

The Single-Family Affordable Housing Market: Trends and Innovations



A National Symposium Convened on July 23, 1997 by the
Office of the Comptroller of the Currency



Comptroller of the Currency
Administrator of National Banks

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Marva H. Harris, senior vice president, manager, Community Development, PNC Bank Corporation64

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Isaac Megbolugbe, practice leader, Price Waterhouse Housing Finance Group67

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Acknowledgments

The Office of the Comptroller of the Currency (OCC) would like to express its appreciation to the program presenters who contributed to “The Single-Family Affordable Housing Market: Trends and Innovations” symposium summarized here. Thanks are also extended to the attendees at the symposium, listed in appendix B of this publication, for their questions, comments, and sharing experiences in affordable mortgages.

The Community Development Division was responsible for planning and implementing the symposium on which this publication is based, under the guidance of Janice A. Booker, director, Community Development Division. Letty A. Shapiro, community development specialist, served as project leader. Other working group members who assisted her were Jacquelyn C. Allen, community development specialist, Community Development Division; Stephen Davey, community reinvestment and development specialist, Community and Consumer Policy Division; Samuel Frumkin, financial economist, Economics and Evaluation Division; Harvey Gantz, Jr., program coordinator, Community Relations Division; and Thomas Watson, national bank examiner, Credit and Management Policy. Administrative assistance was provided by Tawanda Hudge, Aurelia Kovatch, and Lisa Hemphill. The Communications Division, particularly Thomas L. Baucom, Carol Buchman and Rick Progar, helped to bring this publication to fruition.

The project was developed as part of the division’s objective to give banks an opportunity to learn about successful programs, techniques, and risk strategies that are relevant to banks and replicable in their own communities.

The OCC welcomes your comments or questions on this publication. Please contact Janice A. Booker, director, Community Development Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219, (202) 874-4940. For further resources on community development, you may want to visit the OCC’s World Wide Web site at: <http://www.occ.treas.gov>.





I. Introduction

Janice A. Booker, director, Community Development Division, Office of the Comptroller of the Currency

The single-family affordable housing market, still relatively new to the banking industry, has experienced rapid growth and improved performance as the market has matured. While a few national banks entered the affordable mortgage market in the late 1980s, most established their programs after 1993.

National banks make billions of dollars of affordable housing mortgage loans annually. This is a revenue producing product line for many national banks. However, this growing line of business is still new to many lenders and competition can be intense for high-quality affordable mortgage loans. This is why the Office of the Comptroller of the Currency (OCC) released an Affordable Mortgage Portfolio Advisory Letter AL 97-7* (appendix A) that provides guidance for bankers planning to enter this market.

Today, the affordable mortgage market is significantly broad in its participants and includes a variety of program types. The experience of national banks generally reflects the banking industry's experience in this market. Although the available evidence shows that the delinquency rate can be higher for affordable loans than conventional loans, the OCC has found that the delinquency rate for affordable loans falls to levels that are comparable to conventional loans, once the loans have become seasoned.

OCC wanted to provide guidance to banks and other affordable market participants about the opportunities and issues within this market. Therefore, on July 23, 1997, the OCC convened a national symposium in Philadelphia titled, "The Single-Family Affordable Housing Market: Trends and Innovations." The symposium brought together the broad range of participants in this market to discuss the issues, opportunities, and successful affordable mortgage lending strategies and practices that are needed to help keep the affordable market growing and healthy.

National bankers engage in a wide range of activities in the affordable housing market. National banks make loans for affordable single-family mortgages to qualified borrowers; construction and purchase/rehabilitation loans to builders, buyers, and developers of units; mortgage refinancing programs for homeowners; and reverse mortgage financing for elderly homeowners. Many banks sell their affordable mortgages on the secondary market, others maintain them in portfolio, and still others securitize these loans and sell them in private placements.

This publication presents the views of the diverse participants at the symposium and summarizes the important discussions that followed each

session. The symposium offered a sample of public-private affordable mortgage initiatives, discussed numerous issues, and provided examples of lending programs recognized as effective throughout the country.

The traditional reliance on government programs as the major source for affordable housing funding is rapidly changing. Scarce public resources are being used more often to leverage bank funds, spurring joint public-private efforts. Banks and other financial institutions are recognizing new opportunities created by the changing environment and marketplace. The high level of interest and participation in the symposium attested to this growing recognition. Attendees and presenters at the symposium included representatives of banks of all sizes throughout the country; secondary market participants; not-for-profit community development organizations; mortgage insurers; financial regulatory agency representatives; and other active participants in the affordable mortgage market.

We all greatly benefitted from hearing the substantive issues affecting today's affordable housing finance industry. Symposium panelists shared new information and generated lively discussions about successful affordable housing initiatives.

Symposium participants agreed that the information discussed provided for a thought-provoking day, reflecting the continuing demand for affordable housing finance and the many opportunities to ensure that the dream of homeownership can be realized into the next century. This publication summarizes the symposium for the benefit of bankers, bank examiners, and other parties interested in affordable mortgage finance and expanded homeownership opportunities. For additional OCC resources on banking and affordable housing, our World Wide Web site is located at: <http://occ.treas.gov>.

Janice A. Booker is the director of the Community Development Division at the Office of the Comptroller of the Currency in Washington, D.C. Under her direction, the division develops policy and procedures for national banks' economic and community development activities and approves banks' investments in community development corporations, projects, and financial institutions. The division also works with national community and economic development groups and monitors banks' innovative community development lending and investing activities. She also serves as chair of the OCC's Native American Working Group and of the Affordable Mortgage Portfolios Working Group, and is a member of the OCC National Credit Committee.

Before joining the OCC, she managed the American Bankers Association's Urban and Community Development Division, was a banker, and managed economic policy initiatives for a national nonprofit community-based group.



II. Affordable Mortgage Performance: Issues and Opportunities

The symposium opened with a broad discussion of the state of the affordable housing finance market in the United States. Comptroller Ludwig observed the progressive democratization of credit during the past 100 years. He explained that the democratization of credit process has expanded to the affordable mortgage arena, where, as in other consumer credit lines, safe and sound practices are being rapidly learned and disseminated across the lending community. The Comptroller's presentation began the symposium discussion of affordable mortgage lending in the context of its emergence as an American consumer credit innovation.

Marci Mills, vice president and national sales manager of Bank of America (B of A) Community Development Bank in San Francisco, described her bank as one of the first to aggressively enter affordable mortgage lending. B of A has made more than 140,000 affordable mortgage loans in the last ten years through a program based on profitable return and sound market expansion. Ms. Mills described the importance of constant support by top bank management to the growth of the successful program.

Joseph Birbaum, vice president of Affordable Housing at the Mortgage Guaranty Insurance Corporation (MGIC), presented information on affordable mortgage underwriting standards to the session. He described how MGIC has developed new concepts in risk management and risk mitigation based on prudent underwriting practices.

Elisabeth Prentice, from the Neighborhood Reinvestment Corporation (NRC), brought the perspectives of an organization in which public support has achieved successful public-private affordable housing partnerships. Ms. Prentice, as a founding member of the NeighborWorks® Campaign for Home Ownership, described how the campaign has provided homeownership opportunities and mortgages for thousands of Americans by using the NRC's Full Cycle LendingSM.

James Carr, senior vice president of Fannie Mae, described data that reflect the present and future affordable mortgage market and described how the data can help us improve future strategies and performance results.

Eugene A. Ludwig, Comptroller of the Currency, 1993-1998

Let me extend a heartfelt welcome to the many outstanding representatives of our financial, civic, philanthropic, academic, and regulatory communities gathered here today. Coming together in this forum reminds us

that despite the diversity of our backgrounds and workaday worlds, we are partners in a great and historic enterprise: expanding opportunity for our fellow citizens still struggling to enter the mainstream of American life.

Two hundred and twenty-one years ago, just up the road from where we are sitting today, Thomas Jefferson wrestled with the ideas that would serve as justification for the parting of ways between the united colonies and Great Britain. For Jefferson and most of his colleagues assembled that summer, independence contained political and economic elements. And when, in the words that sprang from his pen, America committed itself to the pursuit of life, liberty, and happiness, his countrymen took that pledge as he intended it—as a guarantee of opportunity to make one’s way in the world, to pursue a career or a trade of one’s own choosing, to rise or fall by one’s abilities and exertions. These commitments formed one side of the compact that induced Americans, for their part, to expose their lives and property to the perils of war against mighty England. And when independence was made good, the people who had risked everything to achieve it demanded their due in return. Since then, all who have held power have assumed a solemn responsibility to safeguard and promote the cause of economic opportunity so central to American civilization and the spirit of 1776.

As the place where the contract was consummated, as the wellspring of the ideals that set us apart as a nation, Philadelphia is an appropriate setting in which to meet as we renew our commitment to the cause of affordable housing—a crucial piece of the American dream.

Nothing has been more crucial to making that dream a reality for millions of Americans than what I often refer to as the democratization of credit. Unlike the declaration of 1776, which set the colonies free with a single bold stroke, the democratization of credit has been a slow process.

None of us in this room could have borrowed much money, if any, on the terms that banks made available at the time the Declaration of Independence was signed. Bankers of that era believed that the only really safe lending was short-term lending to an elite clientele of wealthy, landed individuals.

A century later, not much had changed. In 1863, the first Comptroller of the Currency, Hugh McCulloch, repeatedly warned national bankers to make only those types of loans that were specifically authorized by law and tradition. In practice, this meant that national banks made no real estate loans, no long term business loans, and no consumer loans. Personal loans were sometimes extended as a personal courtesy to good corporate clients. But the idea of general market for consumer credit—even for well-off consumers—attracted few converts and much derision among bankers. Without an established record of creditworthiness, ordinary Americans were assumed to be unworthy of it.



But ordinary Americans proved otherwise. Denied credit by banks, they turned elsewhere: to Morris Plan banks, building societies, pawnshops, and other nonbank providers. During the Great Depression, consumer loans outperformed commercial and industrial loans, sending a powerful message that the average American could learn how to handle credit responsibly. Bankers took this message to heart. And so the democratization of credit proceeded.

This century-long change in attitude and practice is nowhere more evident than in the mortgage market. A hundred years ago, three out of four residential mortgages were held by individual investors. Interest rates and down payment requirements for such loans were often prohibitively high. Fifty percent down was customary. It was not uncommon for mortgage loans to run for as little as two or three years. On such terms there were relatively few takers—and, consequently, relatively few homeowners. In 1890, two-thirds of all nonfarm residents in the United States were renters; only one out of three Americans was a homeowner.

Since then, a quiet revolution has taken place in American housing. Today, thanks in large part to the democratization of credit—including, importantly, bank credit—the numbers of a century ago have been reversed. Today, almost two-thirds of Americans are homeowners. More enter their ranks every day, often with financing obtained from a bank. As late as the 1940s, commercial banks ranked dead last among institutional lenders providing housing finance. Today, commercial banks provide more money for mortgage loans than any other financial institution.

The latest phase in the democratization of credit is taking place right before our eyes. Over the past two decades, a serious and successful effort has been under way to make credit available to low- and moderate-income individuals. This effort has resulted in tens of thousands of home mortgage loans to people who would otherwise not have been able to obtain them. These loans have thus far proved to have default rates that are essentially the same as loans to upper-income borrowers. In some cases, default rates have been lower.

For the vast majority of individual borrowers, this has meant a better life—a better home and a safer and more stable environment in which to live and raise children. For society, it has meant stronger neighborhoods and more productive citizens. And for lending institutions, it has meant new profitable customer relationships.

During the Great Depression, consumer loans outperformed commercial and industrial loans, sending a powerful message that the average American could learn how to handle credit responsibly.

To a considerable degree, this quiet revolution in lending to low- and moderate-income individuals has been a dual process of breaking down past prejudices about creditworthy borrowers and replacing old lending techniques with innovative ones to make credit available. For example, we have learned that development lending—targeting lending to an entire distressed neighborhood—has great advantages over hit-and-miss lending in those same areas. Development lending has the advantage of dramatically increasing the likelihood that property values will rise in targeted neighborhoods, thus increasing the borrower's equity and the lender's collateral.

These two decades of increased lending to disadvantaged individuals coincide with the enactment and enforcement of the Community Reinvestment Act, whose 20-year anniversary will be celebrated this October 12. During this 20-year period, a number of observers have argued that the statute's goals—lending to low- and moderate-income individuals—conflicted with the goal of ensuring that we have strong, safe and sound banking institutions. And yet, we have found that what has been true of the democratization of credit at each stage in the process is true in this case, too: that in the majority of cases, lending to low- and moderate-income Americans is also safe lending.

Indeed, I strongly believe that the OCC's statutory responsibilities, both to enforce the Community Reinvestment Act and to ensure a safe and sound banking system, are mutually supportive. Banks do not get stronger by turning their backs on large portions of their communities that could be good, creditworthy customers. In fact, the opposite is true.

I also believe that the symbiosis between community development lending and safe and sound banking is based on facing up to real facts and dealing with those facts. We must ask hard questions and deal forthrightly with the answers. Who is really creditworthy? What innovative techniques can be used to extend credit? Which techniques work and which do not?

These questions are relevant to the business of today's symposium. The affordable mortgage market represents one of the great challenges before the private sector at a time when only the private sector has the resources available to meet the vast need for affordable housing in America.

We know that the affordable mortgage market has its complexities—particularly for lenders new to it—and that some have therefore shied away from it. The higher than average loan-to-value or debt-to-income ratios that typically characterize these loans can mean reduced opportunities for securitization. Private mortgage insurance may not be available or, for competitive reasons, lenders may decline to require it. The concentration of adjustable rate mortgages generally found in some affordable mortgage portfolios can mean higher interest rate risk.

What have we learned recently about these markets?



In 1996 we conducted a review of national banks' affordable mortgage portfolios as part of an overall survey of credit underwriting practices. Early this year, we carried out a follow-up review of 13 banks with the largest dollar volume of affordable mortgage loans.

Here is what we found. Our evidence shows that losses for affordable mortgage loans are about the same as for all mortgage loans—less than one-tenth of 1 percent. However in 1996, total delinquencies in the affordable mortgage portfolios of large national banks averaged 4 percent, compared to 3 percent for residential real estate portfolios as a whole. In the last six months of 1996, the delinquency rate of affordable mortgage loans at some banks increased by about 100 basis points, compared with an increase of 2 basis points for all mortgage loans. The increase in the delinquency rate was more pronounced in those affordable mortgage programs where risk was heavily layered—that is, where more than one traditional risk factor was disregarded in making the loan.

This delinquency rate must be taken seriously. But let's look at those numbers and put them into context. At year-end 1996, about 5 percent—one out of twenty—of affordable mortgage loans at some banks were delinquent. That means 19 out of 20 affordable mortgages at those banks were current.

Think of it. *Ninety-five percent of affordable mortgage customers*—families that would never have been able to receive a home purchase loan under conventional standards—are meeting their obligations on time and in full. Thousands of families that would never have had a chance to enjoy the economic and social benefits of homeownership are doing so today because lenders were willing to give them the chance to prove that "one size fits all" doesn't work all the time.

The OCC's surveys show that the delinquency rate for affordable mortgage loans is lowest—and the proportion of such loans in the total mortgage portfolio highest—in those banks that have held those loans the longest. Affordable mortgage programs that had been in operation for more than three years tended to have virtually no increase in delinquency rates. In short, we found that the more experience banks had with affordable mortgage loans, the better they had learned how to manage the special risks those loans entail.

What does all this suggest?

It suggests that banks that are new to the affordable mortgage area should closely monitor those programs, particularly those that layer risk factors. These banks should look for techniques that will help keep delinquencies under control. In this regard, the results of our surveys suggest banks may want to consider some, if not all, of the steps taken by more established programs to deal with the challenges of affordable lending programs.

What are these steps? We identified three common characteristics shared by banks with the most mature affordable mortgage programs.

- Applicants at these banks were generally required to complete a comprehensive program of prepurchase counseling as a prerequisite for qualifying for affordable mortgages. This counseling varied from a two-hour, self-study program to a four-week, Fannie Mae/HUD-approved course. Banks with the most structured and comprehensive counseling tended to have the lowest delinquency rates—as much as two to three times lower than their peers with less formal programs. Conversely, banks offering little or no counseling typically had the most chronic delinquency problems.
- Banks with the lowest delinquency rates were often the same banks that had in place structured, rapid-response delinquency intervention programs enabling them to contact customers soon after a missed payment. Typically, these banks also had upgraded information systems to track loan performance and formal linkages between servicing units and counseling providers.
- Banks with the lowest delinquency rates were those that exercised care in layering risk factors. Borrowers with a single risk factor—say, a 43 percent debt-to-income ratio—were highly likely to service their loans satisfactorily. But if the borrowers had additional risk factors, the odds of delinquency increased.

Because I believe it is important that these and other findings be shared throughout the banking and affordable housing communities, we are releasing today an OCC Advisory Letter on affordable mortgage lending. It is my hope that by disseminating what we have learned, by encouraging banks to profit from the experiences of others in this field, we can simultaneously promote the growth of affordable mortgage programs, the health of our communities, and the safety and soundness of the banking system.

Sharing information is a big part of why we are here today. Our symposium is designed to encourage dialogue among all parties to the business of making affordable mortgages. Hopefully, our discussions will stimulate ideas that can lead to action on affordable mortgage performance, risk management strategies, pre- and postpurchase counseling, and many other essential issues. I look forward to hearing and learning from you.

Affordable mortgage programs are working and can be made to work better—for the banks that create them and for the borrowers who use them as a bridge to the American dream. As we roll up our sleeves and enter into our discussions today, we should draw inspiration from the American statesmen of 1776, who never shrank from a challenge they believed worth the effort. The cause of affordable housing is one challenge that is.



Eugene A. Ludwig was the 27th Comptroller of the Currency. The OCC supervises nearly 2,800 federally chartered commercial banks that account for more than one-half the assets of the commercial banking system. Mr. Ludwig joined the OCC from the law firm of Covington and Burling in Washington, D.C., where he became a partner in 1981. He specialized in intellectual property law, banking, and international trade. He has written numerous articles on banking and finance for scholarly journals and trade publications and was a guest lecturer at Yale University and Harvard University Law Schools and Georgetown University's International Law Institute.

Mr. Ludwig earned a B.A. magna cum laude from Haverford College. He received a Keasbey Scholarship to attend Oxford University, where he studied politics, philosophy, and economics, and earned a B.A. and an M.A. He holds a LL.B. from Yale University, where he served as editor of the Yale Law Journal and chairman of Yale Legislative Services.

Marci Mills, vice president and national sales manager, Bank of America

Thank you. I am delighted to be here.

For the last couple of years, we have heard a lot about how this Community Reinvestment Act (CRA) mortgage market doesn't perform well, how it's not living up to expectations, and how it's not very profitable. I am delighted to have the opportunity to be here because I have wanted to give this speech for two years.

B of A is the "granddaddy" of CRA mortgage lending among the large lenders. That gives us a wonderful perspective because we have now been doing this for about seven years. There are a number of reasons why I think we have been successful, but frankly, I think you might learn more from our mistakes. I hope you will ask me about some of the things that we did wrong during the question-and-answer period.

To start, back in 1988, there was a very firm corporate commitment to develop a program for affordable mortgage lending. I can't stress too strongly how important that was. The commitment was from the most senior level of the bank—from the chairman's office. There was no mistaking it. The chairman said, "You will do this and you will do it well."

An initial attempt failed miserably. The mortgage division, which is now BA Mortgage, was sent back to do it again and do it right. It was after B of A had spent about a year designing the Neighborhood Advantage Program that the bank and I found each other. They hired me to help take the program public.

Never having worked before for a large company or for a regulated bank, I was astounded at the importance of the commitment of the office of the chairman. No one would have been able to convince me before then

that who decided this was an important thing to do would make so much difference. But having been through the experience, I now believe very firmly that without that commitment and the very effective communication of that commitment throughout all portions of the organization, it would not have happened. That is how important it was.

Our most significant problem turned out to be our biggest opportunity. B of A was a major lender and the largest bank in California. There used to be as many B of A branches as gas stations. We were everywhere. We were a major presence. That certainly sounds like opportunity.

On the other hand, we were a bureaucracy. Not everyone in the bank likes to admit that, but we were huge. We didn't have the possibility of doing something superficial to get a good CRA rating that year. We couldn't just say, well, we are going to really push on this because we really want an outstanding CRA rating and then it can all go away for awhile. Not a chance.

At that time we had four different channels of origination for mortgages. We were a major mortgage lender in California. We had hundreds of branches throughout the state. We had a realty sales division where we were selling through the real estate community. We had a wholesale division where we had certified mortgage brokers who were selling to us. And we had a builder division where we were financing new home construction.

Somehow, all of those groups within this huge structure of the bank had to know both what it was we had decided to do, and how we were going to do it. Then, somehow, they had to pull it off. That was not easy to do.

I want to jump ahead for just a minute so that you can see what has resulted over the last seven years. Then I will go back and fill in the pieces.

Seven years later we have provided more than 140,000 loans to borrowers below 100 percent of local median income, or living in low-income census tracts. (The Neighborhood Advantage Program actually is broader than that, but we don't capture the numbers, for CRA purposes, for loans to borrowers above 100 percent of area median income.) So we had very significant volume.

The loans perform very well. Some of us who came from outside the banking industry—from the community development side and with a lot of experience working in lower-income communities and minority communities—knew that these loans would perform very well.

When borrowers are looking to buy a home for their family, there is no way they are going to let that home go unless they have no other option. They can't go out and rent something for a lot less money. It is not a speculative venture. This is a home for a family. They are not going to walk away from it. Some of us knew they would perform well, and history has demonstrated that fact.



There was a question about profitability, because in some cases very concessionary pricing was used to generate this type of business. We have learned over time that the loans we have made in the CRA category are just as profitable as the non-CRA loans.

Now I need to be sure that you understand what I mean when I say this. Because B of A has chosen to compete in pricing rather than in credit features, we often offer quite concessionary pricing. At the point at which the loan is made, the Neighborhood Advantage loan is not as profitable as a standard loan. But as we have watched this portfolio mature over time—and many of you will smile when I say this because you will know that it's true—many of the borrowers in this category buy and stay in their homes. These loans do not turn over nearly as quickly as the standard book of business.

Over time, then, the pricing that is used initially is more than compensated by the length of time the loan stays in the portfolio. After a few years, the profitability equals out because the other loans are turning over; they are off the books and they are no longer generating income. The CRA portfolio stays and produces ongoing income for the bank.

So we see equality of performance in terms of credit quality and delinquency rates when compared with similar loans in the standard portfolio. There is also equality of profitability, as you see in the graph (see figure 1).

The bank did not have the opportunity to do this in a small way. Rather, it was forced to do it in a big way, which was an effort that required absolutely gut-wrenching institutional change. As a result, we stumbled into something that has created the opportunity for the bank to become one of the largest mortgage lenders in the country. That would not have happened without the CRA lending effort through Neighborhood Advantage. It's very good business for the bank. There is no way we would abandon this market.

Now to go back and fill in some of the pieces. In developing the program, we believed that a single product wouldn't be able to produce what we needed. We had to do a lot of volume and we had to do it throughout all of the channels through which we originated loans.

What we did was not terribly exciting or dramatic, but it was effective. We approached the CRA lending effort in a programmatic way, which cut across all of our mortgage product lines, to be available as fixed rate and as adjustable rate, and to be available in each of the mortgage product types offered, each with different underwriting.

We have learned over time that the loans we have made in the CRA category are just as profitable as the non-CRA loans.

We sought assistance from our nonprofit partners, from community groups, and from a number of minority organizations. We talked to trade groups to figure out who our customers were, what their needs were, and how to look at their credit. We tried to determine what creditworthiness was in populations that we were not used to serving. As you can tell, a great deal of effort was made long before the program was introduced.

We had very good partners in the secondary markets and with the mortgage insurance companies. Our first partners were Fannie Mae, which signed up initially for a \$100 million commitment, and GE Mortgage Insurance.

We had to look very hard at our own organization, a huge, far-flung combination of sales people, credit people, and portfolio managers. We had to take a look at what they knew and how they could handle this new program. We had to deal honestly with the fact that many of the people in our credit underwriting offices, most of which were not located in urban cores,

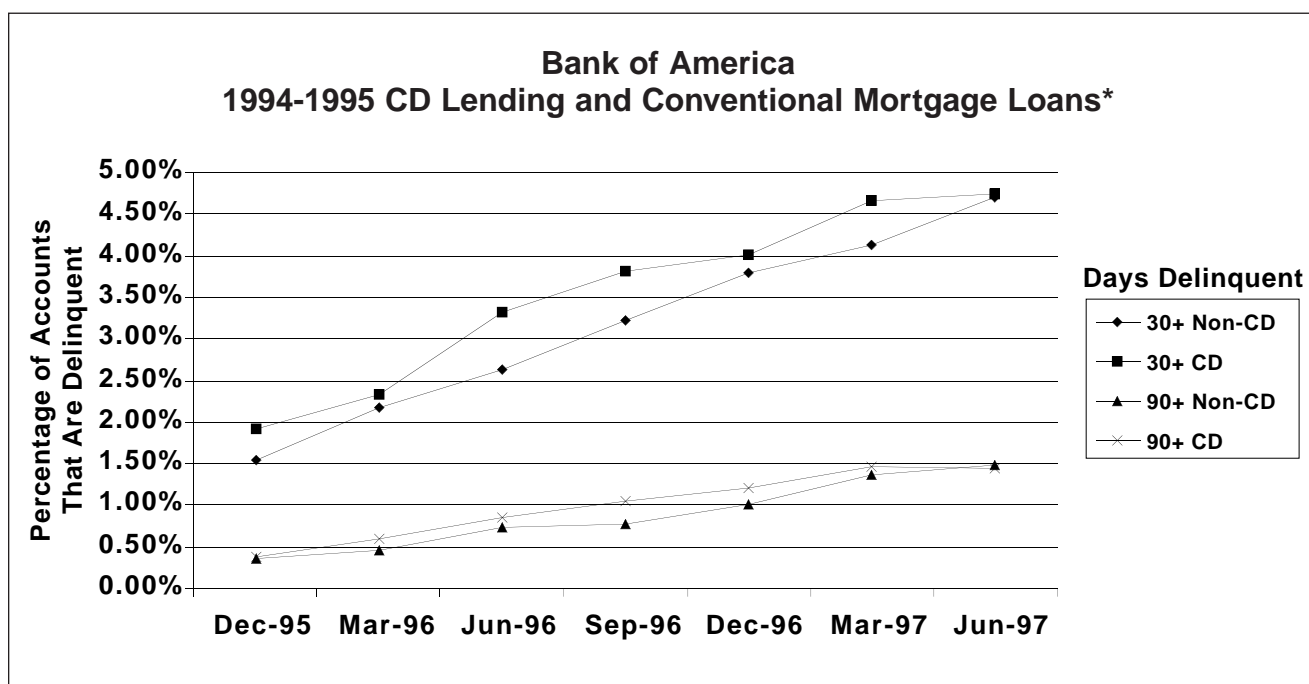


Figure 1: Bank of America's community development home loan portfolio performs as well as its conventional loan portfolio when comparing high loan-to-value conventional loans made in 1994-1995. This comparison holds true for both 30-day (standard loan delinquency) and 90-day (foreclosure risk) delinquency rates.

The *multibillion-dollar Bank of America 1994-1995 portfolio includes home loans of all types (i.e., conventional, jumbo, low loan-to-value, high loan-to-value) funded by the bank during 1994-1995. Typically, loan portfolios are allowed to "season" for a period of several years before statements regarding performance are considered reliable. The segment of 1994-1995 portfolio loans depicted in this graph are "conventional loans," meaning they do not exceed \$214,000 and they can be sold into the conventional secondary market. They are also "high loan-to-value loans" because in each case the borrower put down less than 20 percent to purchase the property, and in many cases the borrower put down as little as 5 percent. This combined category of high loan-to-value and low balance is generally considered to be at higher risk for foreclosure and financial loss than other categories of home loans.



had no experience in evaluating property or credit characteristics for populations that were different from our standard bank business. We had to help them learn how to evaluate different properties and borrowers.

It was not effective to give junior credit officers directions to use their common sense in evaluating a credit when they didn't know the customer, didn't understand the property, certainly didn't know the neighborhood, and knew they might get fired if they made a mistake. The credit training for Neighborhood Advantage was hard work, frustrating, and often unrewarding.

Talking to the sales officers was also frustrating. They knew they made more money on higher-balance loans. They weren't sure how to approach customers in areas they didn't understand well. They knew they would have to spend more time packaging these loans. Why would they want to make these loans?

We figured out that if we wanted loan officers in this market, we were going to have to reward them the way they were used to being rewarded for the other business they did. So we provided financial incentives. We spent as much time and as much energy on internal marketing. This effort was, in my opinion, at least as important as our external marketing for this program. We had to make believers out of our own staff, whether it was in the sales force, the credit staff, or any other division of the bank.

We made lots of mistakes. There was one point where we actually took away all field authority to decline a Neighborhood Advantage loan. Can you imagine a company this large saying you can approve, but you cannot decline, a loan application? We were very unhappy with the decline rates. For awhile, everything was forced to come through the corporate funnel; this created havoc. People hated it. But the result was that eventually they learned how to do it right.

At one point, the highest rank one could have as a credit officer was the authority to decline a Neighborhood Advantage loan. We brought people in one by one by one; we trained them with actual files, using senior credit managers, until they understood the process.

We did the road shows with Fannie Mae and GE Mortgage Insurance. We used slides of properties in urban communities to help our people understand how to make a judgment about each house. Is it okay or not okay? Is the neighborhood okay? How do you look at these properties when you are most used to looking at suburban properties? How do you translate a suburban mind-set into an urban setting? Can you learn to say, "This is okay. This is compatible with the neighborhood. This is a home and it's perfectly acceptable. Furthermore, it's going to do just fine as long as it's safe and sound."

To move from the traditional credit box to common sense posed so many challenges. It was certainly one of the greatest challenges we faced in delivering this program.

It was not easy to evaluate and make a performance judgment for someone with no standard credit experience and no credit card history. Much of what we did we learned piece-by-piece, working directly with customers and learning that their credit history could be demonstrated in a lot of different ways. Many of you are doing this, I'm sure, in your own underwriting.

B of A's beginnings in the early 1900's were with A.P. Giannini. He was very strongly committed to lending to new immigrant communities that were not welcomed by the other banks. B of A founder Giannini understood the urgent desire for assimilation and for an opportunity within this new country. He could discern the eagerness with which people would repay their debts if they had an opportunity to share in this country.

We found that the conventional standard of looking at employment over a certain period of time, with the same employer, had very little relevance for newer immigrant communities. These individuals may lose a job today and find another job tomorrow. We learned to look, more importantly, at a consistent level of income rather than a consistent position with a particular company.

We learned to look at other ways of establishing credit. If there was no credit card history, we looked at other forms of payment, whether it was a regular utility, or furniture payment. Whatever it was, we used it. We tried to reach the point where we could ask the following three questions, and when we had answered them satisfactorily, that was all we needed to know.

Number one, could the borrower handle the debt? Did they have sufficient income to repay this debt?

Number two, based on their previous credit history, whether it was standard credit or whatever, did they intend to repay the debt? Did they intend to repay the loan?

Number three, and equally important, was the property okay? They wouldn't be able to handle unexpected repairs. Were they buying something that was going to fall down around them tomorrow? So the question was: Was the property okay? Was it safe and sound? The question was not: Was it wonderful? Did it look like every other property that we had financed?

If we could answer "yes" to those three questions, we needed to find a way to make a loan to this borrower.

After seven years, the CRA single-family portfolio has probably been studied more carefully, in more detail, and more frequently than any other portfolio of the bank. Slowly but surely, more people are becoming believ-



ers. But every time a new senior officer comes in, we go back and restudy it. Every time it is studied, we find the same thing: It performs well. It's profitable. It's created the opportunity for us to be a major lender, and to expand the home loan market.

If the mortgage market was big to start with, it's bigger now. We found thousands of other people who are good credit risks and profitable borrowers, thus the market has expanded. It's more business for everybody. It's tomorrow's mortgage business.

We are happy to be in it. I am delighted to have had this opportunity to talk with you. Thank you.

Marci Mills is vice president and national sales manager for Home Improvement Programs at Bank of America Community Development Bank. Ms. Mills has more than 25 years of experience in low-income and fair housing, including grass roots community organizing, legislative advocacy, and real estate regulation. Previously, she served at B of A in San Francisco, where she implemented the Neighborhood Advantage Program. Neighborhood Advantage has provided more than \$14 billion in financing for more than 140,000 homes throughout the United States since its introduction in 1990. The program features common-sense underwriting for lower-income and minority borrowers.

In 1993, she was recruited by Wells Fargo Bank to develop and manage their single-family CRA lending program. While at the bank, she helped initiate a minority mortgage broker program and opened a loan production center in the heart of South Central Los Angeles. She serves on a variety of boards and committees of nonprofit organizations in California. In 1995 Ms. Mills returned to B of A as marketing manager for B of A Community Development Bank.

**Joseph L. Birbaum, vice president, Affordable Housing,
Mortgage Guaranty Insurance Corporation**

Good morning. First I am going to talk briefly about performance and then discuss some opportunities and challenges. I don't have all the answers, but I hope we will end with a positive summary.

The largest barrier to homeownership is the amount of funds needed to make the down payment and cover closing costs. This barrier is particularly large for the low- and moderate-income families that make up the affordable housing home buyer market. The private mortgage insurance industry specializes in high-ratio loans that have lower down payments. As a result, our business is making home purchases more affordable, particularly for the low- and moderate-income home purchasers.

Mortgage Guaranty Insurance Corporation (MGIC) began developing and tracking affordable housing loan programs that had liberalized guidelines in the late 1980s. By 1992 and 1993, MGIC was seeing elevated delin-

quencies in these programs. In 1994, we conducted and published a study on the performance of affordable housing loans, and the results were not a surprise. The affordable housing loans had higher delinquencies. If you increase your risk by increasing your ratios, lowering your down payment, liberalizing your credit, and not performing any offsets, what do you expect to happen? These studies were based on originations identified by our customers as affordable housing loans. However, because of political and CRA pressures, lenders and investors were viewed as more likely to accept a marginal or a high-risk loan if it was labeled an “affordable housing” loan. MGIC was concerned that the performance of the affordable housing loans in our study may have been driven by adverse selection when our lender customers labeled loans. We thought the lenders were only labeling the high-risk loans “affordable housing” so they would be sure to get approval. To avoid adverse selection, we took the Government Sponsored Enterprises (GSE) definition, which focuses on borrowers in central cities, those with less than 100 percent of the area median income, and certain selected census tracts. We determined that this was a majority of MGIC’s business. We

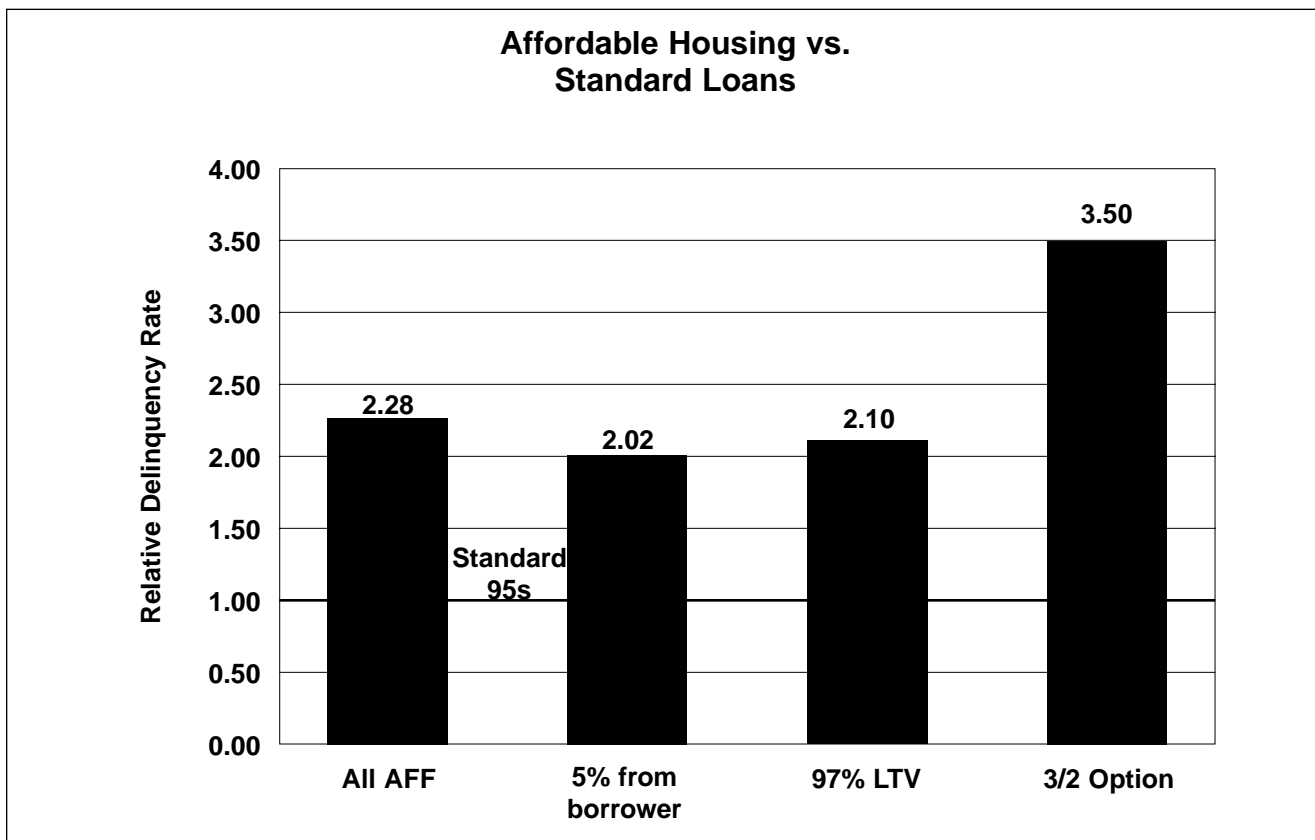


Figure 2: Affordable Housing loans have an overall delinquency rate 2.28 times that of standard 95% LTV loans. Loans with the 3/2 option have significantly higher delinquency rates than loans with 5% borrower cash: 3.5 times those of standard 95s and 1.75 times those of Affordable Housing loans with 5% borrower cash down payments. Meanwhile, 97% LTV Affordable Housing loans are performing only slightly worse than Affordable Housing loans with 5% borrower down payments.



then narrowed the definition of an “affordable housing” borrower by using the GSE definition and limiting it to first-time home buyers. MGIC ran more studies and found that the delinquency rate for affordable housing loans (under the objective definition of first-time home buyers meeting GSE standards) were approximately twice that of other loans. We were also starting to see elevated foreclosure rates (see figures 2 and 3).

Homeowners do not want to give up their homes, but foreclosures are on the rise. What is driving the foreclosures and what can we do at origination to avoid them? We have knowledge that we need to use. We need to look at and understand the predicting factors. For example, poor credit at loan origination is the most important indicator of excessive risk. However, poor credit should not and cannot be equated with low- and moderate-income. With regard to down payments, the smaller the down payment, the higher the risk. In addition, the down payment must be the borrower’s money. Although layering of risk is not good in general, we need to look at the overall picture; that is, good credit should remain a very powerful fac-

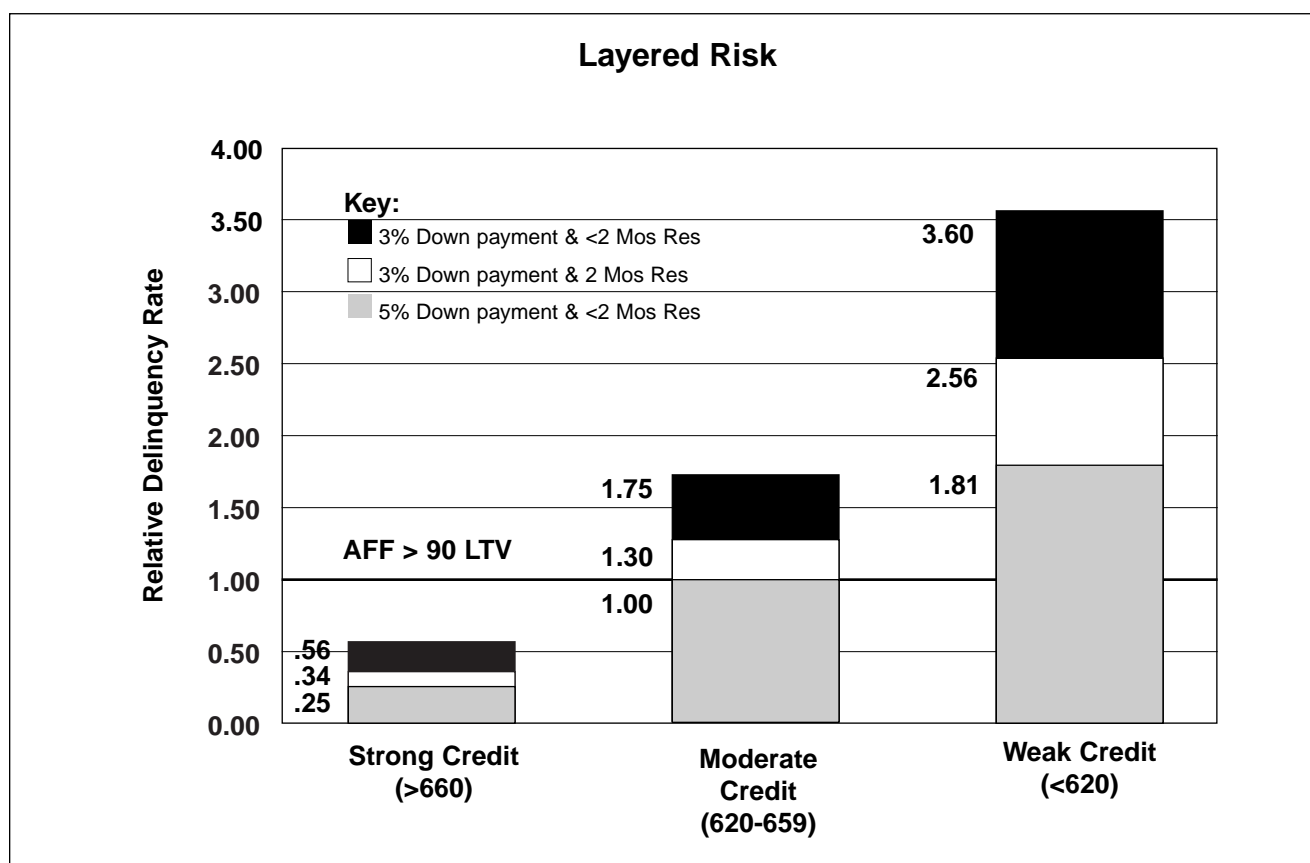


Figure 3: This chart suggests that strong credit can effectively be used to offset other high risk factors, such as minimal down payments and/or lack of cash reserves. However, there are no offsets to weak credit and when combined with other high risk factors, the risk of default on moderate and weak credit loans increases dramatically.

tor and can be used to offset other high-risk characteristics. Good pre-purchase education and counseling are an offset and should be strongly supported. We need to distinguish between education and counseling: education is informative, counseling is more in-depth and remedial. Counseling needs to be tailored to the borrower and be face-to-face.

The mortgage industry has a number of opportunities and challenges. There is an opportunity to expand. If the market is to expand, the target has to be the affordable housing borrower because demographic studies show us that the most rapid population growth and the lowest homeownership rates are among low- and moderate-income families, immigrants, and minorities. The challenge is to reach these segments. We must use our knowledge of risk factors to design programs with offsets to such high-risk features as low down payments or other liberalizations. However, individuals without credit or with poor credit present a challenge. These individuals need counseling and training in money management to prepare them for long-term homeownership, which is necessary to obtain a mortgage that has a normal market rate. Alternatively, they can go to a "B" or "C" lender and pay a much higher rate. Borrowers have a choice: prepare or pay.

If the programs are structured properly, however, higher delinquencies will not occur and the market can be reached efficiently.

There is opportunity from the automation avalanche. Lender profitability is an issue. As a result of automation, costs are decreasing, people are working faster and better, but we are losing the personal touch that is needed for the affordable housing opportunity. Without education and guidance provided face-to-face by someone they trust, affordable housing borrowers will continue to be hard to reach, have higher delinquencies, and loans to them will be more costly to originate and service. If the programs are structured properly, however, higher delinquencies will not occur and the market can be reached

efficiently. There will be a better product and a better industry. The industry needs to create more borrower support alliances (lenders, community-based organizations [CBO], secondary market, government, and mortgage insurers). These alliances and CBOs need to adapt to the automation avalanche to be efficient and to know how to prepare the affordable housing borrower. The CBO should be doing delinquency intervention and borrower education.

I also have a comment in answer to a frequently asked question. [Is risk-based pricing being applied to affordable mortgages?] Risk-based pricing is here and it is here to stay, but not risk-based pricing based on income. We can price on risk but risk and income levels are not synonymous. We have to be careful to avoid confusion in this area.

In addition, it is important to sit back and consider our goals as lenders.



Do we want to put people in homes and keep them there or do we want to put people in homes and sell loans? These two goals are not necessarily compatible. I suggest we want to put people in the homes who can stay for as long as they want.

There is an opportunity to expand markets to the underserved, immigrants, minorities, and low- and moderate-income groups. The challenge is to do it efficiently. To date, we are not yet doing well. Overall, there are higher delinquencies and we are not reaching as many underserved families as we should. We must develop programs to reduce the higher delinquencies found in affordable housing lending and to reach the affordable mortgage market. If we use our knowledge and work together as partners, we can develop those programs.

Joseph L. Birbaum is vice president of Affordable Housing for Mortgage Guaranty Insurance Corporation. He is responsible for coordinating MGIC's efforts to expand homeownership opportunities for low- and moderate-income home buyers. Mr. Birbaum works with Fannie Mae and Freddie Mac, mortgage lenders, housing finance agencies, community housing groups, and others to promote prudent underwriting criteria and practices, as well as to seek innovative concepts for developing affordable housing programs.

Elisabeth C. Prentice, director, New York/Puerto Rico District Office, Neighborhood Reinvestment Corporation

I want to begin by telling you a little of the history of the Neighborhood Reinvestment Corporation (NRC). The NRC is a public benefit entity, (501(c)(3)), which was congressionally chartered in 1978. The board of directors is composed of senior officials from the five financial regulatory agencies and the U.S. Department of Housing and Urban Development (HUD).

In the field division of NRC, we develop and support a network of local resident-led community development partnerships. There are now nearly 200 local affiliate NRC organizations throughout the United States with their own boards of directors. In the field division of NRC, we provide technical assistance, training, and grants to the local network organizations, which are called NeighborWorks®.

The National Campaign for Home Ownership began formally in 1992. I am proud to say that I was a founding member. In my previous work in the private sector, I routinely saw denials of many applicants whose profiles were stronger than those applicants we worked with successfully in the non-profit sector. There had to be a better way to identify the characteristics of successful low- and moderate-income mortgage borrowers.

The campaign began in the early 1990s, when mortgage rates were falling and the opportunity arose for more people to come into homeown-

ership. At the same time, a Federal Reserve Bank study indicated significant patterns of discrimination in mortgage lending. Simultaneously, banks were under increased regulatory pressure to reach the underserved market. Our primary concern was that banks would rush in with homeownership products inappropriate to the long-term success of the low- and moderate-income market. Our main objective in beginning the campaign was to prevent this from happening and to highlight examples of successful programs, in addition to increasing the number and percentage of homeowners in the areas served by network organizations.

Homeownership is a significant strategy in neighborhood revitalization and is an important component of NRC's work. Homeownership is the basis of the American dream, and the largest financial and psychological investment for most American families. It provides increased security and stability in our communities because owners become genuine stakeholders. It is a tremendous part of the American economic engine because it generates sales and property taxes as well as jobs. It is also an important part of American civic life. As a result, our campaign had a lot of public policy mission objectives, in addition to our objectives of increasing private sector financing to increase low- and moderate-income homeownership.

The campaign had the following goals: \$650 million in investments; 10,000 low-income homeowners in five years; and 75,000 potential buyers reached through outreach and counseling. To date, more than \$700 million in private sector mortgage financing has closed, so the campaign has exceeded its five-year goal in four years. We have also exceeded our five-year goal of having more than 10,000 low-income homeowners.

Now, I'd like to show you who the campaign is reaching. Sixty-one percent of campaign buyers are minorities, compared with 16 percent nationally. Forty-two percent of campaign buyers are female heads of household. Ninety-six percent of buyers are first-time homeowners. The median income of campaign buyers is just under \$25,000 per year, compared with \$40,000 per year nationally. The average campaign home price is under \$65,000, compared with a national average of \$139,000. We are definitely reaching a market that the commercial lenders have had a hard time attracting.

The campaign reaches the affordable market in a systematic and regular way. Full Cycle LendingSM is a systematic approach to homeownership that focuses on recruiting, educating, and counseling prospective home buyers (eight prospective buyers are needed before one is successful). Home buyer education is critical; it needs to be interactive and comprehensive. The campaign provides an interactive, eight-hour series. Components of the education include group orientation; an in-depth home buyer education system (eight hours); and individual counseling. The goal is to get the family to the point of mortgage readiness before they meet with a real estate



agent. The nonprofit organization works with the family and packages the loan. Counseling takes place before, during, and after closing.

Home rehabilitation services are very important in this market segment. The loan package must include home repairs from the outset as many of the properties that are affordable to low- and moderate-income families have suffered from lack of maintenance and repair. Families who are using all of their cash reserves and who are paying the maximum principal, interest, taxes, and insurance (PITI) allowed by ratios are not financially able to cope with breakdowns after they purchase their homes. Early intervention delinquency counseling also is important. We work with people early in the process—between day 16 and day 30—in a counseling and collection role.

Innovative financing, such as low down payments, flexible underwriting criteria, secondary financing for rehabilitation, and loan sales to secondary markets, is another key to success. Property services is an area that needs more time and attention, as most lenders are not equipped to handle such services as home improvement inspections and quality control.

We have learned a number of lessons through the campaign. Our buyers are good credit risks. For all loan types in the United States, the average total past due is 4.3 percent. The campaign's average is 4.9 percent and we are reaching a much lower income population. Prepurchase education must be provided before the family begins to search for a home. Property rehabilitation is very important to long-term success. Property improvement

Lessons Learned Through NeighborWorks® Campaign for Home Ownership

- ***Lower-income families are good credit risks***

Performance on these loans compares favorably with conventional loans.

- ***Pre-purchase education***

Homebuyer education is most successful if it occurs BEFORE a family begins to search for a home.

- ***Thorough property inspection***

Knowledge of property reduces the likelihood of unexpected expenses during the first years of home ownership.

- ***Property improvement financing***

Adequate financing is crucial at the time of PURCHASE to stabilize financial demands and expenses during the first years of home ownership.

- ***Early intervention delinquency***

Intervention during the first 16–30 days after delinquency is critical for good loan performance.

financing is crucial at the time of purchase. Early intervention (delinquency counseling) also is very important in preventing defaults.

The market can be reached successfully and prudently if we follow the lessons we learn.

Elisabeth Chambers Prentice is the New York/Puerto Rico district director of the NRC. She is responsible for setting district policy and direction, for overseeing budgets, and for all management functions. The district office provides technical assistance, training, and grants to the 27 affiliated NeighborWorks® organizations in New York and Puerto Rico. She is a founding member of the NeighborWorks® Campaign for Home Ownership and serves as chair of its national Loan Products Committee. She is the chair of NRC's internal Single-Family Practice Group.

She received a B.A. in political science from the University of California at Berkeley and an M.A. in city and regional planning, with an emphasis on housing and finance, from Cornell University. She serves on a variety of nonprofit boards of directors in New York.

James H. Carr, senior vice president, Fannie Mae Foundation

Good morning. I thought that my talk today would try to look at the issue of performance and put it into a useful context. To fully appreciate the current status of affordable loan performance, it is useful to consider loan performance data in such a context. I suggest a three-pronged context: (1) the products and services represented by the available data; (2) the market potential and value of the loans underlying the data; and, (3) efforts required to more fully capture and successfully manage the affordable loan market.

Data in the Context of the Products and Services Provided

Although a few lenders have a long history of aggressively marketing products and services to underserved households and communities, most affordable mortgage products, underwriting criteria, and initiatives are less than a decade old. The result is that much of the data we are examining today does not reflect a full knowledge of the affordable mortgage market; the best possible efforts to prepare nontraditional borrowers for the responsibility of homeownership; and the potential contribution of technology toward lowering costs, managing risk, and targeting viable affordable lending opportunities effectively.

Knowledge of the Affordable Mortgage Market

According to OCC's Advisory Letter AL-97-7*, surveys conducted in 1996 and 1997 show that affordable lending can be profitable business. Affordable loan performance at 13 of the largest national banks indicates



that prior experience in affordable lending improves performance.

The OCC survey found that banks with at least three years of affordable lending experience had generally lower delinquency rates than institutions with less experience. The OCC also found that although delinquency rates were slightly higher for affordable loan products than for other residential real estate loans, losses were virtually nonexistent or minimal. At least one institution with substantial affordable lending experience has found performance of its affordable loan portfolio to be outstanding based on its long-term profitability. Affordable loans now make up 30 percent of its loan portfolio and the number is growing.

In addition, today's default and loan loss data represents yesterday's experience and practice. This fact is particularly important for lenders whose long-term performance is less than satisfactory. The industry is constantly updating its knowledge, products, services, and approaches to the affordable loan market.

Meaningful performance data, such as default and loss statistics, are usually at least three, and up to seven, years old. Even if a product is the same as that provided several years ago, some key underwriting criteria or outreach strategy may have changed. Documentation, allowable ratios, sources of down payment, cash reserves, borrower counseling, and many other requirements and loan processing mechanisms may have undergone modifications that are an important (albeit not yet fully measured) influence on loan performance.

Finally, affordable lending need not be synonymous with high delinquency rates. High delinquency rates often reflect imprudent or inexperienced lending practices. Yet even where high delinquencies do exist, they do not translate directly and automatically into defaults. Successful lenders have demonstrated how a variety of enhanced servicing practices can significantly cure delinquency problems.

The bottom line: affordable lending can be profitable business if it is understood and managed properly.

Efforts to Prepare Borrowers Are Not Yet Fully Effective

Over the past decade, significant emphasis has been placed on preparing traditionally underserved borrower groups to manage mortgage credit as

Finally, affordable lending need not be synonymous with high delinquency rates. High delinquency rates often reflect imprudent or inexperienced lending practices ... Successful lenders have demonstrated how a variety of enhanced servicing practices can significantly cure delinquency problems.

a precondition for loan approval. Home buyer counseling is believed to improve borrower credit performance and is required for many affordable loan products. But counseling's full potential as a risk mitigation tool is not yet known. There are no national standards for counseling, no "best practice" teaching procedures, no widely accepted texts, and no uniform skills training requirements for counselors, to name a few weaknesses.

Counseling can be provided by video, in person, or by telephone. It can be provided over a period of months, weeks, or in a single day. Counseling can be offered in advance of a potential borrower meeting with a sales agent or it can occur at closing. Counseling can cover basic budgeting and credit advice or it can include information on selecting the best mortgage product and other specific information. Counseling can be provided as a prepurchase service or it can also involve post-purchase advice. Each variation in teaching approach, including timing, texts used, and teaching method, can have a significant impact on counseling's effectiveness as a loss mitigation tool.

Moreover, the housing industry lacks information on the effectiveness of alternative counseling techniques and approaches on loan performance. As a result of the diversity of ways in which counseling services are provided, much of the industry's affordable loan performance data reflects borrowers who received counseling that was not delivered in a manner that might improve loan performance most effectively.

Some institutions have attempted to measure the effectiveness of counseling services. But most existing studies of this type are of limited value. Why? Because the analyses were not structured from the outset as experiments that compared counseled borrowers to a control group of households with similar demographic characteristics, who received similar loan products for similar homes, in comparable neighborhoods, at similar points in the economic cycle.

Moreover, where counseling programs have been examined, no effort has been made to isolate the various components of a counseling program to determine the specific aspects of counseling that have a positive, neutral, or negative impact on loan performance. Without this information, it is difficult, if not impossible, to know the extent to which a particular counseling program will improve borrower performance.

The American Home Buyer Education and Counseling Institute recently launched as an industry-wide collaborative institute, which will improve the industry's knowledge of the effectiveness of alternative forms of counseling services and enhance the effectiveness of counseling services.

Technology's Potential to Identify Markets and Measure and Manage Risk

Similar to home buyer counseling, today's performance data also does



not represent technology's full potential to lower costs and assess and manage affordable lending risks. Although credit scoring represents a major technological innovation in home mortgage lending, most scoring models remain relatively crude.

Fully developed customized mortgage scoring models are still far off in the future for most lenders. As a result, many borrowers who would benefit most from highly sophisticated and impartial automated credit risk assessment tools continue to be processed through an unsophisticated and potentially biased judgmental system. Ironically, those borrowers who would have been approved with the greatest ease through a manual or judgmental underwriting process receive the greatest benefits to date of automation.

We know many of the factors critical to successful affordable lending. We know, for example, that the less equity people have invested in their homes, the more likely they are to default. We also know that households with little funds in the bank at the time of closing a loan are more likely to get into financial difficulty than households with more substantial reserves. We know that the more high-risk factors rolled into one loan, the more likely that loan is to sour. But this information is not enough. We must be able to answer the following questions in sufficient detail and include this information in complex mortgage scoring models so that we may measure risks posed by nontraditional borrowers more accurately:

- Why is it that some households can manage exceptionally high amounts of debt while others cannot?
- What distinguishes households with nontraditional credit histories who succeed in maintaining their homes from those who are unable to manage their mortgage debt?
- Why is it that some home buyers experience trouble maintaining a home that was purchased with little equity while others do quite well?
- Why is it that only a fraction of borrowers with house values lower than the outstanding mortgage loan balance actually go into default?
- What role does home buyer counseling (pre- and postpurchase) play in improving a person's ability and willingness to manage housing debt? What role *could* it play?
- What are the best techniques for appraising properties in urban neighborhoods with few comparables, or with highly diverse land uses concentrated in a single block?
- What is the relationship between delinquency and default for various affordable lending products and borrower groups and how can we best increase cure rates among these populations?

In addition, sophisticated technology is not being aggressively applied today to marketing strategies by most institutions. Yet technology tools can allow lenders to examine in some detail the demographic, financial, and physical characteristics of neighborhoods. They can be used to compare institutions operating in various types of communities on a range of performance indicators, both throughout a metropolitan area and across cities throughout the country. Technology can allow institutions to develop marketing tools that can proxy housing credit demand. This would provide lenders with a better understanding of the market potential of communities that might appear similar on the surface, but that have significantly different credit demand potential.

The Potential Affordable Lending Market

A key context in which to examine affordable loan performance is the potential market for those loan products and services. An estimate of the potential market for this lending would tell us whether the losses we expect

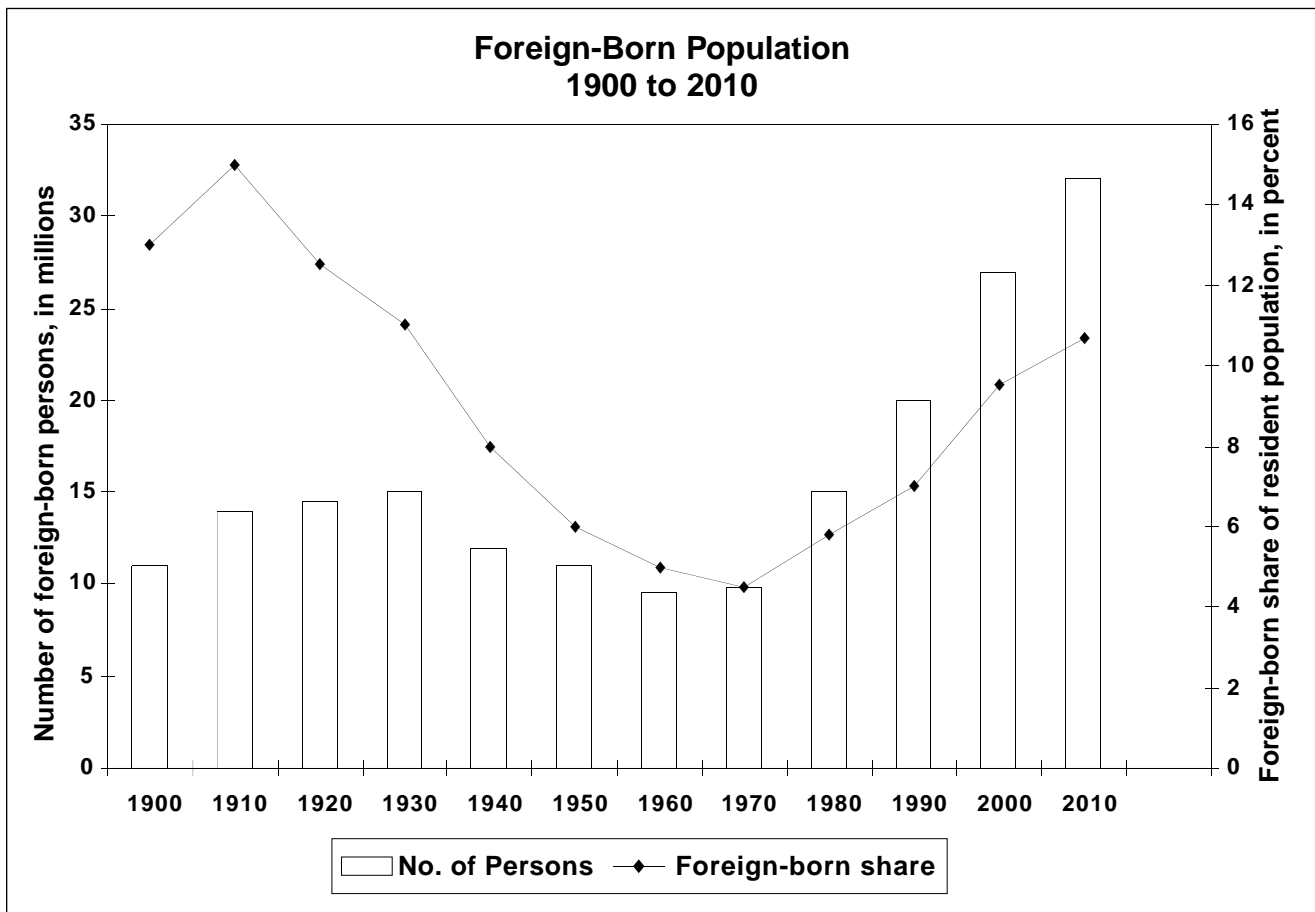


Figure 4:
Source: Pitkin and Simmons (1996)



rience today through experimentation (or the dollars we spend to understand and penetrate this market) are worth the investment.

The emerging mortgage markets of the next millennium are not those households whose credit needs are already fully satisfied or those households who will represent a smaller (if not shrinking) share of tomorrow's market.

A quick look at the demographic realities of tomorrow are instructive. Two trends are clear. The first is that minority households will constitute an increasingly large share of the population and household formation in the U.S. The second is that net immigration will strongly reinforce this trend (see figures 4 and 5).

Looking at immigration first, more foreign-born persons are entering the U.S. in the 1990s than in any other decade in this century. America is experiencing Ellis Island all over again. But this is Ellis Island with a twist. Whereas most immigrants to the United States in the first part of this cen-

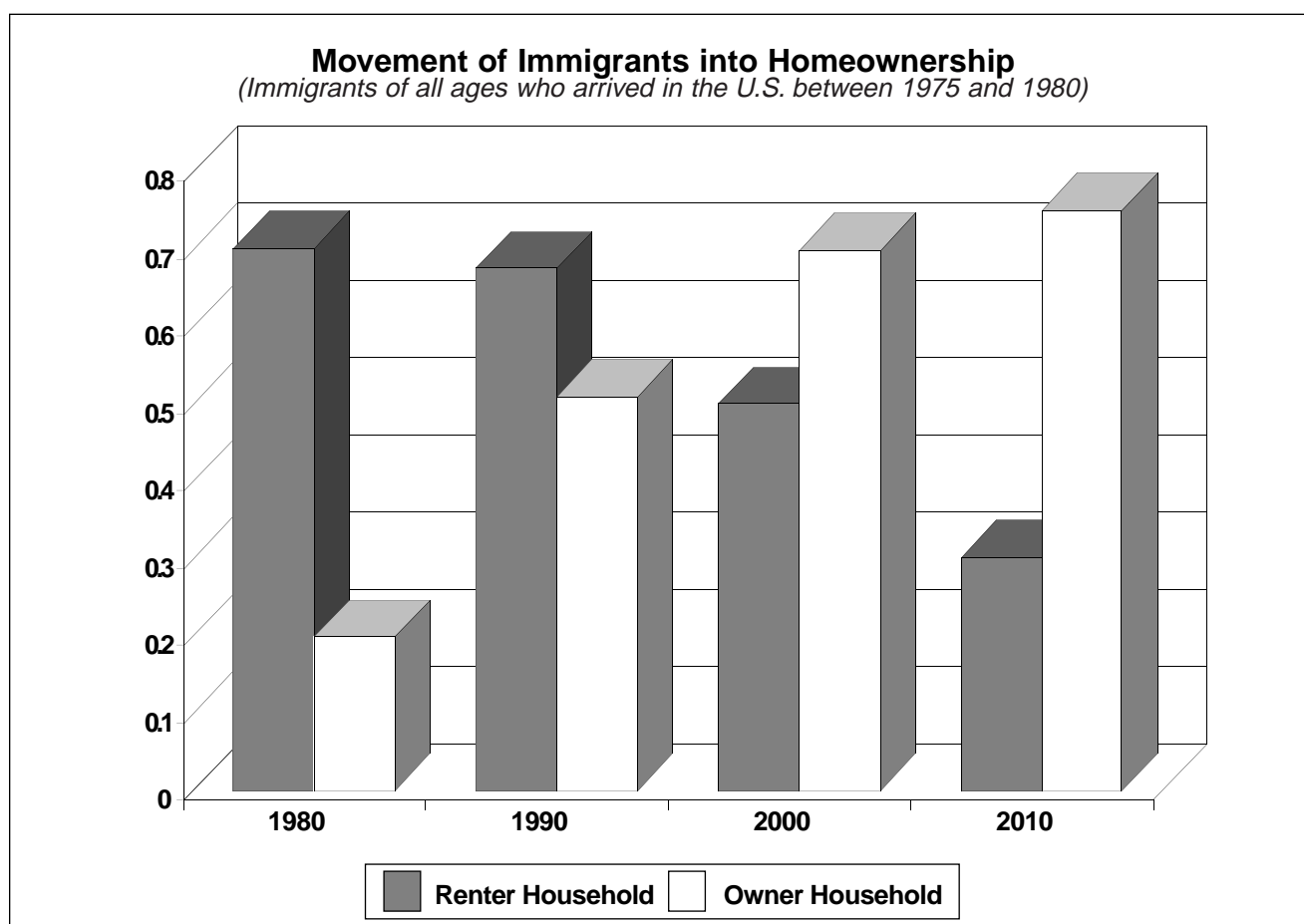


Figure 5: Source: Estimates and projections prepared by John Pitkin of Analysis and Forecasting, Inc., for Fannie Mae Foundation

ture were largely European, most immigrants today (80 percent) and into the next century will be Hispanic, Asian, Caribbean, and other persons of color.

Currently, immigrants are contributing 30 percent to the net annual population growth in the United States. By 2030, post-1992 immigration will account for nearly 90 percent of net annual population growth in the United States. By that same time, the non-Hispanic white population is projected to begin declining. Understanding these trends will be the key to staying in business.

It is not just the size of the foreign-born population that has important implications for the housing markets and homeownership growth, but also its characteristics. The median age of the foreign-born population is projected to increase and, similar to native-born persons, homeownership rates for immigrants tend to increase as they get older.

For immigrants, another important homeownership demand factor is the length of time they have been residents in the United States. Immigrants tend to advance rapidly into homeownership the longer they have lived here. As of 1980, the homeownership rate for foreign-born persons who came to the United States between 1975 and 1980 was 22 percent. By 2010, roughly two-thirds of those households are projected to own their own homes.

Because more than three-quarters of recent immigrants are racial or ethnic minorities, the projected acceleration in immigration homeownership growth also emphasizes the importance of removing discriminatory barriers from the mortgage finance system. As we learn to customize products and services for foreign-born populations with widely varying credit cultures and information and product needs, we also will improve our ability to meet the unique needs of native-born minorities.

As with all other groups in the United States, native-born minorities will increasingly move to age groups that have higher homeownership rates. The result will be that minorities will not only contribute to first-time homeownership, but also increasingly to the more lucrative trade-up market.

Finally, as part of its national homeownership strategy, HUD recently developed several homeownership growth scenarios. The goal of these estimates was to show the potential impact on the national homeownership rate through incremental reductions in the gap in homeownership rates between racial and income groups. The results are striking.

By reducing the income and race homeownership gaps by only 30 percent, the national homeownership rate would climb to more than 71 percent! This means that nearly 8 million additional affordable loans are up for grabs!



Strategic Outreach

The major challenges for greater penetration into the affordable lending market are (1) increasing the use of technology to measure and manage credit risk; (2) enhancing products to more appropriately fit the varying needs of emerging market borrower groups; (3) improving the cost-effectiveness of outreach initiatives; (4) improving borrower understanding of mortgage credit and the ability and willingness to manage mortgage credit; and (5) continuing to reduce artificial barriers to homeownership (such as lending discrimination).

One recommended approach to improved performance is through the increased use of “strategic,” rather than “tactical,” initiatives. Tactical initiatives are short-term in nature; are usually focused on one immediate goal; and are often taken in response to an immediate business need, such as a good CRA rating for a pending merger or acquisition or for political purposes. Tactical initiatives tend to be ineffective and staff intensive, fail to provide information useful to size the affordable loan market and mainstream targeted loan products, and leave companies vulnerable to adverse selection with costly and ineffective pricing responses.

A strategic approach measures the size of the underserved market and determines the share of that market that is reasonable for a single financial institution to command; develops analytical tools to help marketing staff better identify untapped market opportunities and set priorities for their efforts on the basis of economic return (rather than social or political value); develops pricing models that enable targeted businesses to be mainstreamed (this requires understanding in detail the reasons for varying loan performance, including real and potential impact of home buyer counseling); institutes enhanced servicing practices that limit credit risk and improve borrower performance; and forms long-term partnerships with nonprofit institutions to help create and manage market opportunities.

This final issue, forming long-term partnerships, is particularly critical. CBOs can play a key role in helping financial institutions to develop markets if the relationships are structured properly. They can also provide potential borrowers with home buyer counseling services to prepare them to take advantage of lending opportunities.

Conclusion

Over the first half of this decade, we have learned a lot about the emerging markets for affordable loan products. We have learned that one size does not fit all—that there are many ways to successfully underwrite loans. And we have learned that many households are either unaware of their opportunity to become homeowners or are intimidated by the mortgage lending process.

We have learned that many households that were prohibited from entering the market as a result of poor credit histories are capable of gaining control of their finances and successfully managing a home mortgage. And we know more about credit risk today than we did three to seven years ago.

In some instances, we have found delinquency and default rates to be higher than we would want. But we should try to see the positive side of poor performance as we enter new markets. If, for example, we enter a new market in a manner that produced default rates of as high as 10 percent, we could view this result as both bad and good news.

The bad news is that with a 10 percent default rate, you won't be in business very long! On the positive side, however, a 10 percent default rate means that 90 percent of those households that you took a chance on performed acceptably. The challenge is to further refine our credit risk models to weed out that 1-in-10 performance problem.

The recent surge into subprime lending by many of the nation's largest financial institutions is a recognition that many of the established markets have plateaued and that new markets are needed to continue business growth. It also reflects an increasing comfort with customized lending. Over time, the broad categories of subprime versus prime lending are likely to fade and be replaced by a continuum of credit provided through risk-based pricing. Those institutions that invest in understanding this continuum of credit will dominate the mainstream as well as the affordable lending markets.

None of the risk-related issues we face in affordable lending is so technically or theoretically challenging that we can't make adjustments in our programs and operations and successfully meet demand. Affordable lending is the emerging market of the next millennium. Lenders who will be most successful in this market are already beginning to move away from the pack.

James H. Carr is senior vice president of the Fannie Mae Foundation. He is currently responsible for the foundation's research, policy development, program evaluation, and training functions. He is also responsible for the developing technological tools to enhance the capabilities of community development organizations. He previously served as vice president for Housing Research at Fannie Mae. He also served as assistant director for tax policy with the U.S. Senate Budget Committee and research associate with the Center for Urban Policy Research at Rutgers University. Mr. Carr has published and lectured in the areas of housing and urban policy, housing finance, community reinvestment, housing discrimination, and state and local finance. He is editor of Housing Policy Debate and has received an outstanding achievement award from the Neighborhood Reinvestment Training Institute.

Mr. Carr received a bachelor of architecture degree with honors from Hampton University and a master's degree in urban planning from Columbia University.



Q & A Summary

A participant asked about the economics of home buyer counseling. Ms. Prentice stated that a buyer can pay a portion of the costs, along with banks, the secondary market, and private mortgage insurance companies. She reminded the audience that risk is offset for all of them. At present, costs are running around eight-to-one in terms of ratios. Mr. Ludwig noted that an OCC staff member had informally run numbers that indicated that the costs are very low if incorporated into the mortgage and paid out over time. Mr. Birbaum indicated that the cost is approximately \$5 per month if incorporated into the mortgage. Mr. Carr stated that first it should be determined what is effective, and for whom. Then it can be decided who should pay for counseling.

A participant asked whether there is segmentation in the Neighborhood Advantage portfolio. Are there patterns and trends to indicate what is successful? Ms. Mills stated that performance is good where attention is paid to credit, *i.e.*, capacity to carry debt and willingness to carry debt.

A participant asked how to pay for postpurchase counseling. Mr. Carr responded with two answers. If the question is who should pay for counseling, his answer for postpurchase counseling is the same as for prepurchase counseling. However, if the question is whether postpurchase and prepurchase counseling and alternative servicing are a necessity, and should be considered a necessity for affordable lending, his answer is an absolute “yes.” He noted that if one sees the need to change the front end of the process to allow borrowers in, one might logically conclude that there is a need to modify the back end of the process. This is because the back end of the process was not designed for those lenders coming through the door for special, affordable lending programs. In fact, there may be better cure rates for affordable loans that are delinquent with aggressive servicing. Mr. Carr speculated that when a middle-income household understands its credit responsibilities and gets into trouble, it is probably in trouble. Lower-income households may still not fully appreciate the process in which they are involved, even if they receive counseling on the day of closing. A little reminder may go a long way. Mr. Birbaum added that we need to keep in mind that early delinquency intervention and postpurchase counseling are different. For early delinquency intervention, the lender may want to consider working with a CBO or similar entity because the lender may be able to reduce overall costs and compensate the CBO accordingly.

A participant asked about the ideal time frame for a standardized counseling session. Ms. Prentice stated that one size does not fit all. Affordable mortgage counseling is not equivalent to homeownership education. Education is communicating a specific body of knowledge while counseling is individual advising on a plan of action, with reference to a potential borrowers specific financial situation and behavior.





III. What's Working Now: Portfolio Management and Underwriting Strategies for Affordable Mortgages

Loan portfolio management (LPM) is the process by which risks that are inherent in the credit process are managed and controlled. LPM includes affordable mortgages. This session explored successful strategies for mortgage loan portfolio management, including enhancing portfolio profitability, managing loan delinquencies and losses, and developing early delinquency intervention strategies. It also considered lender liquidity options for affordable mortgage programs, the application of flexible underwriting standards, and evaluating the need for private mortgage insurance (PMI). Although many banks have managed affordable mortgage portfolios with solid performance results, there has been an increase in delinquencies recently in some programs, particularly among banks new to the market. In contrast, banks that have experience originating and administering affordable mortgages for years have lower delinquency ratios. Our speakers discussed what their organizations found to be effective practices for affordable mortgage portfolio management.

Donna McAda, vice president, statewide affordable sales manager, Texas Commerce Bank, N.A. (TCB), Houston, described how TCB's portfolio lending program evolved through a process of trial and error. Patricia Hanson, president of community development, Norwest Bank Minnesota, N.A., described the initial objectives of their affordable mortgage program, the obstacles they encountered and how these were addressed, and how they continued to review their portfolio and respond to new challenges as they appeared. The panel's final speaker was Matt Miller, director of single-family affordable lending at Freddie Mac. Mr. Miller described how banks can use secondary mortgage market programs for liquidity and for managing interest rate risk management of affordable portfolios. David G. Gibbons, deputy comptroller for Credit Risk at the OCC, moderated this session.

***Donna M. McAda, vice president, statewide affordable sales manager,
Texas Commerce Bank, N.A.***

Good morning. Today I am going to talk about the stages of our portfolio lending: some of the things we tried, and where we are today. But first, there are some important elements to consider before putting together a portfolio strategy. The primary element is the players. We didn't look carefully at these players when we started. But I advise you to reach out to the

different players if you haven't and learn about the market. You should be aware of your local government interest in single-family housing, of non-profit organizations and community groups, of other bank portfolio products, and of the secondary market lenders.

Understand your local government interests in single-family housing. Do they have HUD HOME funds? How are they using HOME funds? Do they have community block grant funds? How are they using them? What direction is your housing authority taking? We have found that working in partnerships with our different communities and understanding their unique needs means a lot more affordable housing business in the long run.

Next, know your nonprofit and community groups. Know their skills, technical experience, funding sources, and experience. Are they trying to build houses? Are they trying to educate and counsel individuals?

Learn about other bank portfolio products. You heard B of A mention that their product is at a lower interest rate but has the same high credit quality as their traditional product. We took a different approach in our product. But, it is most important that your bank look at what other financial institutions are offering in the form of a portfolio product in your market area.

Last are the secondary market lenders. When we first did a portfolio product, we really didn't stop to reach out and see what the secondary market lenders were doing or were willing to do. Nor did we check with the mortgage insurance companies. We just jumped out there on our own. I don't advise you to do the same.

The next element we considered was housing stock, including existing housing stock (availability, condition, and price), the cost of new construction, infrastructure, and the rehabilitation needs of the existing stock. In Texas, we were very fortunate to have, in some of our markets, a lot of housing stock and a lot of demand. This was older housing stock, some in good condition, some not. In such areas as our Houston market, the price was very reasonable for the affordable market. In El Paso, though, we had very little existing housing stock. Most units have to be built, which adds the cost of construction and offers a lot less availability. The cost of new construction is necessary in a lot of our markets and makes housing less affordable.

Infrastructure, lot availability, and neighborhood needs are also important concerns. To go in and just build housing without taking a good look at community needs offers very few positive results for banks. For example, we put three new houses into a community that we later found had no community base for these new homes. That was a mistake.

Today, we are concentrating on the rehabilitation needs of existing housing stock. We have found that many units could be sold if they were



rehabilitated. There are additional issues that are involved in these projects, such as working with inspectors and contractors and the costs of rehabilitation. Rehabilitation represents a real challenge for us.

The final consideration in setting up a portfolio is to ask why you want to get involved with a portfolio product. It is important to determine whether it's because of excess liquidity; a lack of a secondary market product; for pure profitability; to respond to community need; because the structure, terms, and enhancements can be profitable; or because of other concerns. At Texas Commerce, the big issue was underwriting flexibility.

Our first portfolio product was issued in 1991 and 1992. We devised a product that had one rate and no points. Closing costs were fixed at \$1,000, although closing costs in Texas ranged from \$3,000 to \$4,000. There was no monthly mortgage insurance at that time, so we decided to self-insure by increasing the interest rate. However, when it came down to the credit and underwriting, we fell back onto the secondary mortgage guidelines. By the end of 1994, we moved to flexible underwriting. At that time, we had access to the Fannie Mae Community Home Buyer ProgramSM and we started considering higher ratios, as well as current housing cost in relationship to the mortgage payment. Another consideration was understanding credit dilemmas, particularly the reasons for late or missed payments. We took the Fannie Mae product, which does not require reserves, and pushed it to the limit. Then we added additional layers of risk. And we made a lot of loans.

Today, Texas Commerce has taken a different approach. We have begun to work more closely with the secondary market, and mortgage insurance has been added to the portfolio product. We found we could do more with existing secondary market products and that everything did not need to be in a portfolio. We reassessed our portfolio products and revised them to our markets' needs. For us, this meant putting borrowers with less income documentation into the portfolio. In our markets, cash on hand, or "mattress money," is very typical, which can make documentation difficult. There are still other issues in our market, though, with documenting income. For example, cash on hand may be very typical but borrowers still may have credit history that must be reviewed. The amount of time spent in any one job may be shorter, but the borrower may have been consistently employed over a length of time. We also had to be willing to accept smaller down payments; not to use credit scoring; and to layer risk.

The portfolio has been very profitable; however, there have been high costs incurred in the back end, such as rehabilitation to return foreclosure property to value. The focus now is on counseling the home buyer before the real estate agent and loan officer get to them. We need to look at how people have paid their rent and bills. In some cases, we need to educate the borrower on mailing the mortgage check.

The issues today in affordable lending are education, the responsibilities involved in homeownership, financial planning and budgeting, reserves after closing, property condition, and postpurchase counseling.

Is all of this worth it? I have had people tell me how, as a child, they had to move every six months. Instead of learning math or reading, they had to learn a new environment. Homeownership stabilizes communities, kids, and education. It is more than having a part of a large market share; it affects all of our communities' future success.

The issues today in affordable lending are education; the responsibilities involved in homeownership; financial planning and budgeting; reserves after closing; property condition; and post-purchase counseling.

Donna M. McAda is vice president and statewide affordable sales manager at Texas Commerce Bank, N.A., Houston. She is responsible for generating home mortgages in the targeted low- to moderate-income and minority communities of the major markets in Texas. Ms. McAda works with community groups, nonprofit organizations, government entities, and secondary market planners to develop products to meet the specific community needs. She also serves as chair of the Houston Housing Partnership and is a member of the Houston Fannie Mae Partnership Roundtable. Previously, she worked for the Federal Reserve Bank of Dallas as a commercial and international senior examiner.

Ms. McAda grew up in a small, rural community of about 4,000 people. She is a graduate of Texas A&M University.

Patricia L. Hanson, president, Community Development, Norwest Bank Minnesota, N.A.

Good morning. I would like to thank the OCC for holding this symposium. It is a real opportunity for me to learn from people who have been at it even longer than I and to compare what we're doing.

Norwest established its Community Homeownership Program (CHOP) using a decentralized approach to decision making in local communities to ensure that the program meets the local needs. Our first community homeownership program began around 1986 in Des Moines, Iowa. The Minnesota program was introduced in 1990. As you can see, Norwest has been at this a few years and we've learned from our experiences.

Norwest has the largest mortgage banking company in the United States. At Norwest we had two initial objectives: to fill the gap in the credit needs of the inner cities of Minneapolis and St. Paul, and to revitalize those communities by encouraging homeownership. Today, we have two more program objectives: to maintain underwriting guidelines to ensure continuation of the program and to maintain our outstanding CRA rating.



Norwest Bank, Minnesota received its third consecutive outstanding rating in 1996.

Our product is a defined-territory product. For the Minnesota program, we took 1980 census tract data and identified declining census tracts in the Twin Cities. We wanted to encourage both lower- and middle-income buyers to continue to live in our core cities. There is no income limit and no mortgage insurance required. We updated the territories with 1990 census data, which increased the lending area. The decline had continued to creep outward and we are starting to see some of our first string suburbs with needs.

Although our numbers are not quite as impressive as B of A, we are meeting a very critical need for a niche product. We have made 2,300 loans in the two core cities for more than \$125 million, making us by far the market leader. The average income of our borrower is approximately \$23,000 per year, which indicates that we are reaching a fairly good segment that probably has not been reached by the secondary market products. The average loan size is \$55,000.

The two biggest obstacles for our buyers are down payment funds and credit issues. Our program is very layered, and is probably more like the NeighborWorks® program than the B of A program. We have expanded guidelines in credit history, expanded debt-to-income ratios, and we have made gift funds eligible.

In our initial review of the portfolio, we found that property issues—that is, repairs to the property—were one of the first reasons for delinquencies. We revised our appraisal review process, which has led to improvements. This really helped control our delinquencies. We found that we had motivated sellers in the inner city, and that we could have the new roof, new furnace, whatever repairs were needed, completed before the buyers, who had no cash reserves, went into the home. This was a very important step early on in the CHOP program.

In 1995, Norwest undertook a complete study of foreclosure and loss accounts. We wanted to review the attributes of all the layers of credit risk we were taking. We found that a lot of buyers were first-time home buyers, and that most were first-generation home buyers. They didn't understand homeownership. We would receive calls at our servicing center asking us to make repairs. The mentality was that someone would always come and fix whatever needed to be repaired because for generations their families had been renters.

A second review was conducted in 1996. As a result of the 1996 review, Norwest instituted a home buyer counseling program for all first-time buyers (three, three-hour training sessions). We found that an overwhelming percentage of lost accounts had previous credit problems, ranging from

charge-offs to false collections. We also found that there tends to be pressure on “deadbeat dads,” fathers who don’t pay their child support. We saw borrowers come to the closing table with six months of child support payments, which is not really six months’ demonstrated repayment plan. We had to tighten up in that area.

Adjustments were made that any judgments, liens, charge-offs, or collection accounts within the previous 12 months would not be allowed. We also addressed duplex ownership, which had a high percentage going into foreclosure. In 1996, we eliminated the use of 75 percent of documented rental income on duplexes as qualifying income. We want to continue to do duplexes but we found that the primary reason they go into loss or foreclosure is because they lose their renter. We can’t afford to have these people fail—the bank doesn’t want the house back and we don’t want the homeowner on the street.

In the last six to eight months, Norwest has found some alarming data on early delinquencies on new loans booked. We conducted a study and found that new credit issued has been the primary problem, creating overextension by the borrower. Some borrowers have credit cards charged to the maximum because they receive them in the mail. We have gone back to the Homeownership Center for training and educational materials on how to manage credit. (The Homeownership Center is a collaboration of Fannie Mae and all the major lenders in the Twin Cities.)

One of the areas that we have focused on is how to manage your credit after you get into the home. We also include in the closing package a document that allows us to release information to Consumer Credit Counseling Service about loans that are delinquent. We conduct quarterly training programs with our collectors on services that are available in our local market. For example, in the winter in Minnesota there are energy programs that allow people to pay off their bills over time, and there are even assistance programs. So we want to be sure that our collectors know what is out there and can refer our customers who may be having difficulty to resources that can help them stay in their homes.

Patricia L. Hanson is president of community development, Norwest Bank Minnesota, N.A. She is responsible for managing affordable loan programs, affordable second mortgage lending, residential real estate portfolios, low-income housing tax credit investments, and relations with not-for-profit developers and local government units.

Ms. Hanson received a B.S. from Mankata State University and is a certified public accountant.



Matt W. Miller, director, single-family affordable lending, Freddie Mac

Good morning. I'd like to begin by describing a common management scenario for you. As a manager, you review your portfolio reports each day and realize your affordable mortgage portfolio has grown to levels well beyond your organization's tolerance for the interest rate risks and credit risks. You are instructed to fix it quickly. At the same time, your production staff has just created a new product that they say must go into the portfolio. So what do you do now?

The loans you have been putting into your affordable portfolio for the last several years now may be ideally suited to be sold into the secondary market because the secondary market provides an opportunity for liquidity and interest rate relief for these portfolios.

Over the past several years, Freddie Mac has been using the research for Loan Prospector®, our leading automated underwriting system, to enhance our ability to purchase portfolios. In the past, the secondary market looked at portfolios only in terms of how they were originated and what the payment performance was. This led to the exclusion of many loans because original loan-to-value ratios (LTV) were too high, initial credit performance was weak, or documentation was inadequate. Even if the original LTV was acceptable, was the value still there? Lenders were primarily on the hook for this warranty and had to accept this risk.

The two main features of a loan that change over time are borrower credit and the current LTV.

Today, we take a much more aggressive approach in assessing portfolios and we can more accurately predict the future performance of loans. The two main features of a loan that change over time are borrower credit and the current LTV. Either the risk does not change with most of the other features, such as the number of units, property type, or occupancy, or it becomes less relevant, such as income documentation or source-of-funds documentation. However, credit and LTV change, and can greatly change the quality of the loan.

In the past, we looked at original LTV, took into account some amortization, and used that value to base our decision. However, the lenders were responsible for knowing if the value had fallen, and were expected to repurchase if they couldn't guarantee that the value hadn't fallen over time.

Today, we run all loans through a valuation model to receive updated values. This allows us to take the guesswork out of current values and to price more accurately. Two major advantages are gained. First, the lender no longer has to make the same value warranty as in the past and removes the repurchase risk for the value we use to evaluate the loan. This essentially provides free insurance. Second, if you were managing your own CRA pro-

grams with high original LTV ratios, these loans may now be available for sale to Freddie Mac based on their current value. Another potential benefit is that if your affordable portfolios were made without mortgage insurance originally, then because of amortization and appreciation, they may not all need mortgage insurance to be sold to Freddie Mac.

The other main feature that changes over time is credit. Today, when we look at a portfolio, we obtain updated credit information. This allows us to better predict future performance and provide more accurate pricing. If your seasoned affordable portfolio is performing well, chances are the underlying credit of the borrowers has been improving as well. This relates to the benefit of updated credit scores. Many of you are managing programs where borrowers' credit was not very strong at origination. However, you are relying on strong counseling programs and post-origination servicing to improve the performance of borrowers. In these cases, we can take a second look to see if the credit has improved and if counseling has helped the borrowers manage their credit better. Therefore, many loans that may not have been eligible at origination may be salable at this point.

Other product features may not change over time, and the impact of seasoning may be minimal. However, these features may play a significant role in the evaluation of the portfolio. This is where the use of technology, specifically Loan Prospector®, has added value in analyzing portfolios. Previously, one would have limits on each feature tied normally to LTV; for example, no two unit loans greater than 90 percent LTV. Regardless of the other positive features of the loan, anything that missed the requirement was eliminated. Loan Prospector® considers all of the elements of the loan quickly and objectively to assist in making a purchase decision.

Many lenders put loans in their portfolios simply because the borrower's ratios exceeded the secondary market guidelines. We have learned two significant facts about ratios. First, the most common compensating factor for higher ratios is the borrower's previous housing payment history—if the borrower made similar-sized payments in the past, he or she can be expected to make the same-size payments in the future. While this is still a compensating factor, it is not a significant one and shouldn't be the only one used for high ratios. Second, we have learned that a modest increase in ratios of a few percentage points is not a significant increase in risk as long as the other features of the loan are strong. This has allowed many loans that would have been portfolio loans in the past to become salable products today.

One of the most common features of affordable portfolios is the lack of primary insurance on the loans. This decision was originally made to reduce the up-front costs to the borrowers. Often, lenders increased the interest rate slightly to offset some of their risk. This has been one of the most difficult areas to address, although it is very straightforward. By law, Freddie Mac can-



not purchase loans with LTV ratios greater than 80 percent without private mortgage insurance or a recourse provision on the loan. Over the past several years, we have worked with many different forms of credit enhancements to enable these loans to be sold to Freddie Mac. The key to successful credit enhancements is sufficient diversification. Is the portfolio diversified geographically and is there a large enough number of loans to spread the risk so the amount of credit enhancement required can be minimal?

Through the use of Loan Prospector® research and creative credit enhancements, we can usually structure a transaction to securitize your portfolio and provide liquidity relief, interest rate risk management, and credit risk management.

But what can you do if after all this analysis the product you are holding is not up to the standards of the conventional secondary market? We also can provide additional outlets for subprime mortgages. We are now working with several firms to better understand the subprime markets. Freddie Mac can bring value to this market through better standardization of underwriting, more accurate prediction of defaults through Loan Prospector®, and segregating those loans that would currently meet conventional standards but went to the more expensive subprime market. In the coming months, you will hear more about our efforts in this area.

In the final analysis, the message is clear. A loan that you once thought was destined to live forever in your portfolio is now clearly an opportunity to improve your profits. As technology and research are helping us continue to understand more about predictability of default, what was once a “no” because we did not understand it, may now clearly be a “yes.” So even if you have asked before, the answer may have changed.

Matt Miller is the director of single-family affordable lending in the Expanding Markets Department at Freddie Mac. He is responsible for the marketing and sale of products, programs, and services targeted to low- and moderate-income borrowers, minority borrowers, and those undeserved by traditional markets.

Mr. Miller has been with Freddie Mac for 10 years, the last seven in the structured transactions and affordable lending areas. He has been instrumental in developing many affordable lending products, including Affordable Gold 97, lease purchase loans, and conventional rehabilitation loans. He oversees the transaction management of the community development lending area to ensure that the national alliances reach borrowers in the most underserved markets.

Q & A Summary

A participant asked about the future of portfolio lending as a trend. Ms. McAda responded that her organization will see less portfolio lending. Rehabilitation may lead to something newer in terms of a portfolio product. Ms. Hanson agreed that portfolio products respond to a definite need in our

communities. She also mentioned that Norwest is reviewing some new secondary market products. Mr. Miller responded that Freddie Mac is purchasing rehabilitation products.

A participant asked about the process used to originate affordable mortgages. Are processes mainstreamed or delivered through special vehicles? Ms. Hanson responded that Norwest traditionally has originated its portfolio products through its "mainstream" mortgage originators who are compensated on a commission basis. In addition, Norwest has a two-year-old initiative that provides salary compensation for those loan originators who focus on the affordable loan market. The initiative has worked very well over that time period. Ms. McAda stated that a select group of lending officers focuses on mortgage origination in targeted markets. These individuals are compensated by salary, and their progress is monitored by the number of loans closed, not the amount of money lent.



IV. The State of American Homeownership in the 1990s

The luncheon keynote address was given by Nicolas P. Retsinas, who at the time was assistant secretary for housing and federal housing commissioner, United States Department of Housing and Urban Development (HUD). Mr. Retsinas' keynote address described the state of American homeownership. He mentioned that on June 30, 1996, HUD data showed a homeownership rate of 65.7 percent, close to the historic high. Minority household and central-city homeownership rates have notably shown recent improvement. However, he observed that disparities continue in the rate of homeownership among different population subgroups. The growing interest in new financial products by Wall Street investors and the increasing use of electronic data by the credit industry have turned mortgages into commodities. This has lowered lender and most borrower costs, but threatens future homeownership gains among underserved populations with traditionally lower rates of homeownership. Most often these underserved populations are niche markets, dependent on specialized mortgage products that are less likely to become commodified mortgage products. Technology may be lowering costs but commoditizing only the most common mortgage products threatens to leave behind those groups with the greatest disparities in homeownership rates. Mr. Retsinas went on to say that in the past, the goal of government support for housing finance was to remedy gross marketplace distortions. He concluded that more precise assistance, to add value to disadvantaged subgroups, is now necessary.

Nicolas P. Retinas, assistant secretary for housing-federal housing commissioner, 1993-1998, United States Department of Housing and Urban Development

To start, I would like to talk to you today about the issue that brought us together, to place it in as broad a context as possible, and then leave you with the issues that not only dominate the agenda here today but will dominate the work of many of us in the future.

Now that I have been in Washington for a little over four years, I understand that I am talking to the usual suspects. Some of you are literally the usual suspects because you have heard me speak so many times you could give variations of my remarks. Others of you I feel I know through your good work.

I particularly want to acknowledge the work of the Comptroller of the Currency, Eugene Ludwig. Gene is not only my friend, but one of the real heroes of the administration in terms of the work he has accomplished. He is the right person for the right time for these issues, and the issue of afford-

able housing, the expansion of homeownership opportunities, is the right issue at the right time. This is true because there is a danger that we will be lulled by the prosperous times in which we live and by the progress we have made. And I submit that we have made substantial progress over time. But neither the prosperity nor the progress should have us underestimate the task ahead.

Yesterday, HUD Secretary Andrew Cuomo announced that data released by the Bureau of the Census shows that the national homeownership rate for the quarter ending June 30 increased to 65.7 percent. In that context, that is one-tenth of 1 percent from the all-time high homeownership rate last achieved in the third quarter of 1980. These are good times overall and good times for homeownership. The increase, which is a three-tenths of 1 percent increase over the last quarter, means that we are literally on the doorstep from breaking through the ceiling of the all-time homeownership rate. A little more than two years ago, President Clinton set forth a national goal to increase the homeownership rate to 67.5 percent by the end of the decade, which would mean that we would need eight million new homeowners. With the announcement yesterday, we are a little over three million and on target to meet the goal. The economy, in large measure, is the reason, as are the efforts of many of you. When President Clinton announced the goal in June 1995, he also called for a partnership that now includes 65 different organizations from the public and private sectors.

There is other good news. There was a substantial increase announced yesterday in the rate of homeownership for minority households. There was a smaller increase, but an increase, in the rate of homeownership for central cities—all show some improvement. The largest increase announced yesterday of all the different categories was among Hispanic households, a very significant increase of 0.7 percent.

All of this is good news. The not-so-good news is the work undone. Because as good as that news is, there remain significant disparities in homeownership rates among the different subgroups. For example, notwithstanding the increase in homeownership for minority households, the overall homeownership rate for minorities is 45.7 percent; for nonminority households, it is in the 70 percentile. For female heads of households, the rate is approximately 50 percent; for younger families, it is 58.6 percent. Within cities, the rate is 49.9 percent. To provide you with an extreme example, in the disabled communities—one of the communities with which we work—it is 2 percent. The disparities continue.

The secret way to achieve the increase in the national homeownership rate that President Clinton has called for is to reduce those disparities. There are not enough people who could afford to own homes who do not already own homes. That puts a premium on your work.



Many of the tools that have evolved over the years are working and are working very well. It is not a coincidence that we have made progress. For example, 1997 marks the 20th anniversary of the Community Reinvestment Act, a major contributor to reducing disparities. As I reflect on housing finance in the United States, I submit that one of the reasons it has been so successful is that it is a mixed system. It is a mixed system undergirded by a variety of federal support mechanisms. Some of those involve the Federal Housing Administration (FHA). Others are the government-sponsored enterprises: Fannie Mae, Freddie Mac, the Federal Home Loan Bank System. All of them are part of the Community Reinvestment Act. All of them are part of what makes us a successful system.

What message can I give you about the challenges ahead and how you can address them? We have become so good as an economy and as a country, and have made our housing finance system so efficient, that we have almost converted mortgages into commodities. That has paid substantial dividends because it has lowered cost through a variety of mechanisms. Commodities lower cost because they call out for price competition. In the big picture, that is very good and will help us. It poses a new danger, however. The “commoditizing” of mortgages will only be accelerated by the increasing use of technology. A couple of years ago, when I was with FHA, we were considering whether to become involved in pursuing credit scoring or mortgage scoring. Many people were against the idea because they felt it would shut people out of the market. I believed there was an inevitability to it.

If you extrapolate the credit scoring, once it is figured out, the next step is the increased use of risk-based pricing. Who is likely to be left behind? It is precisely those groups that have the greatest disparities in homeownership rates. What do we do about that? Let’s look into our history books, at the Luddites. The Luddites were people in England who were concerned about the loss of their jobs when factories came into play; they tried all they could to sabotage the factories and the machinery. Obviously, that is not the answer. The answer is to figure out what we can do to add value to those groups who, absent value added, will be left out and left behind. You addressed this issue earlier when you talked about prepurchase and post-purchase counseling, home buyer education, and loss mitigation techniques. The challenge for all of us is to figure out how to add value. In the end, technology will test us. It will require us to home in on how we reduce these disparities.

We have become so good as an economy and as a country, and have made our housing finance system so efficient, that we have almost converted mortgages into commodities.

As I reflect on the years of government support for housing finance, and I take special interest in the historical origins of the FHA as one of the ways in which this country got out of the Depression, I think it is fair to say that those types of tools, including the emergence of government that supported secondary market agencies, were aimed at very gross distortions in the marketplace. The housing finance system was broken. In 1934, before there was an FHA, the typical down payment was 50 percent. It was no big surprise people were not buying homes. In a sense, we as the government were working on the big picture.

The challenge for us now is to surgically help the housing finance system. How do we maintain the underpinnings that we have and add value in a surgical sense? At times, President Clinton receives unfair criticism because people want one magic-wand solution to all of the problems. The world does not work that way anymore. We need to try a variety of new tasks. For example, President Clinton recently announced a new initiative in conjunction with Freddie Mac that would allow us to use Section 8 vouchers for homeownership. It is an interesting idea. Section 8 vouchers now go to landlords so they can pay their mortgage. Can they go to individuals to help them pay their mortgages? The idea raises all kinds of credit issues but it is the type of surgical program we need to discuss.

If we are to achieve President Clinton's goal, we have to be sure we are adding value. We can address this and I am sure that we can meet that goal by working together.

Nicolas P. Retsinas was assistant secretary for housing-federal housing commissioner, 1993–1998. He administered the single-family and multifamily insurance funds, as well as programs that resulted in financing for elderly and disabled housing initiatives. He was responsible for regulatory matters related to manufactured housing, interstate land sales, and the Real Estate Settlement Procedures Act. He also oversaw the President's National Homeownership Strategy and through that, was responsible for coordinating HUD's mission and for the regulation of Fannie Mae and Freddie Mac. Mr. Retsinas served as HUD's representative on the Federal Housing Finance Board. At the time this symposium took place, he was director of the Office of Thrift Supervision, where he was responsible for the supervision of the nation's thrift industry. Previously, he was executive director of the Rhode Island Housing and Mortgage Finance Corporation and director of policy for the governor of New York.

Mr. Retsinas received his B.A. in economics from New York University and a M.A. in city planning from Harvard University.

Q & A Summary

A participant asked about disseminating information on credit scoring. Mr. Retsinas responded that one way is to attend sessions such as the symposium. Another challenge is to examine the components of credit scoring



and determine ways to “add value” to low- and moderate-income borrower applications. Value can be added by applying the appropriate credit scoring criteria that indicate applicants are able and willing to repay loans that require increased specialization. He suggested that some people are now being left out because the wrong criteria are being applied.

A participant asked about standards for homeownership and mortgage counseling. Mr. Retsinas stated that those working in the field are beginning to establish quality standards for counseling. The best way to develop standards is to establish a clear definition of counseling from a quality control perspective. This will require good, hard research.

A participant asked how Section 8 vouchers will be used for homeownership. Mr. Retsinas responded that there are currently certain statutory restrictions in the use of vouchers for homeownership. Appropriate changes are in public housing reform legislation that is now before Congress. In anticipation of these statutory changes, HUD is working on the implementation of a demonstration program.





V. Promising Innovations: Cutting-Edge Techniques and Innovations for Affordable Mortgage Programs

This panel discussed the increased use of credit scoring practices, the rising need to understand the benefit of homeownership counseling and education, and various loss mitigation strategies. These are the tools that are helping affordable housing lenders better manage mortgage credit risk and make strides in sound affordable housing finance programs. Alan Stoddard, director of community development at Zions Mortgage Company in Salt Lake City, Utah, described his experience establishing an affordable mortgage department and specializing programs to reach this emerging market, as well as the importance of community-based partnership efforts. Karen Hill, chief executive of the American Homeowner Education and Counseling Institute (AHECI), discussed the evolution and direction of AHECI. Mark Goldhaber, vice president of affordable housing and government business development at GE Capital Mortgage Corporation, described how banks can improve their loss mitigation processes. Ellen W. Lazar, former executive director, National Association of Affordable Housing Lenders, moderated the session.

Alan L. Stoddard, director of community development, Zions Mortgage Company

Hello! I arrived at Zions Mortgage Company about four years ago, new to the mortgage industry, to develop an affordable housing department. Zions was the first lender in the State of Utah to develop this type of department.

The goals I set in 1993 have not changed greatly; what has changed is my vision of the future. I am here to talk about a changing environment in the affordable mortgage market. Who is the typical mortgage borrower now? She or he is white, 35 to 44 years old, whose income is 140 percent of median income. But what about those people at 60 percent, 80 percent, or 100 percent of median income? This is where Zions' affordable housing programs fit into the picture. In the future, Zions will be making some "typical" loans, but not as many as they have in the past. Our future market is changing and affordable housing is where the bank is going.

Today, the population of the United States is 265 million; by 2040, the population will increase to 370 million. More than 50 percent of the increase will be new immigrants and their children. This will create a demand that we, as lenders, will have to fill. For the secondary market, there will be a lot of originated loans to be purchased. We lenders will need

to write guidelines so the loans originated meet the needs of the expanded population and are still salable on the secondary market.

Education is an important part of that process. Homeownership remains the American dream and new immigrants are three times more likely than other renters to consider home buying their number one priority. Because they lack knowledge and experience with the mortgage system and ownership responsibilities, we need to educate them and bring them to their goal.

The population of the United States is also changing. The country is becoming a place of seniors as the median age climbs. We are helping those seniors who are house rich and cash poor. Great programs, such as reverse mortgages, have been created with this in mind. This is another example of preparing for the future mortgage market.

The initiatives of the Good Neighbor Program at Zions are public service outreach and education, broader access to mortgage finance for everyone, breaking down barriers to discrimination, and enhancing Zions' effectiveness in the communities. Every summer I travel to different communities within Zions' lending region to meet with those communities, find out their needs, and determine how Zions can meet those needs. After my travels, I sit down with Fannie Mae and Freddie Mac to see if we can negotiate a specific program to meet our specific needs, aside from the standard programs. Our tools for success are the community lending products, special-needs housing products, single-family government agency finance programs, nonprofit agency finance programs, and the state housing finance agency programs.

Zions Lease-Purchase program is one program I thought would be ideal for nonprofits. A nonprofit organization could purchase a home for 3 percent down with a 97 percent LTV. Zions Mortgage and our mother bank, Zions First National Bank, are partnered in this program. Zions First National Bank makes the loan to the nonprofit organization for the down payment. Zions Mortgage additionally makes the permanent financing so that our organization is doing a 100 percent loan for the tenant family through the nonprofit organization. The program was initiated about 18 months ago, but we have not had one single loan yet. The nonprofits are concerned about becoming landlord managers. Zions needs to educate nonprofits and partner with them to help them see how this program can work.

Other programs include the magnet Employer-Employee Assist Program, where an employee can obtain a grant or gift from an employer; reverse mortgages; Native American initiatives; rural housing; and first mortgages for improvements. Zions views first mortgages for home improvement as a big future market. The average age of American housing stock is 28 years and we think it is in need of rehabilitation.

Zions uses the secondary mortgage market programs, such as Desktop Underwriter® and Loan Prospector®, as processing programs to help us



determine how to process and underwrite affordable housing loans. The programs enable us to get borrowers into homes rapidly. Zions recently developed an innovative affordable housing product with Fannie Mae. A nonprofit developer approached Zions with a project it had purchased from the Resolution Trust Corporation. The project consisted of 166 contiguous units. The partnership put together a single loan for the purchase and rehabilitation, and 166 individual take-out loans using the lease-purchase program (the 97 with the 3/2 option). It was a great program. So great, in fact, that it was sold to a private developer three months later.

Zions has some very specific programs for affordable housing that are based on local needs and crafted with the secondary market. This is our way of addressing some of the issues being faced by the industry. At Zions, we know that partnerships are the only way we can succeed with the affordable market. We need to partner with the secondary market, with government agencies, and with nonprofits. Without these partners we cannot get the job done.

Alan L. Stoddard is director of community development at Zions Mortgage Company in Salt Lake City, Utah, where he is responsible for the development and administration of affordable housing loan programs that are acceptable to the secondary market. Mr. Stoddard directs the training of staff in loan production, processing and underwriting mortgage loans, the design and implementation of housing education and public-awareness programs for low- to moderate-income families, and the introduction of these programs to the community.

His work in partnership with Fannie Mae resulted in the creation of a new mortgage loan product for Native American trust lands.

Karen V. Hill, Chief Executive, American Homeowner Education and Counseling Institute

Good afternoon. I would like to provide some context for how counseling services began and how the institute got started. Then I will discuss our principal areas of focus and provide you with my perceptions of the tensions and conflicts we'll be confronting in the future.

Counseling is not a new market for nonprofit organizations; in fact, some nonprofit organizations are celebrating 25 to 30 years' involvement in the area. I find it very, very interesting every time I meet with lenders who talk about their deep involvement for the last five or six years in supporting education and counseling services, without having a good knowledge of the diligent and transforming work many not-for-profits have done, in very localized ways, that has substantially increased and sustained homeownership throughout the country.

The programs enable us to get borrowers into homes rapidly.

Our institute evolved from an effort to harness the rapid growth that took place in homeownership counseling and educational services as a result of CRA activity, mergers and acquisitions among lending institutions, and the National Affordable Housing Act of 1990, which required counseling or educational assistance. Tremendous growth occurred when not-for-profits and lenders created their own home buying centers to get subsidy dollars.

The industry is fragmented, in disarray, severely underfunded, and lacking in consistent, standard services. The issues that drove the development of the institute were a desire by all members of the lending community to support counseling; to gain control of cost-effectiveness, services, expectations and outcomes, and quality control measures; and to receive accurate data.

Last May, the institute held its inaugural meeting of the founding directors. The institute established five goals, one of which is to provide national standards for competency in counseling. The institute is developing the standards through a collaborative committee representing all sectors of the industry. The board wants to set standards for homeowner education services, separate from housing counseling services, and to test providers' competency in that area in a way that all of the industry groups can approve. We are developing one curriculum for homeowner education and one for housing counseling, as well as a code of ethics that is based on the assumption that no one should personally benefit from providing these consumer-driven services. The institute also wants to develop continuing education and advanced education, which would focus on default and delinquency counseling as a loss mitigation technique.

The institute will also focus on determining costs and real benefits. To date, only data from local sources are available for direct benefits, indirect benefits, and the true cost of counseling. Finally, the institute will conduct a comprehensive literature search, which will be followed by the development of a survey design to establish data sets for collecting information on costs and benefits. Eventually, a long-term study will provide a clearer sense of the relationship between counseling and sustaining homeownership.

After the institute has obtained a clear picture of the core competency standards, the curricula, and preliminary costs and benefits through data collection, we will have an informed and intelligent conversation on how to sustain counseling services and homeowner education services. A lot of existing programs for counseling and education are structurally flawed. They provide lots of money to support the overhead of organizations, but not a lot of money to design a comprehensive counseling program. We have an environment in which thousands of people that are part of these programs believe they are ready for homeownership, yet very few are successful in obtaining a mortgage. If you are in the industry, you wonder why



you're getting so few loans for your investment. We hope to deal with these and other, similar issues.

The institute represents all of the relevant interests in the affordable housing industry. My job as steward is to have our directors ask how we can best design consumer services for value in the marketplace. I think we can accomplish our goal, and I have already seen some very good local programs. For example, I saw a design in Minneapolis where all the partners in the community, working through the homeownership center, have assembled the critical pieces. We now need the national framework to support these kinds of programs.

The agenda developed through the core curricula, certification, and licensing will be reviewed by all industry groups for further refinement and endorsement into a clear set of national standards. We are hoping to improve the quality, timeliness, and effectiveness of services. The accomplishment of this goal will make a tremendous difference in transforming neighborhoods and in enhancing communication between the not-for-profit and for-profit sectors.

By the first quarter of next year, the institute will have a draft competency standard, draft code of ethics, and draft core curricula for homeowner education, housing counseling, and advanced housing counseling. But refinement will continue in order to build a broad consensus, which is key to the institute. Our publication, *Counseling Continuum*, discusses our agenda and how we are getting there. Our agenda is ambitious but I believe it is doable. We will all have to step back from our self-interests and operate in the knowledge that there is a phenomenal wealth among people who cannot obtain homeownership. We have to organize that wealth so that it can be truly life-transforming. Homeownership is the first step on that economic ladder.

Karen V. Hill is chief executive of the American Home Education and Counseling Institute, a national nonprofit agency created by the housing industry and several nonprofit organizations to improve homeowner education and counseling services and increase their relevancy. Ms. Hill's experience includes drafting sections of HUD's "Handbook for Housing Counselors" (HUD 7610). She has conducted training courses in housing counseling and has participated in research to measure the costs and benefits of these services. Previously, she headed a team from the National Low-Income Housing Coalition in cosponsoring, with Freddie Mac and the Mortgage Bankers Association of America, a national seminar series titled "Working Together to Expand Homeownership Opportunities."

Ms. Hill has served on Fannie Mae's Housing Impact Advisory Council and as a director for Housing and Economic Development Programs for the National Urban League.

My job as steward is to have our directors ask how we can best design consumer services for value in the marketplace.

**Mark E. Goldhaber, vice president, Affordable Housing Group,
GE Capital Mortgage Insurance Corporation**

Good afternoon. The focus of my presentation today is loss mitigation and how to build effective loss mitigation into product design. There is a lot of creativity and energy devoted to the front end of homeownership—getting people into homes. Over the last year, GE has been working with non-profit organizations to bring these qualities to the back end: loss mitigation, or keeping people in the homes. I would like you to think about loss mitigation as a process because if we can improve that process, we can improve your profitability on affordable housing.

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There has been a dramatic shift in the marketplace; there have been a lot more products with lower down payments and more flexible guidelines introduced recently. In the early 1990s, about 25 percent of GE's business was above 90 percent LTV. At the beginning of the 1990s, agencies' purchases (i.e., Freddie Mac and Fannie Mae) above 90 percent LTV were in single digits. Today, their purchases are in the mid-teens. That is a dramatic shift. In terms of the big trend, it means that our business above 90 percent LTV is now approaching 45 percent of all the business that we transact. Mortgage insurance is about managing risk; as you reduce the

down payment amount, you increase the risk. As a result, the difference between a 90 percent LTV and a 95 percent LTV is a doubling of risk, and between a 95 percent LTV and 97 percent LTV is a doubling again of risk.

We know we have a product that will experience some losses. The question is: How can we build in more effective loss mitigation to get people back on track and minimize the number of defaults? This goal makes really good sense from a neighborhood's perspective and from a human perspective, and certainly from a mortgage insurance point of view, it makes great economic sense. I know that if we can improve your loss mitigation, even incrementally, it can make a big difference in your bottom-line profitability.

At GE we have been using nonprofits to reach people in trouble quickly. We believe that nonprofits can be invaluable in determining if someone is in trouble. My company's bet is that we're going to get more effective communication by using a nonprofit organization that has a real sense of the community and of the borrower who may be in trouble. We believe that the borrower is more likely to open up with a nonprofit and discuss his or her challenges and problems. GE has worked with a number of nonprofits, including Neighborhood Housing Services of New York and Consumer Credit Counseling Service (CCCS) of Durham, North Carolina. GE has also just initiated programs with Fannie Mae and CCCS in Miami.



Early and complete communication is the key to success in loss mitigation. Nonprofits can be especially helpful in the problem-assessment process. If you know what the problem is, the tools are available to work through the problem. Some of the problems encountered are major medical events, lack of medical insurance, temporary job loss, downsizing in the workplace, death in the family, and credit management.

Credit management has become a big problem, one that must be the focus of education. I continue to be stunned when I hear about low- and moderate-income people with \$25,000 on revolving credit and 12 to 14 credit cards. We in the industry must rally around getting better information to people and helping people understand credit.

The decision on which tool to use is going to be GE's. We have short-term tools for people with temporary challenges, as well as other tools for people in serious delinquency or those who clearly cannot repay the mortgage. Some short-term tools include the repayment plan, where the borrower will make two payments over a set period of time to catch up; the forbearance agreement, in which a lender agrees to delay foreclosure and have the individual make a lump-sum payment to become current; a loan modification, where the terms, such as interest rate or term of the loan, are changed; and the frequently used Borrower's Assistance Program (BAP). In the BAP, GE advances funds to the servicer on behalf of the borrower who has a temporary challenge or problem. We use the BAP in situations where we think there is the ability and willingness to get back on track.

I'd like to add a little bit more about nonprofits. What does the nonprofit organization do for us as part of the partnership? Initially, they quickly send out information to let home buyers know that they are in trouble and that services are available. This is followed by an initial phone call to evaluate the problem. Through the initial phone call, the nonprofits may quickly help the borrowers by letting them know there was a miscommunication, such as the exact due date of the payment. There are a lot of people who habitually pay late and do not recognize this behavior as a problem. GE is trying to find a better way to deal with it. We are also building this kind of information into the information we give consumers on the front end. Nonprofits can help with budgeting, debt management, credit counseling, and identifying local resources for home buyers in trouble. In our technology-driven society, the nonprofits can provide more personalized service.

We think of this as having a funnel effect. A nonprofit organization can contact a large number of delinquencies in process, but the actual cures are far fewer. Since we initiated the program in Durham, less than one year ago, GE has had about four cures. In New York, GE has had about four or five cures in the same time span. This may not sound like a large number today, but we believe the number of cures is going to increase.

I am excited about the program because of its human aspect. For example, we had a customer who had to leave her job because she had a complicated pregnancy and fell behind in her mortgage payments. Through BAP, GE has been able to advance to the servicer three mortgage payments so that she could get back on her feet. She will pay back the borrower assistance funds over a two-year period with only an addition of \$50 per month. Clearly, from the homeowner's and GE's point of view, this is much better than a default. Early and effective communication with the lender or servicer to work out a creative solution makes the program work. Although stories like these make us seem like nice people, you must understand the economic power of this approach from a mortgage insurer's point of view. Every time GE avoids a claim by curing it, we save well over \$20,000. It does not take a lot of cures to show that this make good sense. Lenders, as well as insurers, that build better loss mitigation processes can make affordable product performance better and economically more profitable.

In closing, I would like to share a couple of thoughts about working with nonprofits. It is important to understand and share with a nonprofit your goals for the loss mitigation process and the partnership, and to hear their goals. It is also important to define and communicate the measurements and standards that indicate successful accomplishment of each goal.

GE and I are ready to work with any lender in developing loss mitigation programs that work. It is time well spent and will ultimately result in much more profitable programs.

Mark E. Goldhaber is vice president of Affordable Housing and Government Business Development at GE Capital Mortgage Insurance Corporation. He is responsible for developing a comprehensive channel that allows GE to work more effectively with state and local governments to expand homeownership nationwide. Mr. Goldhaber participated in the development of the Community Home Buyers Program and the 97 percent LTV program. He previously served as vice president of Public Affairs at Freddie Mac and worked for HUD in legislation and regulation.

Mr. Goldhaber received a B.A. from American University and a J.D. from the University of Illinois.

Q & A Summary

A participant asked about the impact of effective counseling on mortgage performance. Karen Hill responded that increases in homeownership rates should ultimately be the result of effective counseling. The AHECI was created to help those currently outside of the homeownership market become homeowners and sustain the ownership. The institute's work also includes the establishment of a counseling clearinghouse, which will be a national repository of best practices and information. The institute expects to provide technical assistance to not-for-profit counseling organizations



and the mortgage industry in developing effective counseling practices.

A participant asked how to promote prepurchase counseling among real estate agents. Mr. Goldhaber responded that lenders may be in the best position to educate real estate agents about the need for prepurchase counseling in the affordable market. Ms. Hill stated that the leadership of the National Association of Realtors® and the National Association of Real Estate Brokers are actively involved in the AHECI. These trade organizations have been receptive to the need for, and benefit of, counseling services.

A participant asked Mr. Goldhaber about data supporting his statement on the doubling of risk when downpayments are reduced from 5 percent to 3 percent. He responded that the mortgage industry has a long-term database on risk characteristics and risk performance. Historically, as a borrower's down payment amount is reduced from 5 percent (95 percent LTV) to 3 percent (97 percent LTV), the risk equation value doubles.





VI. The Future Affordable Mortgage Market: What Will It Look Like and What Must Banks and Their Partners Do to Participate Successfully in It?

The symposium's last session looked at the future of the single-family affordable mortgage market and proposed some solutions to issues and challenges described earlier in the day. Panelists discussed ways to stimulate market demand and to supply the market with adequate numbers of affordable housing units. Panelists also cautioned attendees about avoidable mistakes and likely challenges that lie ahead.

C. Everett Wallace of Wallace Enterprises International in Chicago, one of the nation's top 20 minority-owned firms, described essential components he considered necessary for the continued expansion of the affordable mortgage market. Among other actions, he stressed the importance of disseminating information on the single-family affordable housing market and the need to produce a large number of affordable housing units, adequate to meet the local need. Marva Harris, senior vice president and manager of community development, PNC Bank Corporation, Pittsburgh, described PNC Bank Corporation's success in improving market penetration and loan performance of the low- and moderate-income mortgage market. The biggest challenges facing the corporation are balancing risks, competing for a limited pool of qualified low- and moderate-income borrowers, and making better use of technology to make labor-intensive loans more cost-effective. She also reviewed the value of community partnerships to her organization and the opportunity to make loans to the emerging market of immigrant households. Finally, Isaac Megbolugbe, practice leader at Price Waterhouse Finance Group, explained that the environment for affordable housing in the future will be affected by a number of forces, including a movement away from mortgages sold as generic commodities to a market of niche products and increasing competition for qualified affordable mortgage borrowers. He indicated that the tools lenders can use in the future will include increased reliance on credit scoring to reduce loss exposure and greater use of geographic information systems and mapping software. He concluded that making housing affordable to people of limited income is the most persistent challenge facing the industry. Douglas W. Roeder, deputy comptroller for Large Banks, OCC, moderated this session.

C. Everett Wallace, president, Wallace Enterprises International

Hello. Neighborhood Oriented Affordable Housing (NOAH), a program that my company is working on under the National Alliance Program, brings together a collection of players in a manner that will ultimately produce more affordable housing.

Neighborhood-oriented affordable housing is a concept developed by Wallace Enterprises for a simple reason. We believe that affordable housing has worked to a very limited degree. The most frequent request of lenders is for more volume. The current approach, however, is not working because there is not enough production in the marketplace to result in affordable housing; we continue to orient people toward houses with problems, causing them to default on the loan in five or ten years. We have to become more responsible partners with purchasers. We need to ask the question: "Is what you're buying worth the money that we're putting into it?" The answer should not be, "Yes, because an appraiser agreed it was worth the money." Rather, it should be, "Yes, because we understand that we're trying to provide a lifelong investment."

We have to look at programs that will identify potential purchasers; develop new and revitalized affordable housing in targeted markets; create effective collaborations; tap into local, public, private, and philanthropic resources; develop programs for economic development that are tied to new development in these communities; and create programs that will result in new investment opportunities for increasing CRA credit.

The goal of the NOAH/Freddie Mac partnership, which is a three-year National Alliance Program agreement, is to make 2,500 affordable Freddie Mac-quality loans in 15 target markets. Elements of the program are to bring three to five direct-investor relationships to Freddie Mac, to create market-sensitive programs, and to work on product development.

How does the partnership work? We introduce and promote Freddie Mac products for affordable housing, community development, and mortgage products; provide capacity-building and technical assistance; create marketing materials for local partnership meetings and mailings; and present the program to national and local public and private pension funds and trust funds. An important part of the program is finding people who are interested in seeing that the secondary market is capable of coming out with new and innovative products in some of these marketplaces.

The NOAH/Freddie Mac partnership was created by Wallace Enterprises, a financial services and advisory consulting firm. We have extensive experience in the public and private sectors. We design, organize, and implement programs for both sectors and have established relationships with local and national organizations in the affordable housing field and in government. We survey, analyze, and identify the affordable housing needs



of each of the markets; establish relationships with the public and private sectors; identify potential local partnership participants; establish a local alliance in each of our markets; and develop a NOAH/Freddie Mac plan to meet the needs of the market.

Today, we need to focus on market needs and on the development of new tools and new approaches. We can help by identifying priorities, building new working coalitions, and reducing and eliminating duplication. I want to emphasize reducing and eliminating duplication. This is very important. Everybody in this room probably sits on 50 different committees with 30 different people doing the exact same thing, getting nowhere fast. We should be consolidating resources in the hands of those who can deliver what we need to take advantage of economies of scale. We also need to increase the dissemination of information and the coordination of subsidies in order to build and deliver to scale.

Another objective is to develop innovative financing strategies. A problem I encounter with a lot of lenders is that they're waiting for someone to tell them what else they can do. Lenders need to become more innovative, take more of a risk. We also need to expand the pool of affordable housing developers, expedite the land assembly process, improve existing financial assistance programs, and increase the awareness by our local partners of the programs in their communities.

In terms of the Freddie Mac/NOAH Alliance, there are existing products and products in development, including affordable second mortgages, lease/purchase mortgages, 2-Plus modules, Freddie Mac rehabilitation loan modules, and mortgage revenue bonds. I am working directly with those individuals who are providing the second mortgages, who are looking for lease/purchase projects and mortgage revenue bonds as a way to reach this underserved market in their community.

Some of the specialized programs have been created with Freddie Mac and other partners, including the NeighborWorks® mortgages, FHA 203(k) mortgages, HomeWorks mortgages, and Family Plus mortgages. Perhaps the most significant part of the NOAH/Freddie Mac Partnership are the market-sensitive, negotiated programs. We're designing products that Freddie Mac is willing to buy that may be at variance from what they buy in the general marketplace but are tailored for the needs of a specific marketplace. Freddie Mac provides a number of tools for community lending, including Loan Prospector®, Gold Measure®, Home Buyer Inspection Kit, Freddie Mac Underwriting Guide, Discover Gold® through Home Buyer Education, and Discover Gold® through Expanding Markets.

I would like to describe three of the NOAH alliances. The first is the

Today, we need to focus on market needs and on the development of new tools and new approaches.

Chicago/NOAH Alliance, which has a very large community development corporation (CDC). We work with the public housing authority, the third largest in the United States, and a minority bank CDC (the only African-American bank on the West Side of Chicago). The bank has been certified as a Community Development Financial Institution and is actively involved in rebuilding the Lawndale community around it. The Lawndale community is adjacent to Holman Square. It is part of a major undertaking by Sears to redevelop a large part of this West Side area, which they owned as their national headquarters and abandoned about 20 years ago. Sears decided that the right and civic thing to do was to return and do something useful with the area. They hired a major developer, the Shaw Group, to rebuild the area. The Community Bank of Lawndale sits on the corner of the area and they are partnering with us to build the rest of the area.

Also involved in the Chicago/NOAH alliance are four other banks. The structure of the alliance is to get all of the players we believe are necessary for a successful program, including our primary lenders, which are Freddie Mac Seller Services. We then work with Freddie Mac to develop appropriate mortgage products that Freddie Mac will buy.

In Chicago, we are also working with employer-assisted programs for production of about 200 loans, and a public housing second loan program, which wants to produce 2,000 loans between now and the end of 1998. We've been nationally recognized for the programs we set up in Chicago and we are working toward putting 5,000 new homeowners in homes by the end of the year 2000.

In Chicago, the alliance also is working with a lease/purchase program called the Lease Equity for Neighborhood Development (LEND) Program. The LEND Program answers a lot of questions about who should pay for what, including counseling. We believe that the beneficiary should be the one who pays for the product. If you want long-term counseling, you should pay for long-term counseling—we need to figure out how we can make that affordable to you. The answer is not to continue to create programs that are going to make people believe that someone else is going to make it happen for them. We have to create programs that you can finance yourself if you want to be a homeowner. Until we adopt that belief, we will never have a program capable of moving to scale.

In Memphis, Tennessee, we have established an alliance between the United Way; Free the Children, a local CDC/Community Development Organization (CDO); Students/Mothers and Concerned Citizens (SMACC), another CDC/CDO; the city's Department of Housing and Community Development, Foundation for Home Ownership; Memphis Housing Development Corporation; and three banks. We are working with them on their Hope VI Project, a program that is moving to scale in the urban market. They are tearing down existing public housing and rebuild-



ing them as mixed-income communities. It can't be done without the help of local lenders and the secondary market. They also have a Bicentennial Initiative, a large area surrounding the Hope VI project. The goal is approximately 300 to 500 housing rehabilitation or new construction projects. Also, in another area, the goal is 75 houses. This is a scattered site approach, within a four- to eight-block area, where we'll do massive redevelopment.

In New Orleans, we have executed a memorandum of understanding with the mayor of New Orleans and other partners, including Freddie Mac and the AFL-CIO Housing Investment Trust. The AFL-CIO Housing Investment Trust is a principal player with economically targeted investments. They are interested in creating new opportunities for their membership to work in and to expand job opportunities in these communities. To accomplish these goals, they are bringing buying power to the back end of this deal. We effectively will have a pass-through transaction from our loan originators to Freddie Mac, and from Freddie Mac to the AFL-CIO Housing Investment Trust. The product we have developed together is for acquisition and rehabilitation.

Wallace Enterprises has been hired by the City of New Orleans to put together 300 single-family homes. We will provide architectural and design services, construction management services, legal and process review, financial services, and marketing and outreach. The point here is that we are indeed moving this process to scale.

I would like to close with a discussion of my belief that moving to scale is where we should be today. There will come a time when you can no longer justify to your shareholders or your superiors why you're spending money on programs if they don't create new loans and new activity within the bank. The federal government has begun to see the light and will be funding areas that produce visible improvements in communities. Some of the initiatives and programs are Home Ownership by Zones; Hope VI; Community Development Block Grant (CDBG) Funding; Section 8, which is a CDBG-driven program that provides a loan guarantee; and Section 5(h).

As Nicolas Retsinas mentioned this morning, HUD is trying to bring about homeownership for public housing residents. In Chicago, there are more than 600 people who pay more than \$700 in rent to live in public housing. We are working to provide these folks with a new opportunity, a new lease on life; Section 5(h) allows us to do that.

As of yesterday, we did something unique in Chicago. We took money from selling public housing units to public housing residents and used a portion of the proceeds to provide a second mortgage for a non-public housing person who is at 50 percent of median income with three children. This financing allowed her to buy a house that a nonprofit CDC had built. The unit was built under a program guaranteeing that utilities will not run more

than \$200 per year. Thus, this woman has moved into a new, highly energy-efficient house without ever touching the public rolls. The CDC became a facilitator, showing that public housing can be innovative enough to meet the needs of lower-income individuals. This experiment closed the gap between what a buyer could afford and what was needed for her to become a homeowner, instead of a member of public housing.

A number of cities are relying very heavily on tax incremented financing (TIF) as a means of getting things done. TIFs are another way of moving to scale. The approach is that if a city redevelops an area, the tax increases will be put back into that area as a means of paying off the bonds floated to get the area started in the first place. It is a means of large-scale redevelopment.

C. Everett Wallace is president of Wallace Enterprise-International of Chicago, one of the nation's top 20 minority-owned companies. He has spent a significant part of his public career shaping national issues and administering public services in both the legislative and executive branches of the federal government. Previously, he served as general deputy assistant secretary to HUD; senior legislative assistant to the U.S. Senate majority leader; senior analyst and counsel to the Senate Budget Committee; and special tax consultant to the secretary of HUD. He received HUD's "Secretary's Award for Excellence" and the Department Health and Human Services "Secretary's Award for Exceptional Achievement in Public Service."

Mr. Wallace received his B.A. from Northwestern University in Evanston, Illinois, and a J.D. with honors, specializing in taxation and corporate law, from Northwestern University School of Law.

**Marva H. Harris, senior vice president, manager,
Community Development, PNC Bank Corporation**

Good afternoon. As a manager of community development (CRA) for the Pittsburgh market of PNC Bank, I have a long-standing involvement in meeting the financial service needs of underserved communities. As a company and as a market, we have enjoyed many successes in increasing the flow of capital to lower- and middle-income (LMI) communities. It would be a lot easier to stand here today and look back and evaluate our results, rather than look ahead and outline how financial institutions, mine included, should chart a strategic course for servicing LMI families and communities in the future.

One of the biggest challenges we face today is to balance competing objectives. Homeownership offers many benefits to individuals, communities, and financial institutions. Homeownership stabilizes communities; the home is the principal asset for LMI families. In short, residential mortgages are key to healthy communities.



We want to preserve, sustain, and revitalize neighborhoods. Yet as a business we need to generate income, to produce performing loans, and to observe principles of safety and soundness. PNC Bank has had many successes. We have strong market penetration across racial lines and across income strata. Our comparative denial ratio has narrowed. We have put many loans on the books with layered risk factors, and yet these loans have performed well. One of the ways, though, in which we have erred (and this is one of the things we are going to have to work our way out of) is that we began in 1988 to fund loans at discounted rates. And once you have introduced that in the market, or you have tried to compete in that way, it is exceedingly difficult to back off from it. And that is one of the challenges we are now facing.

We have engaged our community partners in an honest dialogue in which we have attempted to explain to them the long-term implications of portfolio lending and discounted products, while emphasizing our objective of continuing to serve LMI communities. The discussions have been intense but productive. It has been a tough process, but we are making inroads. Community groups recognize our need to generate income through market-rate loans, and develop an outlet to the secondary market so that we can reinvest that capital in our markets.

Turning to the future, I consider our biggest challenges to be balancing risk, using technology, leveraging partnerships, telemarketing, and identifying emerging markets.

Balancing Risk

As we move to new regulations, and I presume some of you have seen the public evaluations under the new CRA examination process, it is clear that when examiners said they were going to focus on performance over process, that is precisely what they are doing. The challenge for those of us who are trying to serve the community and generate loan volume in a safe, sound manner is to book quality assets while competing for a finite pool of qualified borrowers. Communities targeted for redevelopment cannot afford to have vacant properties as a result of foreclosure or abandonment. There's risk to the family, to the community, and to the lender. We must resist the temptation to put a family that's not ready for the responsibility of homeownership into a home.

In the discussion of counseling today, I heard a reference to requiring eight hours of counseling. The families for whom we make mortgages typically go through counseling for three months to one year. This may make us atypical, but I do not believe there are any quick fixes.

Technology

I am a convert with regard to using technology to evaluate and book mortgages for LMI families. Affluent families will some day originate some of their loans over the Internet. Given the cost savings that can be achieved through technology, those of us working with families that require more labor-intensive efforts should also take advantage of making loans in more cost-effective and efficient ways. At PNC, we estimate that between 35 percent to 40 percent of community development mortgage loans have credit quality that would be acceptable under an automated system. We also need to look at more creative ways to share some of the responsibility for origination and processing costs with organizations that have lower overhead, such as CBOs or housing advocacy groups. By doing this, we can reduce our costs, remain competitive, and retain a personal approach with borrowers.

Partnerships

Partnerships and the caliber of nonprofit organizations have been discussed at length. In Pittsburgh, rather than rely on existing nonprofits to provide counseling, we partnered with a group of community activists to create a nonprofit organization that could provide creditworthy applicants. It is an approach to consider. We also have worked with individuals who have a strong commitment to their communities to educate them on the mortgage buying process, and let them serve as our marketing team. We can cull participants from the marketing seminar—those who are ready to finance a home, those who will require long-term remediation—and respond appropriately.

In Pittsburgh, rather than rely on existing nonprofits to provide counseling, we partnered with a group of community activists to create a nonprofit organization that could provide creditworthy applicants.

Telemarketing

Similar to many other financial services providers, PNC has increased its use of telemarketing as a means of marketing and delivering services. Historically, we have used seminars as a primary means of outreach in marketing our products to targeted LMI communities. The problem with this approach was follow-up. Telemarketing provides us with an efficient and effective way to follow up with prospective customers, particularly in the initial stage of their financing a home. Another potential market could be tapped by banks reviewing public records, in their respective markets, to identify families who have financed homes originally with “B” and “C” loans, for whom a refinance may be a possibility. This tactic could introduce “economic literacy” to these families while at the same time generating new volume for financial institutions. Some of the initial follow-up with these families can be done through telemarketing.



Emerging Markets

Immigrant households will represent an increasing first-time home buyer market. With this emerging market, we need to understand the characteristics of buyers—that they can be skeptical of financial institutions and they can have different and multiple income sources. We need to understand these populations to reach out to them. Typically, new immigrants tend to be more mobile than the native-born population; initially, they rent, often live with relatives or with multiple families. Asians tend to hold multiple part-time jobs, live on less disposable income, and make a commitment to saving.

While racial and ethnic groups have made gains, there is still immense opportunity to extend homeownership to historically disadvantaged minorities and to new immigrants. Targeting them can expand our markets and help to restore stability to inner-city and distressed communities. The Harvard University Joint Center for Housing Study indicates that families who immigrated to the United States in the 1970s own homes at a rate that surpasses native-born minorities and at a rate that is approaching that of native-born whites. For those of us who are willing to modify our underwriting technology, address unique borrower characteristics, investigate new delivery systems, and seriously pursue emerging markets, there can be tremendous opportunity in the future.

Marva H. Harris is senior vice president and manager of Community Development for PNC Bank Corp. She is responsible for managing all functions of the bank's Community Reinvestment Program. Ms. Harris provides strategic guidance to direct the planning, marketing, and service initiatives that target the community development and economic revitalization of low- and moderate-income areas, customers, and emerging small businesses.

Ms. Harris holds a B.A. degree from Chatham College. She attended graduate school at the University of Pittsburgh and Harvard University, where she received a certificate in education administration.

Isaac Megbolugbe, practice leader, Price Waterhouse Housing Finance Group*

Good afternoon. The goal of our meeting today is to address challenges to the growth and stability of the affordable single-family housing market, and to suggest strategies for how lenders can address these evolving issues. I'd like to start by tracing the evolution of the mortgage market, beginning with government intervention in the housing finance system, the market and political pressures that are leading to the integration of the housing finance system with the global capital markets, and the growing importance

* Mr. Megbolugbe's presentation at the symposium was a condensed discussion of this written paper on the same topic.

of market discipline in the mortgage market. Next, I'll talk about the future composition of the mortgage market and the trends that will shape it. I'll then discuss the strategies, products, and services that will carry the market into the future. I'll conclude with a discussion of the challenges and barriers we face today in the affordable mortgage market.

Evolution of the Mortgage Market

Traditionally, housing finance has been an area of government intervention, especially through the creation of program mechanisms through which funds can flow. This market paradigm is changing rapidly, though, as a result of inflationary pressures, interest rate volatility, deregulation, technology, and the integration of international financial markets.¹ Over the last 20 years, political and market forces have lessened the need for these program mechanisms. The housing market in the United States has experienced a substantial decline in these mechanisms, and has moved toward the integration of housing finance with the broader competitive, market-driven financial system. This trend should continue well into the next century.²

During the 1970s and 1980s, many of the program mechanisms developed to shield housing finance came under enormous strain from a combination of factors: higher inflation rates and interest rate volatility aggravated the cost and inelasticity of funds supply and threatened the financial stability of specialized lenders; populations with rising affluence chafed under climates characterized by various forms of nonprice rationing; and banking systems faced with corporate disintermediation and increased competition for funds turned their attention to consumer lending, particularly housing. These pressures, along with improvements in financial technology and a political shift toward a conservative emphasis on reliance on markets, became powerful forces for deregulation and integration of markets, on both the asset and liability sides. Thus, the special program mechanisms for housing finance were reduced in importance, or eliminated and replaced with a more market-based allocation of credit to housing.

In this new environment, the supply of funds generally became more elastic, and pricing of credit began to reflect the resource costs of provision. Competition increased, which led to increased diversity in contracts and funding sources. As a result, the efficiency of housing finance systems, as measured by the total costs, private and public, of intermediating a given amount of funds for housing, improved. These changes, though, brought greater volatility in the price of credit, the price of owner-occupied housing, and the potential for default on mortgage loans.³

Today, mortgage markets are under increasing pressure to become fully integrated with global capital markets and are subject to market discipline to a much greater degree than before. There also is growing pressure on the government to provide a separate and transparent accounting of the financ-



ing and subsidy costs of housing so that capital markets investors can readily identify the sources of funding of their cash flows.

What Will the Future of the Affordable Market Look Like?

Population Trends

According to a 1996 study by the Harvard University Joint Center for Housing Studies on the state of the nation's housing, the changing age structure and racial and ethnic composition of the population will alter the mix of family types, but will not lead to a significant change in the number of new households formed each year. The study estimates that household growth should average 1.2 million annually during the 1990s, which is consistent with growth during the 1980s. Similarly, the production of new conventional units plus manufactured homes should average 1.7 million annually between 1996 and 2010, which, again, is essentially the same as in the past 15 years.⁴

Income Distribution

Over the past two decades, the changing wage structure of the United States economy has altered the distribution of income. The labor force has become increasingly divided between well-educated and well-paid workers who can take advantage of expanding employment opportunities, and less educated and lower-paid workers who cannot advance up the economic ladder.

The growing income gap has two implications for the future. The first is that the growth of high-income households will increase the demand for better quality homes, second or vacation homes, and high-end renovations. The second is that the number of low-income households now facing excessive housing cost burdens, or who live in structurally inadequate units, will only continue to grow as the income distribution widens.

Spatial Patterns

In keeping with long-term migration trends, population and employment will continue to move away from the Northeast and Midwest to the South and West. Because land is usually more abundant and less expensive in these regions than in the more densely settled parts of the country, this shift favors lower-cost and lower-density types of housing construction.

Within regions, people and jobs are steadily moving away from high-density center cities to lower-density suburbs and outlying areas. As a result,

Today, mortgage markets are under increasing pressure to become fully integrated with global capital markets and are subject to market discipline to a much greater degree than before.

construction on the fringes of metropolitan areas is surging, while construction activity in the center cities of older metropolitan areas has virtually stopped. In addition to draining the economic life of major urban centers, this decentralization requires costly infrastructure investments to support low-density housing development. This has profound implications for the low-income households who remain in the center cities.

The move away from center cities may accelerate as high-income households trade up to better homes in outlying areas and purchase second homes for vacation or retirement. The growth in the number of high-income minority households and the home-purchase patterns of recent immigrants should also reinforce the movement away from center cities to suburban areas. As decentralization strengthens, poor households will become more and more isolated in inner-city neighborhoods.

Housing Affordability

Between 1994 and 1995, 2.3 million households made the transition to homeownership, boosting the national homeownership rate from 64 percent to 64.7 percent. This surge in homeownership reflects increased affordability brought about by moderate interest rates, stable home prices, and continued employment growth. Although mortgage rates have edged up from their 1993 lows and home prices have begun to outpace inflation, homeownership is still more affordable now than it was five years ago.

Unlike homeowner costs, rents have become less affordable over the past 20 years—despite the persistent weakness of rental markets and high vacancy rates, rents have changed little from their 1990s peak. Also, the affordable housing stock is steadily shrinking as low-cost units are removed from inventory through demolition, upgrading, or change to nonresidential use. The limited amount of new multifamily use that is taking place tends to add units primarily to the high end of the market.

High rents and limited affordable housing opportunities have made severe payment burdens the primary housing problem facing low-income renters. Impending cutbacks in federal housing assistance programs will worsen the already intense shortage of affordable and structurally sound housing available to low-income families.

Market Structure Commoditization versus Nichification

Rapid changes in technology and the emergence of the secondary mortgage market over the last 20 years have spurred banks, in many respects, to treat their products as commodities. The ability to deliver products faster and more cheaply, along with the standardization of products required by the secondary market, has allowed the mortgage industry to reach a large segment of the mortgage market at an unprecedented rate. This has led to



the belief of many industry participants that the market is best served by leveraging the economies of scale derived from product commoditization.

The mortgage market has become increasingly fragmented, however, as the secondary market has demanded more information regarding the sources of risk in mortgage banks' portfolios and the competition for loans from both traditional and nontraditional lending institutions has increased. As a result, the general consensus in the mortgage industry is that the home loan market can no longer be characterized as a large core market with a generic home loan surrounded by many specialized but small market niches. The new view of the mortgage market of the future is that there is no generic product. The market is a collection of niches.⁵ This view is thought of as the nichification,⁶ rather than the commoditization, of the mortgage market.

Products and Services

The primary implication of market nichification on the future of mortgage products and services is that it raises questions about the validity of existing price comparisons across lenders or areas because there is no generally accepted base product to which these comparisons apply. This favors the development of multi-lender systems because the market participants who group together can offer a wide variety of products and more widespread coverage of different market niches, thereby reaching more markets than individual lenders offering a single line of products.

Technology

Changing technology also will play a significant role in the affordable mortgage market of the future. The long-term view is that technology will offer access to credit to a wider spectrum of households than are currently being served, while saving institutions time and money. Electronic data interchange standards are rapidly increasing the sharing of information between computers. Automated underwriting and appraisal, as well as credit scoring systems, are increasing the speed, improving the quality, and lowering the cost of the underwriting process.

I believe that automation can provide at least five key benefits in the delivery of products and services:

- Lower closing costs and faster processing times;
- More robust credit risk assessment, customized products, and objectivity;
- Greater awareness of product options and cost;
- Enhanced consumer education opportunities; and
- Faster, more standardized, and more meaningful market analyses and CRA performance reviews.⁷

Size of the Market

Although the exact size of the affordable mortgage market is hard to assess, we can conclude that the nation's changing racial and ethnic composition and income distribution, along with the erosion of the stock of affordable housing over the last two decades, will intensify the competition for borrowers who fall in the affordable category. Fueled by improved technology, this competition will, in turn, lead to the creation of an enormous number of distinct market niches. Nichification also is driven by the secondary market, which prices every borrower, based on property characteristics reflecting default risk, prepayment risk, and servicing cost. Originators pass these pricing adjustments through to the primary market. Because the information base and the research that underlies judgments about risk and cost are continually improving through advances in technology, nichification will continue.⁸

Legislative Trends

With consensus support for a balanced budget, we will probably see cutbacks in federal housing development and community development resources; this would create a vacuum in the affordable housing market. However, a combination of private and public initiatives could mitigate some of the impacts of these cuts.

On the private sector side, housing suppliers could pick up some of the slack by working to reduce the cost of housing—each dollar saved on building, remodeling, financing, and operating homes and apartments can help to broaden the supply of affordable units in an era of scarce resources. Housing industry efforts to promote fair lending practices also could make a valuable contribution to the affordable mortgage market. As the fastest growing population group, minorities represent an important new segment of the home buying public.

On the public sector side, state and local governments can mitigate some of the negative impacts of federal cutbacks. Housing assistance is just one component of a comprehensive attack on poverty and neighborhood deterioration. Better coordination of current housing, community development, employment and training, and human services can help stretch scarce funds while expanding community participation in program design and implementation. Another possible public strategy is to find ways to preserve the existing housing stock and urban infrastructure. Regulatory reform for construction and rehabilitation activities could lower housing costs and extend the useful life of the existing low-cost inventory.⁹

How Will We Get There?

There are a number of tools and strategies that mortgage banks might use to help define and set the effective limits of the affordable market and



to leverage potential opportunities. As the mortgage market continues to subdivide into smaller niches, and the competition for borrowers continues to intensify, the need for mortgage industry participants to leverage technology and implement market and product differentiation strategies will increase. I'd like to talk now about some of these tools and strategies.

Mortgage and Credit Scoring

Using computers to generate credit scores and other statistically driven measures of risk allows lenders to accept more applicants while reducing their exposure to losses. Robust mortgage and credit scoring systems are important because better measures of risk translate into more customized mortgage products, greater objectivity, flexible assessment methods, and more accurate performance predictors.

Although there are many benefits to automated mortgage and credit scoring, automation also poses several challenges. Today, the most controversial aspect of mortgage finance automation is credit scoring. Credit scoring systems that rely heavily on consumer debt repayment history rather than on mortgage loan repayment history are controversial because they can produce misleading credit scores. Why? Because borrowers may perform differently with consumer debt than they would with a home loan. Credit scores based on analyses that underrepresent certain borrower groups may also lack their full predictive power. There are three general areas of concern about scoring systems: validity, neutrality, and accessibility.¹⁰

Geographic Information System (GIS) and Mapping Software

GIS tools make it possible to investigate time and space at the same time, and to create models that better describe the relationship between geographic location, house price and quality, borrower performance, and the consumption patterns of housing and mortgage credit. GIS systems also will enhance the analytical power of automated underwriting systems and related advancements.¹¹

Subprime Lending

As home equity loans gained cultural acceptance, the demand for second mortgages flourished from both low-risk (prime) and credit-impaired (subprime) borrowers. The subprime home equity market now has an ample supply of funding from the asset-backed securities market, which is using a growing number of entrepreneurial finance companies as distribution channels for investment products. Home equity loans to credit-impaired consumers represented the fastest growing residential mortgage segment in 1995.

Although it is hard to arrive at a consensus on the size of the subprime mortgage market, this segment grew faster than any other residential mort-

gage segment in 1995. Some of the theories on why this segment grew so much include the following:

- Increasing competition has reduced interest rates and closing costs.
- More borrowers are seeking to consolidate their growing levels of revolving credit card debt for a lower rate or payment.
- Product innovations, such as first mortgage conversions, revolving lines of credit, home equity lines of credit, and adjustable



rate features have increased the attractiveness of home equity loans to both prime and subprime consumers.

- Slow growth in real estate appreciation in certain regions is causing an increase in the number of borrowers seeking to make home improvements.
- Recovering real estate values in certain regions are providing a greater amount of equity in homes.
- The increasing availability and use of credit cards have been creating more “A” and “B” customers out of historically “A” customers, and have increased the attractiveness of debt consolidation loans.
- Lenders are becoming more comfortable with their ability to properly gauge credit risk through more reliable credit bureau formation.
- Lenders are becoming more comfortable with their ability to track loan performance through technological innovation and sophistication.¹²

Subprime Servicing

Servicing subprime mortgages requires a much more aggressive approach than servicing conforming mortgages. The tendency of subprime customers to become delinquent and the frequency of customer contact needed to successfully collect payments call for a higher level of resources devoted to this area.

Unlike prime mortgage services, the key to an effective subprime mortgage servicing operation is to focus more on actual collection performance, not scale-generated efficiency. The most important areas of a subprime mortgage servicing operation are the collection and real estate owned (REO) areas. The level of investment in loan servicing systems also is a key element when assessing the relative strength of a subprime mortgage servicer. The ability to contact borrowers is greatly helped by tools that allow for more effective and efficient telephone correspondence to mortgagors. Other tools, such as branch office automation, on-line applications, and electronic imaging of loan files, are also ways to become more efficient through information systems.¹³

Challenges

The biggest challenges we face in the affordable mortgage market will come in the form of accessibility, availability, affordability, and marketability. These four areas will be instrumental in shaping corporate decision making when it comes to affordable lending.

Accessibility

Recent literature shows that equally creditworthy borrowers differing only in race or ethnicity have received different treatment in the rental, home purchase, and mortgage markets. In particular, studies have shown that minority households with similar income and other socioeconomic characteristics are treated differently than nonminorities during the housing search; are less likely to own; are more likely to experience rejection of their mortgage applications; and are more likely to be steered to FHA mortgage loans. Some evidence also indicates that geographic areas with a large share of minority residents exhibit higher rejection rates for mortgage applications and higher proportions of FHA loans in total mortgage originations.

Individual, cultural, or area-based differences in treatment limit the choices of minority households in their housing and location decisions, and thus worsen housing affordability problems. Discrimination also may be an underlying factor leading residents of affluent, predominantly white residential areas to oppose the construction of affordable housing in their communities. Removing these accessibility barriers to affordable housing requires vigorous enforcement of antidiscrimination laws. Effective enforcement techniques include fair housing testing and fair lending testing. For the mortgage industry to aggressively pursue affordable lending, it must confront issues arising from lack of access.¹⁴

Availability

Institutional factors perpetuating segregation in urban neighborhoods—redlining by lenders and insurers, steering by brokers, and discrimination by owners—have attracted a lot of attention lately. However, natural market forces, such as supply and demand, also can create spatial neighborhood heterogeneity, or neighborhoods that are different from each other on the basis of such factors as income, race, type of housing stock, age of residents, or proximity to public transportation. To understand the impact of neighborhood heterogeneity on affordable lending, the industry must establish a framework to examine the market forces that create such heterogeneity.

Although spatial neighborhood heterogeneity itself is not undesirable, most housing and community policy development efforts have attempted to reduce the degree of heterogeneity for two reasons. First, we generally assume that concentrations of minority populations and low-income households will have negative effects on neighborhoods, such as fewer educational opportunities, greater cultural barriers, constraints on capital flows, fewer employment opportunities, and a lack of incentive to invest in the housing stock. The second reason to reduce the degree of heterogeneity is because we believe that all Americans are entitled to a decent home and suitable living environment, as suggested in the 1949 Housing Act.¹⁵



Affordability

It is helpful to understand what is meant by the term “affordable housing” and how it is measured. By most accounts, housing conditions in the United States have improved dramatically over the past 50 years. The national homeownership rate is at or near an all-time high, and most analysts agree that average housing quality has increased and that the prognosis for the long-term health of the nation’s housing stock is good. Despite these improvements, though, a sizable share of the country’s households live in housing that is physically inadequate, overcrowded, or unaffordable.¹⁶ A disproportionate share of these households are low-income or minority. To understand why disparities between the homeownership rates of different groups and in different areas of the country continue to persist, it is helpful to develop a working definition of the term “affordable housing” and a standard measure of affordability.

Over the years, a number of definitions have been used to quantify the size and nature of the affordable housing problem. Most have centered around expanding housing opportunities in specific geographic areas and for underserved families and individuals, and identifying the barriers that produce affordability problems. The first step in determining housing affordability is to examine the relationships between a household’s income, the cost of housing in the household’s geographic area, and the household’s other expenditures. A common measure used to assess housing affordability is the percent-of-income standard. For our purposes, a unit of housing which costs more than 30 percent of household income will be considered unaffordable.¹⁷

The affordability of housing, especially among low-income and minority households, continues to be the most persistent challenge facing the housing industry. Although many of the reasons for the persistence of this problem remain unknown, the industry knows of several barriers to affordable housing. The barriers are caused by a number of factors, from household characteristics such as income, wealth, or credit history, to barriers which result from institutional policies, regulatory policies, discriminatory behavior, and the complexity of multifamily finance. Lack of information and inadequate technology also affect households’ access to affordable housing.

Marketability

Traditionally, the major participants in the affordable mortgage market have been government institutions, such as the Federal Housing Administration and the Department of Veterans Affairs; government-sponsored enterprises, such as Fannie Mae and Freddie Mac; private mortgage insurers; depository institutions, such as commercial banks and savings associations; and nondepository lending institutions, such as independent mort-

gage banks, mortgage brokers, life insurance companies, and pension funds.

These organizations will likely remain the principal participants in the mortgage market of the future. However, advancing technology, financial globalization, and industry consolidation have fundamentally reshaped the delivery of financial services. Judicial rulings and regulatory decisions have further eroded the legal walls that bar commercial and investment banks and financial services firms from poaching each others' business. Increasingly, there is cross-pollination and integration across the various sectors of the financial services industry. As a result, participants in the affordable market are likely to face greater competition not only from traditional market participants but from a variety of nontraditional mortgage lenders, such as investment banks and securities firms. This means that to remain competitive, market participants must continually re-evaluate the composition of other portfolios, the lines of business in which they choose to participate, and the markets (or niches) they choose to pursue.

Finally, there are both incentives and disincentives for lenders to participate in the affordable market. Incentives include profit and community good will. The primary disincentive for participating in affordable lending is risk, or perceived risk. Because of this, we must answer several questions about the affordable market whose effect on underwriting standards remains unclear.

- Why can some households manage exceptionally high amounts of debt while others cannot?
- What distinguishes households with nontraditional credit histories who succeed in maintaining their home from those who are unable to manage their mortgage debt?
- Why do some home buyers experience trouble maintaining a home that was purchased with little equity while others do quite well?
- Why do only a fraction of borrowers with house values lower than outstanding mortgage loan balance go into default?
- What role does home buyer counseling play in improving a person's ability to manage housing debt? What role could it play?¹⁹

Answers to these questions will help clarify real risks from perceived risks and help lenders minimize risks while maximizing the market size.

Notes:

¹ In many countries, governments have intervened in the market to set up "special" circuits, characterized by a significant degree of regulation, segmentation from the rest of the financial markets, and often substantial government subsidy. One rationale for the creation of special circuits was that



private markets were incapable of allocating sufficient funds to meet demand (at a “reasonable” price), reflecting problems posed by the special characteristics of mortgage lending. See Diamond and Lea (1992) for a more complete discussion.

² Douglas B. Diamond, Jr., and Michael J. Lea, “The Decline of Special Circuits in Developed Country Housing Finance,” *Housing and Policy Debate*, vol. 3, no. 3, 1992, 747–778.

³ Ibid.

⁴ Harvard University Joint Center for Housing Studies Staff, *The State of the Nation's Housing*, 1996, Harvard University Joint Center for Housing Studies, 1997.

⁵ Jack Guttentag, “Commoditization Versus Nichification: Exposing the Myth,” *Mortgage Banking*, vol. 57, no. 3, December 1996. pp. 44–52.

⁶ Nichification is the modification of prices and underwriting requirements for an extraordinary large number of combinations of transactions and borrower and property characteristics. A market niche refers to loans having characteristics that depart from a set of standard specifications in ways that lenders recognize in their pricing or their underwriting. Some part of the standard specifications are essentially uniform across all lenders. These include (1) collateral is single-family home; (2) borrower is purchasing the home as a principal residence; (3) borrower is a citizen and an “A” (or perhaps “A”) credit; and (4) standard documentation is used. On the other hand, there is no standard type of loan, loan size, LTV ratio, rate or points, or lock period.

⁷ James H. Carr, “Technology and Affordable Lending: Opportunities and Challenges” (Presentation given at The United States Department of Housing and Urban Development Conference on Automated Underwriting, June 26, 1996).

⁸ Guttentag, “Commoditization Versus Nichification.”

⁹ Harvard University Joint Center for Housing Studies Staff, *The State of the Nation's Housing*, 1996, Harvard University Joint Center for Housing Studies, 1997.

¹⁰ James H. Carr, “Technology and Affordable Lending: Opportunities and Challenges” (Presentation given at The United States Department of Housing and Urban Development Conference on Automated Underwriting, June 26, 1996).

¹¹ Ibid.

¹² Duff & Phelps Credit Rating Co., “Business & Financial Risks of Subprime Mortgage Lending,” Financial Services Industry Special Report,

August 1996.

¹³ Ibid.

¹⁴ The Fannie Mae Foundation, "Overcoming Barriers to Affordable Housing" (Fannie Mae Foundation Draft Research Paper, August 1, 1996).

¹⁵ Kerry D. Vandell, "Market Factors Affecting Spatial Heterogeneity among Urban Neighborhoods," *Housing Policy Debate*, vol. 6, no. 1, 1995, pp. 103–140.

¹⁶ The Fannie Mae Foundation, "Overcoming Barriers to Affordable Housing."

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ James H. Carr, "Has Affordable Housing Lending Failed?" (Remarks at the Neighborhood Reinvestment Training Institute, Oakland, Calif., November 1, 1995).

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* The book Mr. Megbolugbe referenced was *Housing Partnership: A New Approach to a Market at a Crossroads*, by Andrew Caplin, Sewin Chan, Charles Freeman, and Joseph Trach, MIT Press Books, 1997.



Appendixes

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Appendix A: Affordable Mortgage Portfolios, OCC Advisory
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Appendix B: List of Symposium Attendees



