benefits of Building Equity" disclosure statement
  8. Fully amortizing over not more than 30 years
  9. No subsequent second mortgages for the first five years. If after five years a subsequent second mortgage is applied for by the borrower, there must be prior approval by the current investor and mortgage insurance company (if any).

Regulators

In order for the program to be supported in the marketplace, certain regulatory issues must be clarified regarding mortgages originated under the program:

- *Home Ready Mortgage* accounts set up by financial institutions should receive regulatory credit under Community Reinvestment Act ("CRA") requirements.
- *Home Ready Mortgages* should receive regulatory acknowledgement that they meet the Qualified Mortgage ("QM") definition under the Dodd–Frank Wall Street Reform and Consumer Protection Act.
- *Home Ready Mortgages* should receive regulatory acknowledgement that they meet the Qualified Residential Mortgage ("QRM") definition under the Dodd–Frank Wall Street Reform and Consumer Protection Act provided the term of the mortgage does not exceed 20 years.

Paying for HRB

Preparing first time homebuyers and home-ready buyers with remediated credit issues to succeed with the obligations of homeownership will require an investment. However, as we've just witnessed, that cost pales in comparison to the substantial social costs associated with putting people in the home they're not prepared to sustain. The collateral damage has been devastating. A recent report issued by the Center for Responsible Lending estimated that neighbors in close proximity to foreclosures have lost $1.95 trillion in property value through no fault of their own.[5] Meaningful housing and credit counseling and financial education that encourages borrowers to use accelerated amortization mortgages are risk mitigants and worth investing in.

We propose charging a one-time five basis point assessment on every purchase mortgage (the "HRB Assessment"). Revenues generated by the *Home Ready Buyer* Assessment would be dispersed at closing to the housing finance agency in the state where the loan was originated and used to pay for the cost of administering the *Home Ready Buyer* program. Using data from 1990 through 2011 (FHFA Data - Single Family Originations), the average annual total assessments generated by such a charge would have been $813 million. Importantly, this cost would be self-contained within the mortgage finance system and paid for by the primary beneficiaries of a less volatile home price environment, the homeowners themselves

[5] Center for Responsible Lending: “Collateral Damage: The Spillover Cost Of Foreclosures,” www.responsiblelending.org/mortgage-lending/research-analysis/collateral-damage.html

Conclusion

After millions of foreclosures, Americans now understand the linkage between their neighbor's foreclosure and the impact on the value of their individual home. Just as importantly, they've witnessed the devastation on communities and the economy as a whole when mortgage defaults rise and foreclosures are concentrated in neighborhoods. Returning to the principle of building equity through homeownership is critical. Disappointingly, the recent government sponsored refinance initiatives emphasize increasing discretionary income for spending rather than using these unprecedented low mortgage rates to shorten mortgage terms and build equity.

It is equally clear that in order for a housing market recovery to be self-sustaining we must create a supply of capable, credit-worthy borrowers rather than wait 7 to 10 years for these borrowers to potentially rehabilitate themselves. The *Home Ready Buyer* program addresses this issue in a self-sustaining manner by providing the underlying infrastructure for today's issues and tomorrow's homebuyers.

THE AUTHORS

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