Conferences Focus on Unprecedented Foreclosures and other Challenges Presented by the Subprime, Nontraditional Mortgage Market

by Steven W. Kuehl

For more than a decade the Consumer and Community Affairs (CCA) division of the Federal Reserve Bank of Chicago has worked with community development and governmental organizations to understand and address geographically concentrated foreclosures in lower-income communities. Foreclosure is a continual problem in low-income communities; foreclosures have a more pronounced effect in low- and moderate-income (LMI) communities because foreclosed homes tend to stay vacant longer, and lower-income families have less savings to fall back on, and accordingly a much more difficult time recovering from the financial impact of foreclosure than middle- and upper-income households (Schloemer et al., 2006). The current crisis has reached into much higher levels of income and wealth, and is the focus of much attention from lawmakers, regulators, consumer advocates, economists, and others. It has also had an even more pronounced impact in communities that already suffered high rates of foreclosure. These communities have few traditional financial institutions, such as banks and thrifts, and must largely rely on fringe and/or less regulated financial service providers, such as payday lenders and mortgage brokers, for credit.

During 2007, the Emerging Consumer and Compliance Issues unit of the Chicago Fed's CCA division held two major conferences that focused on the challenges presented by the subprime/nontraditional mortgage market for both lenders and consumers. The purpose of this article is to summarize the major areas of discussion during these two meetings, some of which may offer insights as the Federal Reserve System and many concerned groups and individuals work to address and contain the current crisis.

In January, CCA convened "An Informed Discussion of Nontraditional Mortgage Products and Other Risks." The conference was intended as a drill down on nontraditional mortgage products, the financial markets that fueled rapid growth of these products, and their impact on housing markets, both within the state of Illinois and nationally. A December conference held in Waukesha, Wisconsin, was titled "An Informed Discussion of Nontraditional Mortgage Products and Escalating Foreclosures." This conference looked at the issue in Wisconsin, and created a regional task force to reach recommendations and an action plan in 2008.

An Informed Discussion of Nontraditional Mortgage Products and Other Risks

Representatives from the Federal Reserve Bank of Chicago provided an overview of the risks posed by nontraditional mortgage products. "Nontraditional," "alternative," or "exotic" mortgage products are residential loans that include interest-only and payment option adjustable-rate mortgages (ARMs) that allow borrowers to defer repayment of principal and sometimes interest – essentially to exchange lower payments during an initial period for higher payments later. Nontraditional mortgages offer potential benefits for home buyers in strong, stable housing markets, and to sophisticated (higher-income) borrowers with irregular earnings, such as consultants, sales executives, and others. They were not originally developed for mass marketing purposes; these loans were originally intended for only a narrow band of mortgage consumers. Amid industry concerns, federal regulatory agencies have issued guidelines to help curtail unprecedented default and foreclosure rates that have resulted from mass marketing of nontraditional mortgages. These guidelines stress the need for clear disclosure of loan terms to the consumer, and commitment on the part of financial institutions to sound underwriting standards and risk management policies for alternative mortgage products.

Morning Panel Discussion

The morning panel discussion was entitled "Nontraditional Mortgages: A Conversation with Diverse Perspectives." Examiner John Taylor of the Federal Reserve Bank of Chicago moderated the panel. John Bellini, senior vice president of Paramount Bank, discussed his bank's policy of offering nontraditional mortgage products, but only to qualified and properly vetted applicants who need flexibility. Allen J. Fishbein, director of Housing and Credit Policy of the Consumer Federation of America, expressed concern that such products may have a very detrimental impact on consumers who don't fully understand the related financial implications and potential hazards. Michael Mangin, executive vice president of Marquette Bank, also expressed concern that the mortgage industry in general was extending mortgage credit to unprepared and under-qualified households. Robin Conner, vice president and assistant general counsel of the Securities Industry and Financial Markets Association, discussed the important role that the secondary market plays in liquidity and risk management for financial institutions (mortgage originators), emphasizing the importance of smoothly functioning markets, even if some fallout – defaults and foreclosures – is inevitable. Mr. Fishbein remarked that the fallout impacts LMI communities and households disproportionately, and that smoothly functioning capital markets should not be the only consideration.

Keynote Address

The keynote address, entitled "Predatory Lending – What's Working in Illinois, A Litigation and Legislative Update," was provided by Thomas James, senior assistant attorney general for the State of Illinois, Consumer Fraud Bureau. Mr. James began by stating that the attorney general's office has significantly evolved its approach to detecting and litigating fraud in the lending sector over the past ten years. As recently as the late 1990s, no attorneys in the office had litigated a mortgage fraud case.

Mr. James explained that his involvement with mortgage fraud cases began when a couple walked into his office with a thick folder of mortgage papers and stated that they thought "something was wrong" with their mortgage. He went through the papers and determined that the couple, who had gotten a $125,000 loan, had been charged a $22,000 loan origination fee. The couple did not know they were charged such a large fee. He asked the couple about the amount of their loan. They said it was a $100,000 loan plus $2,000 for closing costs. According to the loan documents the loan amount was actually $125,000 and the couple had been charged a $22,000 loan origination fee. The lender was First Alliance Mortgage Company (FAMCO). Mr. James determined there had been 35 to 40 complaints lodged against the company, and found that each borrower had been charged a 15 to 25 percent origination fee. Mr. James interviewed the borrowers, who told him in each case that the loan officer drew their attention on the Truth in Lending (TIL) statement and to the disclosed amount financed, which by statute does not have to include fees, as if it were the actual loan amount, which does not appear on the TIL statement. Mr. James, along with several other states and the Federal Trade Commission, subsequently filed a lawsuit against FAMCO alleging violations of federal and state consumer laws. The case was ultimately settled for $60 million.

"The FAMCO case taught us two major lessons," stated James. "First, the current loan disclosure [process] doesn't work. In fact, it proved useful for confusing consumers." He also noted that disclosures are especially inadequate in relation to nontraditional mortgage products, whose payments, depending on actual terms, can potentially double in two years or less, depending on the borrower's payment behavior. Low initial rates make these products more enticing to borrowers, and without adequate information about potential payment increases, which are not legally required, the combination makes for an easier sale if there is intent is to mislead a borrower. He further stated that, initially, FAMCO targeted low- and moderate-income areas, but later began using the same techniques on all applicants.

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Afternoon Panel Discussion

The afternoon panel discussion was entitled "Initiatives to Address Predatory Lending: A Conversation with Diverse Perspectives." The panel was moderated by Harry Pestine, community affairs program director of the Federal Reserve Bank of Chicago. Jim Wheaton, deputy director for Program Services and Strategy at Neighborhood Housing Services of Chicago, discussed the NHS foreclosure intervention program and the impact of recent legislation, House Bill 4050, which targeted a few Chicago zip codes as areas where borrowers with low credit scores were required to receive home buyer counseling. The law was passed, but was fairly rapidly repealed. Community leaders had voiced strong concern that the law was paternalistic, unfair, and limited credit opportunities, as well as home sales in the target areas. David Rose, research director for the National Training Information Center, noted the importance of identifying areas with particularly high concentrations of foreclosures, and the need to focus resources on these communities, some of which have historically high foreclosure rates, even in times of rising home values. Carl J. Malone, assistant vice president at Harris Bank, discussed affordable loan products for individuals with lower FICO scores as alternatives to exotic and/or subprime loans. Marva Williams, senior vice president at the Woodstock Institute, described the general state of payday lending and nontraditional mortgage loans in Illinois against the backdrop of the Community Reinvestment Act, and its purpose.

An Informed Discussion of Nontraditional Mortgage Products and Escalating Foreclosures

On December 11 and 12, 2007, the Federal Reserve Bank of Chicago, Consumer and Community Affairs division, in co-sponsorship with the University of Wisconsin Extension, and the Wisconsin Housing and Economic Development Authority (WHEDA), hosted "An Informed Discussion of Nontraditional Mortgage Products and Escalating Foreclosures." The conference was held in Waukesha, Wisconsin. Like the Chicago conference, the Waukesha event offered valuable insights from industry experts regarding the risks posed by nontraditional mortgage products. The Waukesha conference also reconvened a coalition formed in February 2007 comprising three task forces to build an effective community response to the rising rate of Wisconsin foreclosures.

Day One

Topics on Tuesday, December 11, 2007, included nationally recognized practitioners and researchers in the mortgage finance field. Many of the speakers represented Wisconsin-based organizations that have helped to identify best practices, partnerships and information sharing arrangements for the benefit of financial institutions, community development professionals, government agencies, and researchers seeking to address the crisis.

Steven W. Kuehl, consumer regulations director for the Federal Reserve Bank of Chicago, opened the meeting and provided an update on related consumer and banking regulations. Kuehl discussed the federal regulatory response(s) to protect consumers and promote safe and sound underwriting practices. He provided background and context on the subprime mortgage market, recent trends, and remedies for subprime borrowers. He also discussed moves by the federal banking regulatory and supervisory agencies, particularly in relation to the ways banks can obtain CRA credit for preventing foreclosures, in some cases refinancing troubled borrowers.

Allen Fishbein, director of Housing and Credit Policy for the Consumer Federation of America, provided the consumer perspective on nontraditional mortgage products and escalating foreclosures. Fishbein characterized foreclosures as a severe epidemic likely to spread beyond subprime borrowers. He faulted reckless lending, flawed products, and lack of accountability as major contributors to the crisis. Fishbein stated that misplaced incentives to make bad loans remain in the industry, and pose major obstacles for mortgage market self-correction. He believes that more consumer disclosures alone are insufficient to solve the problem.

The conference featured a video presentation entitled "A Personal Portrait of Foreclosures in Wisconsin." The video depicted the true story of one Milwaukee woman's experience dealing with the foreclosure on her family residence. The video enabled the audience to get behind the statistical data on foreclosures and to see, on a more personal level, what a foreclosure means to a Wisconsin family. The project was directed by Suzanne Dennik, Consumer and Housing Education coordinator, University of Wisconsin Extension, Milwaukee and Racine Counties. The film was produced by Jim Leser, digital media producer, and Donna Anderson, graphic designer, UW-Extension, Cooperative Extension Distance Education/Digital Media Unit.

Morning Panel Discussion

The morning panel discussion was entitled "Foreclosures at Home – The Wisconsin Story." The panel was moderated by Suzanne Dennik. Highlights of the panel included a presentation by Brad Geary, assistant special agent in Charge for U.S. Department of Housing and Urban Development (HUD), on fraudulent mortgage schemes perpetrated throughout the Midwest; Chief Staff Attorney Catey Doyle, Legal Aid Society of Milwaukee, presented findings on foreclosure filings in Milwaukee, uncovering common themes, which included exotic mortgages made by, generally, few lenders, and [on] unscrupulous terms. Dr. Russell Kashian, an associate professor at UW-Whitewater, presented research on economic and demographic commonalities on foreclosure cases throughout Wisconsin. Martin Collins, commissioner of the Department of Neighborhood Services for the City of Milwaukee, discussed the human resource and other related expenses to municipalities that the current crisis continues to generate.

Keynote Address

The keynote address was delivered by Antonio Riley, the executive director of the Wisconsin Housing and Economic Development Authority, excerpted here.

"On behalf of Governor Doyle, it is a great pleasure to address you all today.

At WHEDA we are very proud of our lending record – for the last four years in a row we've surpassed a half billion dollars in lending, providing loans to around 5,000 first-time home owners annually. In fact, since 2003, under the Doyle administration, WHEDA has written over 22,000 loans, totaling $2.3 billion. That is a 28 percent increase in the number of loans from the prior five-year period, and a 92 percent increase in the dollar volume. And the low foreclosure rate on those loans is something of which we are also very proud.

WHEDA has also been working hard over the last year to increase home ownership among African Americans. Over a year ago, we noticed that our lending to African Americans was declining. Our lender partners were noticing the same thing. However, as we were losing these customers, brokers focusing on subprime lending were cropping up in neighborhoods where we wanted to be. So, we launched the Partnership Neighborhood Initiative, which featured a below-market interest rate and down payment assistance for eligible home buyers in select neighborhoods. To date, 190 families purchased homes using WHEDA loans in those neighborhoods, and that loan product continues to be popular.

Many of you know that last month, WHEDA unveiled its own foreclosure prevention initiative, a partnership with NeighborWorks® America, NeighborWorks® Green Bay, Housing Resources, Inc., and a number of lender and realtor partners. The partnership strongly encourages the use of the (888) 995-HOPE hotline, as well as provides a variety of resources to people. As we worked on this project, we learned the real life stories of people in subprime ARMs, or other loans with payments they weren't able to keep up with.

We met Tiffany, a single mother of five, living in Milwaukee. A few years ago, Tiffany refinanced her home. The broker promised to help her pay off some current and past due bills, including some mortgage payments that she had missed. But that broker went out of business, leaving her bills unpaid and putting her deeper in debt. Over those two years, Tiffany fell behind in her mortgage payments and became overwhelmed. Each month, the payments kept increasing. She feared she and her children would lose their home.

Tiffany called the HOPE hotline. Seventeen months delinquent on her mortgage, and just days from a sheriff's sale, Tiffany needed the one-on-one help of a counselor at Housing Resources, Inc. After working on a budget, Tiffany and her counselor contacted another lender. They refinanced her loan, and today, Tiffany is still in her home.

In Green Bay we met Emily. Emily had an ARM that started increasing every six months. Serving on the board of directors for NeighborWorks® Green Bay, she knew to call NeighborWorks®, and they helped her refinance into a fixed-rate mortgage.

These women were intelligent, well-intentioned home owners trying to raise their children in a place of their own. But they received bad advice, worked with the wrong people, and found themselves in a difficult spot. They are proof that the HOPE hotline, coupled with trusted lenders and good refinance products, works.

We know that we didn't cause this problem, nor did any of you here today. But because all of us represent respected organizations and institutions, we are looked upon to be part of the solution. There is no one solution; there is no easy answer. And that's why we're all here – to see what the other can bring to the table and work together.

We at WHEDA are proud of our approach. A partnership between our closest friends, including NeighborWorks® America, local counseling agencies, our top lenders, and our realtor partners, we realize we can stave off hundreds, if not thousands, of foreclosures with good counseling and prudent refinance products.

We've heard a lot in the news lately about proposals coming out of the Bush administration, including:

- The HOPE NOW alliance, which supports the (888) 995-HOPE number
- Regulatory actions intended to make the mortgage industry more transparent
- A 2008 budget request to Congress for $120 million for NeighborWorks®, and another $50 million for HUD's mortgage counseling program
- Giving states and cities the authority to issue tax-exempt mortgage bonds to refinance existing loans
- And a freezing of the rates for individuals who are in a subprime ARM

We couldn't be more supportive of the administration's request for more funding for NeighborWorks® and HUD's credit counseling programs. And while we recognize the good intentions behind taking regulatory actions, we caution that these steps should be reasonable and thoughtful. We do not want to take action that will lead to problems in other parts of the housing market. Nor do we want to take steps that will reduce resources available to people with good credit who would otherwise be able to purchase a home.

The proposal that would give WHEDA the ability to refinance existing loans is dicey. We have seen other housing authorities in other parts of the country offer refinance products, only to have little to no volume. They are finding that not only are they competing with banks who offer similar products, but the home owners who are looking to refinance simply don't meet the underwriting guidelines for the loans.

Finally, the proposed freeze represents an approach that would not only help a number of families, it would help save the neighborhoods whose strength is being threatened by multiple sales and foreclosures. In Wisconsin, about 6 percent of all home loans were subprime ARMs, which would be eligible for the proposed freeze. As of the end of September, 14 percent of those were in foreclosure. There are lots of numbers that we can throw around – rates increasing, percentages of some populations, or counties being affected by this worse than others.

Any way you look at it, the numbers are startling. While we are fortunate here in Wisconsin that we are not seeing employers shutting their doors, or massive layoffs like other Midwestern states have had, the numbers of people going into foreclosure continue to rise. More and more subprime ARMs will reset in the coming months, and we must all act to help save people's homes and our neighborhoods.

Your being here today is an important step. We all need to work together to keep Wisconsin's economy healthy and housing market strong. This is a call to action – now is the time to do whatever we can to help Wisconsin's families and communities."

Afternoon Panel Discussion

The afternoon panel discussion was entitled "Initiatives to Address Foreclosures, Subprime, and Predatory Lending In Wisconsin: What Can We Learn from Other Models as We Move Forward?" The panel was moderated by Diane Schobert, business development officer at WHEDA. Bruce Gottschall, executive director of Neighborhood Housing Services of Chicago, Inc., discussed the Chicago NHS foreclosure intervention program, a partnership with Chicago city government, major financial institutions, and the Chicago Fed. In its three-year pilot phase, the Home Ownership Preservation Initiative (HOPI) counseled over 4,000 home owners, averted over 1,600 foreclosures, and reclaimed 330 foreclosed buildings. Gottschall discussed some of the necessary measures to adapt a HOPI-type program to Wisconsin. Dana Dillard, senior vice president for EMC Mortgage Corporation (a wholly owned subsidiary of Bear Stearns), discussed the impact on consumers of selling and securitizing mortgage loans; while the capital markets create liquidity and reduce the cost of financing, they also create one-off relationships that sometimes complicate loss mitigation or restructuring. Dillard discussed her group's work to expedite help to troubled borrowers. Joel Ramos, compliance officer at ShoreBank, discussed ShoreBank's rescue loan program, and ways the bank is working to refinance 10,000 Chicago borrowers that have subprime mortgages with unfavorable or unaffordable terms. Geoffrey Cooper, director of Emerging Markets for Mortgage Guaranty Insurance Corporation (MGIC), discussed MGIC's role and experience with Wisconsin foreclosures. Thomas James, senior assistant attorney general for the State of Illinois Consumer Fraud Bureau, provided a litigation perspective on predatory lending issues and insights into regulatory efforts at drafting legislation to address financial abuses.

Day Two

Steve Kuehl provided a presentation entitled "Implications of the Federal Right of Rescission for Lenders and Borrowers." Mr. Kuehl discussed the federal right of rescission, a potentially useful tool to borrowers with rescindable loans facing foreclosure. In the case where all of the requirements pertaining to the right of rescission are not followed, by law the transaction remains rescindable up to three years. While this power may not have broad applicability, many consumer advocates have pointed to shoddy and in some cases fraudulent underwriting and documentation by some lenders. In cases where proper procedures were not observed, this may provide an avenue of relief.

Catey Doyle, chief staff attorney for the Legal Aid Society of Milwaukee made a presentation entitled "The Foreclosure Process in Wisconsin – A to Z." She described the legal procedure for terminating a mortgagor's (borrower's) interest in a property, and the foreclosure options available to creditors in Wisconsin. Wisconsin is a "lien state" as opposed to a "title state," meaning that the mortgagee (lender) holds a lien on the mortgaged property. The owner retains title to the property until the property is transferred. Ms. Doyle explained that Wisconsin is also a judicial foreclosure state, meaning all foreclosures in Wisconsin must go through formal court proceedings, which usually protracts the process compared to nonjudicial states. She discussed alternatives to foreclosure; advice for borrowers during the foreclosure process; potential procedural and substantive affirmative defenses to foreclosure; what to look for when issue spotting for predatory loans; and legal claims and defenses to predatory lending.

Anthony Pennington-Cross, associate professor, Department of Finance, at Marquette University presented "Regulatory Responses to the Subprime Financial Crisis and their Implications." His study measured the effect of state anti-predatory lending laws on subprime credit availability. Some of his findings are counterintuitive. For example, it has long been asserted that broadening anti-predatory lending laws would impede access to credit. However, he found that broader coverage is associated with much lower probabilities of subprime loans being rejected, meaning expanded coverage tends to increase access to subprime credit, as do increased enforcement mechanisms. Stronger restrictions have the opposite effect, by limiting the types of subprime loan products that a lender can offer. The 2007 crisis in subprime is evidence that the subprime mortgage market is immature and in a state of flux. Pennington-Cross stated that the near future of the subprime market is uncertain, but he expects greater future controls, with some coming through legislation, and others through more stringent industry underwriting standards.

Morning Panel Discussion

The purpose of the panel was to promote a dialogue between organizations that offer services and/or products of high value to persons facing foreclosure. The panel was moderated by Ms. Dennik and included: Attorney Gai Lorenzen, managing attorney for Legal Action of Racine; Tom Rice, multifamily management consultant for NeighborWorks® America; and Diane Waller, Housing Program specialist for HUD. Each discussed measures to address rising foreclosures, including HUD's FHA Secure Mortgage Product, NeighborWorks®' National Foreclosure Campaign, and pro bono legal services offered throughout the state by Lorenzen. Ms. Dennik shared her foreclosure prevention programming efforts through UW-Extension that include collaborations with outside organizations, including the Chicago Fed, to implement foreclosure outreach and education. Examples include foreclosure resource flyers sent with municipal tax bills, consumer foreclosure education classes and community in-person help nights. "The collaboration between the Federal Reserve Bank of Chicago and the University of Wisconsin Extension College for this and ensuing conferences highlighting Wisconsin foreclosure solutions, has been imperative in bringing current information, resources, and collaboration from across Wisconsin," stated Dennik. Dennik also noted that WHEDA's involvement had generated renewed urgency toward a statewide response.

Afternoon Meeting of Foreclosure Task Forces

The afternoon session of the conference was titled "Building an Effective Community Response to Foreclosures in Wisconsin." Participants had the opportunity to join and help shape the agenda for several task forces. Diane Schobert moderated the Options and Outreach task force, whose goal is to provide appropriate, timely, quality information to Wisconsin consumers about options when facing delinquency and potential foreclosure. Suzanne Dennik moderated the Stabilization and Maintenance task force, whose goal is to implement a comprehensive post-purchase counseling program for Wisconsin home owners. The program will address home owners' overall finances, as well as home maintenance, to foster stable, long-term home ownership. Betty Kalscheur, HOME Home buyer and Rehabilitation program manager at the Wisconsin Department of Commerce, moderated the Financial Options and Strategies task force to explore what additional short- and long-term financial options and strategies may be needed in Wisconsin to complement existing solutions to prevent foreclosure.

Conclusion

These two events helped to shed light on the ongoing (national) foreclosure crisis, in part as it relates to areas of the Seventh Federal Reserve District. The Chicago Fed's Consumer and Community Affairs division is committed to addressing this crisis, and is working on many fronts to mitigate its impact across our Midwest region. *Profitwise News and Views* will continue to document these efforts, as well as related national and regional trends.

References

Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners; Schloemer, E., Wei, L., Ernst, K., and Keest, K.; Center for Responsible Lending, 2006.

Biography

Steven W. Kuehl is the consumer regulations director for the Consumer and Community Affairs division of the Federal Reserve Bank of Chicago. Mr. Kuehl conducts seminars and workshops, and prepares articles and other written materials dealing with consumer compliance banking regulations. Since joining the Reserve Bank, Mr. Kuehl has served as a commissioned senior examiner on consumer compliance and CRA examinations, as well as manager for Consumer Complaints, HMDA Processing, and the Advisory Service program. Mr. Kuehl holds a B.S. in finance and economics from Carroll College and a Juris Doctor from Chicago-Kent College of Law.