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Joint Center for Housing Studies

WORKING PAPER SERIES

The Changing Industrial Organization of Housing Finance And the Changing Role of Community-Based Organizations

William C. Apgar and Allen J. Fishbein

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Joint Center for Housing Studies

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Introduction

This paper examines forces that are reshaping the mortgage banking industry and the ongoing efforts of community-based organizations (CBOs) to expand access to mortgage capital for lower-income people and communities.[1] Today's mortgage market bears little resemblance to the one that existed just a few decades ago. Key changes include increasing use of automated underwriting, credit scoring, and risk based pricing, as well as the rise of a mortgage delivery system dominated by mortgage brokers, secondary market activities and national mortgage banking and mortgage servicing operations. While these changes have prompted a surge in lending in lower-income and minority neighborhoods, this growth is linked to the emergence of a dual mortgage delivery system characterized by a noticeable absence of conventional prime mortgages in these same areas. Instead low-income and minority borrowers and communities are today disproportionately served by government-backed, subprime, or manufactured home lending, and exposed to new threats linked to rising rates of mortgage delinquency and default and a noticeable uptick in abusive lending practices.

Even as the dual market has expanded access to capital to families that historically have been shut out of the mortgage market, it has also prompted some CBOs to rethink their role in the marketplace. Following a discussion of the changing structure of the mortgage industry, this paper examines how a small number of CBOs have responded to change by restructuring existing operations and by initiating new programs and activities. In particular, some CBOs have altered their advocacy efforts to expand access to mortgage capital by lower-income people and communities. Others have restructured their community lending programs by partnering with private sector mortgage companies to establish new automated mortgage lending or loan servicing operations, or by creating their own state of the art mortgage lending and servicing systems. Still other approaches just now in their early stage of development – including efforts to combat abusive lending practices, increase the effectiveness of homeownership counseling or expand foreclosure avoidance initiatives – also hold much promise.

Unfortunately, most community groups have not fully digested the enormity of the changes that have occurred in the mortgage banking industry and have failed to make the needed

[1] In this paper Community Based Organizations (CBOs) are broadly defined as non-profit providers of housing services, homebuyer counseling, and mortgage finance, as well as non-profit housing advocacy organizations. As used here, CBOs range from relatively small Neighborhood Housing Services organizations operating in a single neighborhood, to larger Community Development Financial Institutions (CDFIs) that may operate on a regional or even national basis.

adjustments. For example, even as private sector lenders are increasingly selling off servicing rights to a handful of mortgage servicing giants, only a relatively few CBOs now outsource their loan servicing operations. This not only prevents small scale CBOs from gaining access to state of the art servicing technology, but also diverts resources and management capacity from away from those activities where the CBO's presence in the community give them a strong comparative advantage over their private sector counterparts. Recognizing the fact that many CBOs continue to do business as they have for decades, the final sections of this paper also examine factors that limit the willingness and ability of CBOs to adapt to the changing market environment.

The paper builds on previous research conducted at the Joint Center for Housing Studies and utilizes the Joint Center Enhanced Home Mortgage Disclosure Act (HMDA) Data Base. This data base combines HMDA data on borrower and loan characteristics with Federal Reserve Board (FRB) data on lender characteristics, as well as 1990 and 2000 Census tract information on the characteristics of the neighborhood where loans were made. In addition to quantitative analysis, this paper draws on qualitative information gathered from 150 community leaders and mortgage industry experts during in-depth telephone and in-person interviews and discussion groups held in Atlanta, Baltimore, Birmingham, Chicago, Los Angeles, New York, and San Francisco.

The Changing Structure of the Mortgage Banking Industry

The mortgage industry today bears little relationship to the mortgage industry of even a decade ago. Key changes include the use of new tools, such as automated underwriting, credit scoring and risk based pricing, as well as the rise of new mortgage brokers and mortgage banking organizations, the unwinding of regulations governing the geographic expansion of branch activity, the growth of secondary mortgage markets, and the associated decline in the share of mortgages funded by bank deposits. In combination, these changes fostered dramatic increases in lending to low-income people and communities, but also gave rise to what appears to be a dual mortgage market in mortgage finance in which low-income and often minority borrowers are served by different lending organizations using a different mix of loan products

than is found in the mainstream market.[2] This section summarizes these trends and assesses their implications for the evolution of mortgage markets.

Consolidation Reshapes the Banking and Mortgage Banking Industries

Consolidation continues to be one of the most striking aspects of industry change. Today, a handful of financial services giants dominate home mortgage lending. Indeed, the largest 25 lending organizations accounted for 78 percent of the $2.5 trillion in home purchase and refinance mortgage loans originated in 2002. As indicated in Exhibit 1, as recently as 1990 the top twenty-five originators accounted for only $130 billion (or 28.4 percent) of an industry total of less than $500 billion home mortgages.

As is true with the broader mortgage industry, consolidation has been an important feature of the rapidly expanding subprime lending industry. Though variation in the definition of what constitutes a "subprime mortgage" hinders precise measurements, according to one widely utilized mortgage industry source subprime loan originations increased from $35 billion in 1994 to $213 billion in 2002. In 2002 the 25 largest subprime lenders along with their affiliated brokers and correspondents, accounted for over 88 percent of total subprime volume. In that same year, the top five subprime originators accounted for nearly 40 percent of the market. In 1996, the share for the top 25 subprime originators was only 47 percent and for the top 5 only 20 percent.[3]

Structural shifts in the industry were largely driven by the declining importance of bank deposits as a source of funds for mortgage lending. Historically, deposit-taking institutions (thrifts and commercial banks) originated the bulk of all home mortgages. In 1980 nearly half of all home mortgages were originated by thousands of thrift institutions, while another 22 percent were originated by commercial banks.[4] Over the past two decades this system has changed. The ability to package and sell loans to the secondary market reduced the need to hold deposits (or other sources of cash) to fund mortgage loans. The government sponsored enterprises, Fannie Mae and Freddie Mac, along with private market conduits, mandated standardization of loan contracts and thus played an important role in fostering an increasingly efficient mortgage

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[2] For a more complete discussion of the factors influencing the growth of mortgage lending in the 1990s see Joint Center for Housing Studies, Harvard University, The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System, a report prepared for the Ford Foundation, March 2002.
[3] Inside Mortgage Finance, 2003 Mortgage Market Statistical Annual
[4] U.S. Department of Housing and Urban Development, Survey of Mortgage Lending Activities, 1997

delivery system.[5] New technology and marketing approaches enabled lenders to reach customers via mass media and to interact with them via phone, fax, and now the internet. Enhanced telecommunications also allowed lenders to consolidate "back office" functions needed to originate, underwrite, and service loans. Together these shifts not only expanded the source of funding for home mortgages, they made mortgage lenders less dependant on the physical location of their branches to reach customers

Regulatory changes also supported this consolidation as the 1980s saw most state-level restrictions on intrastate banking removed or relaxed.[6] At the federal level, interstate banking became a reality in the 1990s. Banks could now expand beyond boundaries that had been in place since the Depression, and larger organizations increased the scale and scope of their operations through mergers and acquisitions. Many large banking operations took advantage of the changing regulatory environment and consolidated retail banking operations within and across individual metropolitan market areas. Growth of both regional and national banking operations reflected a desire of larger banks to capitalize on potential scale economies and name recognition, as well as reduce risk by diversifying across numerous spatially distinct market segments.[7]

Lacking the economies to scale to compete in this increasingly automated business, many smaller banks and thrifts abandoned their mortgage origination activities entirely. At the same time, several large independent mortgage and finance companies continued to compete head to head with banking organizations in mortgage markets across the country. The largest -- Countrywide Financial -- made more than $250 billion in home purchase loans in 2002. But many other independent mortgage banking operations have either failed to grow over the past decade, or merged with or were acquired by a large banking operation. This latter category includes North American Mortgage that was acquired by Dime Savings Bank, and Norwest Mortgage that merged with Wells Fargo.

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[5] Leon Kendall and Michael J. Fishman, A Primer on Securitization, (Cambridge, Massachusetts, 1996). See especially the chapter by Lewis S. Renieri, "The Origins of Securitization, Sources of Its Growth, and Its Future Potential," pp 17-30.

[6] For a more complete discussion of trends in federal regulation of the banking and mortgage banking industries see Joint Center for Housing Studies, The 25th Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System, March, 2002, particularly Section 2.

[7] Robert W. Avery, Raphael W. Bostic, Paul S. Calem, and Glen B. Canner, "Changes in the Distribution of Banking Offices," Federal Reserve Bulletin, Volume 85, 1999, pp. 81-102.

New Origination System Facilitates Industry Growth

Growth in mortgage lending was aided by the creation of a highly automated origination system. Today, loans are originated through one of three channels: retail, correspondent, and broker. Retail activity is most akin to traditional lending where employees of a banking or mortgage banking organization reach out to potential customers, take a mortgage application, underwrite and fund loans for those who meet the underwriting standards. Many retail mortgage lending operations conduct business from branch operations, though increasingly the marketing and even closing of loans is being done via fax or internet. Once funded, these loans may be held in portfolio, sold to another lender or packaged and sold to the secondary market.

Correspondents are typically smaller mortgage brokers, thrifts or community banks. Similar to the retail channel, correspondents reach out to borrowers, take mortgage applications, underwrite and fund mortgages. While loans are funded in the name of the correspondent, they are then sold to a larger wholesale lender under prearranged pricing and loan delivery terms, and in compliance with established underwriting standards. In contrast to correspondent lenders, mortgage brokers do not fund loans with their own money and only serve to identify potential customers, process the paper work, and submit the loan application to a wholesale lender, who underwrites and funds the mortgage.

Two decades ago, retail lending dominated the business. Since then wholesale activity (the combination of correspondent and broker channels) has grown rapidly, as has the number of firms engaged in these activities. For example, one industry source estimates that in 2002 there were 44,000 firms (with 240,000 employees) engaged in mortgage brokerage and correspondent lending activities, almost double the number of firms operating in 1995 and up markedly from the estimated 7,000 firms operating in 1987.[8] In 2002, retail lending accounted for 40.2 percent of origination volume, while brokers (30.8 percent) and correspondent lenders (29 percent) accounted for the rest.[9]

Subprime mortgages are also originated by each of three channels: retail, broker, and correspondent. Of these, the broker channel plays a dominant role in subprime lending. In 2002, some 44.7 percent of all 2002 subprime originations flowed through a mortgage broker channel,

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[8] Wholesale Access Mortgage Research and Consulting, "Mortgage Brokers 2002," August 13 2003.

[9] Estimates from Inside Mortgage Finance, the 2003 Mortgage Market Statistical Annual. These figures closely approximates data presented in 2002 Mortgage Industry Directory, a publication of the National Mortgage News. They estimate that in the first quarter of 2002, the retail channel accounted for only 39.7 percent of all lending, with the broker and correspondent share totaling 29.9 and 30.4 percent respectively.

compared with only 29.5 percent for prime mortgages. The growth of subprime lending was also supported by secondary market activities. Prior to the 1990s, subprime mortgages were chiefly provided by large finance companies that funded them with secured and unsecured debt. As recently as 1994, subprime lending totaled only $35 billion and less than one third of this volume ($11 billion) was securitized. As subprime lending expanded in the 1990s, so too did the securitization of subprime loans. By 2002 , the securitization of subprime loans totaled $133 billion or 62.2 percent of total subprime originations of $213 billion.[10] The growing issuance of subprime mortgage-backed securities was accomplished primarily by a handful of large mortgage banking operations and Wall Street firms. Recently, Fannie Mae and Freddie Mac have entered into the subprime arena, as they extend the reach of their secondary market purchases to include a growing share of 'Alt A' and 'A-' loans.

The Emergence of a Dual Market in Mortgage Lending

The changing mortgage industry structure – and particularly enhanced risk evaluation tools -- enabled lenders to offer mortgages with lower downpayment requirements to creditworthy but low-income or low-wealth borrowers, or to make higher priced loans to borrowers with less than perfect credit. The result was a surge in home mortgage lending to low-income borrowers and communities.[11] HMDA data indicate that home purchase loans to low-income borrowers and/or low-income communities increased by 80.4 percent over the period 1993 to 2001. The growth in this market far exceeded the 48 percent overall growth in home purchase lending.

The surge in lending to lower-income borrowers was matched by equally strong gains in lending to minorities, although growth in the number of HMDA loan records without borrower race identified makes precise tracking of these trends difficult.[12] From 1993 to 2001, HMDA data indicate that the number of home purchase loans made to African-American borrowers increased by 93 percent, to Hispanic borrowers by 159 percent, and to Asian and other minority

[10] Inside Mortgage Finance, The 2003 Mortgage Market Annual

[11] Throughout this report low-income borrowers are defined as having incomes less than 80 percent of metropolitan area median, and low-income communities are census tracts with 1990 median family income that was less than 80 percent of their metropolitan area median.

[12] Over the period 1993 to 2001, the number of home purchase loans with race missing increased by nearly 400,000 to 458,000. For home refinance loans, the increase was from 189 thousand to 1.06 million. In 2001, no information on borrower race was present in the HMDA files for some 12.1 percent of all home purchase loans, and 18.6 percent of all home refinance loans.

borrowers by 93 percent. In contrast, home purchase lending to white borrowers increased 29 percent over the same period.

Unfortunately, the growth of lower-income and minority lending is intricately linked to the emergence of a dual mortgage delivery system. In particular, there is a noticeable shortage of prime loans in lower-income and minority markets. Typically products targeted to lower-income and/or credit impaired borrowers have higher interest rates and less favorable terms than the conventional prime loans that serve the larger mainstream market. This has led many housing advocates to question whether households in these areas are gaining access to financing on the best terms for which they qualify. In addition, many of the newer and rapidly growing organizations that provide alternative mortgage products fall outside of the existing federal regulatory framework that remains largely focused on deposit-taking banking organizations. Lack of federal regulation may help explain the rise in "predatory lending" in recent years and the associated increase in defaults and foreclosures in low-income neighborhoods across the country.

Using HMDA data it is possible to assess trends in conventional prime lending, as well as subprime, government-backed, and manufactured lending by borrower type.[13] Each of these three types of lending are 'alternatives' to conventional prime lending in that they typically entail different pricing and terms than conventional prime mortgages, which remain the standard. Over the 1993 to 2001 period, subprime, government-backed, and manufactured home lending accounted for nearly one third of the 1.4 million increase in the number of home purchase loans. These alternative financing types figured prominently in the growth of lending to lower-income borrowers in lower-income markets. Here, conventional prime loans accounted for only about 40 percent of all growth in home purchase lending (Exhibit 2). These numbers contrast significantly with higher-income areas, where conventional prime lending accounted for almost 80 percent of all 1993-2001 home purchase lending growth.

[13] While HMDA does not label the loan type directly, The U.S. Department of Housing and Urban Development (HUD) supplies a list of each lender's 'specialization' in prime, subprime, or manufactured home lending. Government-backed loans are reported in HMDA, and are defined here as loans made by prime lending specialists that are insured or guaranteed by the Federal Housing Administration (FHA), the USDA's Rural Housing Service, or the Veterans Administration. For a brief description of the HUD methodology see Randall M. Scheessele, "1998 HMDA Highlights," Housing Finance Working Paper, No., 9, Office of Policy Development and Research, HUD, 2002.

While there were significant increases in government-backed and manufactured lending over the 1993 to 2001 period, there was a dramatic eight fold increase in the number of home purchase loans reported by subprime lending specialists. By 2001, subprime lending specialists accounted for over 6 percent of all home purchase lending, up from just 1 percent in 1993. For lower-income households living in lower-income communities, the subprime share topped 10 percent of home purchase lending in 2001.

Subprime lending was also a growing share of the more volatile home refinance market. By 2001, the share of refinance lending captured by firms specializing in subprime loans was fully 10.4 percent, up from only 2 percent in 1993. For households living in lower-income communities, subprime represented a striking 27.5 percent of home purchase loans in 2001, a more than four fold increase in market share since 1993. In predominately African-American, lower-income areas, the sub-prime share of home refinancing stood at 45.2 percent in 2001.[14]

The tendency for subprime lenders to focus on lower-income and/or minority markets is well documented elsewhere. For example, Bunce and Fishbein concluded that a lack of competition from prime lenders enabled subprime lenders to gain a growing share of mortgage lending activity in lower-income and minority communities.[15] A similar conclusion was reached by Bradford who examined subprime lending patterns in 331 metropolitan areas.[16] Combining HMDA data with data from the 2000 Census, Bradford found that African-Americans and Hispanics are disproportionately represented in the subprime refinance market, and that these disparities appear to grow as income increases. Moreover, he pointed out that racial disparities in lending exist in all regions and in cities of all sizes. Indeed, the study suggests that some of the biggest disparities exist in the nation's smallest metropolitan areas.

Mortgage Industry Structure Perpetuates Dual Market

The mortgage industry is highly competitive, as literally thousands of mortgage banking and mortgage brokerage operations offer products to millions of potential borrowers. Indeed, in many ways, mortgage markets are more competitive today than two decades ago. Despite the

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[14] Here, a census tract where African-Americans constitute more than 50 percent of the population are classified as being "predominately African-American," while as before "lower-income areas" are census tracts where median household income is less than 80 percent of the metropolitan area median.

[15] Allen Fishbein and Harold Bunce, "Subprime Market Growth and Predatory Lending," in Housing Policy in the New Millennium .

[16] Calvin Bradford, Risk or Race? Racial Disparities and the Subprime Refinance Market, A Report Prepared for Center for Community Change, May, 2002

fact that many smaller thrifts and savings institutions have ceased their mortgage lending operations, they have been replaced by over 25 well-capitalized financial services giants that gain access to low-cost mortgage funds through an increasingly sophisticated secondary mortgage market. Aided by the outreach efforts of thousands of mortgage brokers and correspondent lenders, these mortgage banking giants have extended their reach to every corner of the market, including lower-income and minority communities.

Despite the potential for substantial competition on the "supply-side" of the marketplace, a dual market persists. In this dual market, some individuals pay more for their mortgage credit and/or receive less favorable treatment (or more abusive treatment) than other similarly situated and equally creditworthy borrowers. As a result, well-informed borrowers benefit significantly from the range of product choices, the speed and efficiency of the current mortgage delivery system. At the same time, less informed borrowers -- especially those that have lower credit quality and/or are attempting to purchase homes in riskier neighborhoods -- remain vulnerable to overpaying for mortgages, or not receiving the best terms for which they would qualify.

Misaligned Incentives Inefficiently Allocate Mortgage Credit

An efficient market will allocate mortgage capital according to the ability and willingness of potential borrowers to pay for mortgage credit. Though efficient in many ways, today's dual mortgage market fails to achieve what economists term "allocational efficiency," in that similarly situated borrowers pay different prices to obtain a mortgage of given characteristics and terms.

Central to the emergence and the persistence of this allocational inefficiency is a market failure linked to "principal-agent risk" that arises from the growing importance of mortgage brokers and correspondent lenders in the market. Brokers and loan correspondents, also called third party originators, have different incentives in the market than participants in retail lending operations. As noted, brokers neither represent the borrower nor the investor in the mortgage transaction. Subject to whatever regulatory constraints are effectively operating in the market, a broker's incentive is to charge the highest combination of fees and mortgage interest rates the market will bear.

A mortgage delivery system where brokers are compensated for making loans, but have no long term interest in loan performance is subject to "principal agent risk." In broker

originated loans, there is a lack of alignment of interest between the lender/investor (or the principal) and the mortgage broker (or the agent). In such a situation, the broker has little incentive to worry about whether the information presented in the mortgage application is accurate, so long as the information gathered is sufficient to cause the mortgage banker to fund the loan, and trigger the payment of the broker's fees. Lacking a long-term interest in the performance of the loan, the broker is immune from many of the adverse consequences of failing to match the borrower with the best available mortgage or providing accurate data needed for loan underwriting to assess the probability that the loan will default or otherwise prepay faster than anticipated.

At the same time, the broker has substantial incentive to provide less than accurate information, even though it is often not in the best interest of the borrower, and may not even be in the best interest of the investors. This could result in the broker devoting inadequate attention to check the accuracy of information presented on the borrower's loan application, or even attempting to falsify income or other measures of credit worthiness or the value of the property being mortgaged. Armed with inaccurate information, the lender (and the ultimate investor) may not have a full understanding of the default risk associated with a particular loan. Even situations where the broker inappropriately places a prime quality borrower into a subprime loan may eventually add to investor risk, especially because borrowers saddled with an "excessive" mortgage payment may be more likely to prepay than otherwise similarly situated borrowers with lower monthly payments.

Many Borrowers Have Limited Capacity to Shop for Mortgages

In a market where people have the ability of comparison shop, brokers risk losing business if they push costs too high. Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower has difficulty evaluating the details of the mortgage. At best, this implies that potential borrowers lack the information needed to shop for the best mortgage product available in the market. At worst, it implies that some brokers may actively seek to identify "naïve" individuals who lack the experience to correctly evaluate the terms being offered.

Available data suggest that all too many borrowers, especially elderly borrowers, and borrowers in lower-income and/or minority areas, succumb to the sales pitch of aggressive

brokers, in effect becoming unwitting accomplices in the dual mortgage market.[17] For example, a recent AARP survey of 1008 individuals aged 65 and older who refinanced their home between January 1999 and December 2000, showed that nearly half (49 percent) obtained a retail lender originated loan, 39 percent a broker originated loan, while some 12 percent reported receiving their loan from a home improvement contractor or some other source. Compared with lender-originated refinance loans, broker-originated refinance loans were nearly twice as likely to be subprime (33 vs. 17 percent). The survey also demonstrated that a higher share of broker-originated loans went to African-American borrowers and borrowers who were divorced or female.

What is perhaps most striking is the way homeowners in the sample searched (or in many instances did not search) for the best loan available. The AARP survey supports the notion that in many instances refinance loans are "sold, not sought" in that they result from extensive and often unsolicited outreach by brokers. Consistent with this view, some 56 percent of borrowers with broker-originated loans reported that brokers initiated contact with them, compared with only 24 percent of borrowers with lender originated loans. Since they did not initiate the search activity, it is not surprising that a larger share of borrowers with broker-originated loans (70 vs. 52 percent) "counted on lenders or brokers to find the best mortgage." In addition, borrowers obtaining broker originated loans were more likely to pay points (25 vs. 15 percent) and more likely to have a loan with a prepayment penalty (26 vs. 12 percent) A greater share of borrowers with broker originated loans also believed that they did not get a loan that was "best for them" (21 vs. 9 percent), received a loan with mortgage rates and terms that were not "fair" (23 vs. 8 percent) and did not receive "accurate and honest information" (19 vs. 7 percent).

A recent paper by Courchane, Surette and Zorn echoed the AARP findings.[18] Using a survey of prime and subprime borrowers, this study examined whether borrowers are "inappropriately" channeled into the subprime segment. The paper confirmed that determining whether borrowers obtain subprime or prime mortgages depends in large measure on risk-related mortgage underwriting variables (including FICO score, Loan To Value, Front End

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[17] Kellie K. Kim-Sung and Sharon Hermanson, "Experience of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans," AARP Public Policy Institute, Data Digest, AARP

[18] Marsha J. Courchane, Brian J. Surette, and Peter M. Zorn, "Subprime Borrowers: Mortgage Transitions and Outcomes," in Journal of Real Estate Finance and Economics, forthcoming

Ratio), and other factors including mortgage type, market channel, shopping behaviors, opportunity to make choice, age and ethnicity.

Armed with data gathered from a survey of mortgage borrowers, the study explored mortgage lending patterns using FICO scores and other traditional measures of risk as well as what the authors describe as "borrower self-assessed credit risk factors."[19] The survey data suggested also that subprime borrowers are less knowledgeable about the mortgage process, are less likely to search for the best mortgage rates, and are less likely to be offered a choice among alternative mortgage terms and instruments.

Detailed Studies Confirm Existence of Mortgage Pricing Disparities

In addition to available survey data, there is a growing body of econometric evidence that mortgage brokers do in fact target uninformed borrowers, and that their focus on the subprime marketplace is reinforced by a mortgage delivery system that provides incentives to participants to take advantage of the situation. For example, in the paper mentioned earlier, Courchane, Surette and Zorn, combined survey data on how mortgages are marketed and offered to borrowers, with loan specific data on borrower demographic, economic and credit risk characteristics. They found that the addition of measures of market knowledge, search behavior, and choices available contributed significantly to the explanatory power of the model. The authors concluded that the superior performance of the "full" model in explaining whether a borrower obtains a prime or subprime loan implies that credit risk alone may not fully explain why borrowers end up in the subprime market. Rather, their paper supports the alternative view that the current mortgage delivery system generates an allocational inefficiency in which households of similar economic, demographic, and credit risk characteristics do not pay the same price for mortgage credit.

These findings are reinforced by a series of econometric studies that demonstrate how "principal agent risk" associated with third party originations can result in borrowers with similar characteristics obtaining different pricing depending on the process or channel through which

[19] For example the survey gathers data on whether the borrower believes that they "have good credit," "pay bills on time," and are "in control of their finances," as well as information on search behavior and adverse life events such as loss of job.

they receive their loan.[20] Building on an earlier study by LaCour-Little and Chun, a recent study by Alexander et. al demonstrated that broker originated loans are not only likely to prepay faster, but also more likely to default than loans originated through a retail channel, even after controlling for credit and ability-to-pay factors.[21] Alexander et. al further demonstrated that prior to 1997, the differing default characteristics of broker originated loans were not recognized in the market place, and that these differing risk characteristics were not priced. They argued that as a result of growing capital market awareness of the "principal agent risk" associated with brokered loans, borrowers receiving their funding via the broker channel are now charged a premium over apparently similar borrowers who receive their loans through retail channels. This is to compensate lenders for the higher default and prepayment risk associated with these loans.

This discussion is a reminder that investors care primarily about being compensated for the risks they bear. The fact that a pool of mortgages includes individual mortgages with "excessive" fees or rates, or contains some inaccurate information is not important so long as the investor is able to assess prepayment rate and/or foreclosure rate associated with these transactions. Recognizing that misrepresentation and mispricing still exists, rather than working to weed out "bad loans," some lenders/investors simply protect their interests by buying loans from less reliable brokers at a discount.

Of course, lenders/investors do care deeply about receiving misleading information from brokers, particularly about the appraised value of the mortgage property or the capacity of the borrower to repay the loan. As result, there is aggressive and now technologically sophisticated monitoring on the part of lenders/investors, as well as Wall Street rating agencies designed to root out fraud.[22] However, these systems are costly to acquire and not universally implemented.

A careful review of financial disclosure documents prepared for investors by issuers of subprime mortgage-backed securities further confirms that investors focus less on whether

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[20] For example, Passmore and Sparks (1996) show how asymmetric information and adverse selection can negate the benefits of government sponsored mortgage securitization programs; Shiller and Weiss (2000) examine moral hazard in home-equity conversions; Brickman and Hendershott (2000) investigate adverse selection in the refinancing of FHA loans; Brueckner (2000) studies the impact of asymmetric information on mortgage default, and LeCour-Little and Chun (1999) assess prepayment risk of mortgages originated by third parties.

[21] William P. Alexander, Scott D. Grimshaw, Grant R. McQueen, and Barrett A. Slade, "Some Loans Are More Equal than Others: Third-Party Originations and Defaults in the Subprime Mortgage Industry," Real Estate Economics, Volume 30, 2002, pp. 667-697.

[22] See July 2003 issue of Inside Mortgage Technology for a discussion of the growth of automated fraud detection systems.

specific loans are likely to default or prepay, and more on whether the risk-adjusted rate of return is sufficient to cover any expected losses. A recent assessment of disclosure documents associated with the issuance of subprime securities noted that the individual loans had a high potential to move to default and foreclosure – in many instances ten times as high as prime quality loans.[23] But despite the fact that such high foreclosure rates – if realized – would have potentially devastating consequences for individual borrowers and communities, the documents simply note that the pools were priced to compensate investors for bearing these risks.

Since returns depend on details concerning the underlying mortgage assets and the performance of the mortgage pool, mortgage investors are faced with the problem of deciding how to manage the risk. In an extreme example, an investor could present relatively strict rules governing the process of loan originations, and through a system of "representations and warranties" hold the mortgage banker accountable for any deviation from these terms. Mortgage bankers in turn would have incentives to hold their brokers accountable to these standards, and in effect push this risk back downstream. Since there are reputational risk considerations associated with loans that go into foreclosure, such actions should pressure brokers to more closely align their practices to general industry standards. Undoubtedly some of this is happening, but Alexander et. al demonstrate that currently in the subprime market, the tendency of brokers to charge excessive fees or present misleading information is not "corrected," but rather priced in the market. As a result, some buyers pay more, the broker earns a premium return, and investors are compensated.

Changes in Banking Industry Challenges the Activities of Community-Based Organizations

The mortgage market in the United States has evolved into one of the most efficient capital markets in the world. Even so, the emergence of a dual mortgage market structure has limited the ability of unsophisticated borrowers, including many lower-income and/or minority borrowers, to gain access to the best mortgages for which they qualify, and is associated with rising defaults and foreclosures in the subprime marketplace. These trends not only threaten to undermine the work of CBOs in revitalizing distressed neighborhoods, but also call into question the effectiveness of many CBO activities, including direct lending and homebuyer education operations.

[23] See Cathy Lesser Mansfield "Consumer Choice and Risk in Society."

The Historical Role of Community-Based Organizations

CBOs have long been central to efforts to expand access to mortgage capital to low-income people and communities. Seeking to rally public support against redlining - the systematic denial of mortgage credit to neighborhoods and groups in less prosperous sections of the US metropolitan areas - grass roots organizations began in the 1960s and 1970s to mobilize residents of economically distressed neighborhoods. Banks were one logical target of this activism. Indeed, much of the effort that led to the passage of the Community Reinvestment Act (CRA) in 1977 was built on the simple proposition that federally insured and regulated commercial banks and thrift institutions had an affirmative obligation to lend in areas where they maintained deposit taking operations or were otherwise chartered to serve.

What emerged from the combination of community-based activism and legislative efforts was a period in the 1980s and early 1990s described by one community group leader in Chicago as the "Golden Age of Community Activism" – a period when community-based organizations put significant pressure on banks to expand the reach of their lending and banking activities. Dubbed "regulation from below," community groups armed with Home Mortgage Disclosure Act (HMDA) data and backed by the legislative mandate of CRA pressured federally regulated banking organizations to increase the number of loans made to minority and/or low-income borrowers.[24]

The relationship that evolved between community groups and banks involved both 'collaboration' and 'confrontation.'[25] Negotiations between community groups and local banks focused on mortgage or small business lending, provision of banking services in particular low-income areas, and the weak record of particular institutions in servicing minority communities. Forced to take a closer look, some banks found these markets held some potential borrowers that could be served through existing loan products.

Of course, many CRA-eligible customers presented additional lending risks that banks were reluctant to tackle. In these instances, one common approach was for CBOs to work to "restore the market" by developing an array of lending programs that relied on both public and foundation monies, as well as grants and below market rate capital from the banking industry to

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[24] Allen Fishbein, "The Ongoing Experiment with Regulations from Below: Expanded Reporting Requirements for HMDA and CRA," Housing Policy Debate, Volume 3, Number 2, 1992, pp. 601-636.

[25] Alexander Schwartz, "From Confrontation to Collaboration: Banks, Community Groups, and the Implementation of Community Reinvestment Act Agreements," Housing Policy Debate, Volume 9 Number 3, 1999, pp. 631-662.

write down mortgage interest rates, help borrowers to make the required downpayment, or otherwise expand access to mortgage capital to borrowers unable to qualify for a market rate loan.

These local lending initiatives got a shot in the arm when in the mid-1970s, the U.S. Congress chartered two national non-profit organizations: the Neighborhood Reinvestment Corporation (NRC) and Neighborhood Housing Services of America (NHSA). NRC provides financial support, technical assistance, and training for community based revitalization efforts to what has emerged as a national network of local Neighborhood Housing Services organizations (NHSs), while NHSA pioneered in the creation of a secondary market outlet for local mortgage lending efforts aimed at traditionally underserved markets.[26] In addition, private, non profit organizations such as the Center for Community Change, the Enterprise Foundation, the National Community Reinvestment Coalition, the National Low Income Housing Coalition, the Housing Assistance Council , along with intermediaries such as the Local Initiatives Support Coalition have also provided crucial support to CBOs in their advocacy and organizing and economic and housing development efforts.

A recent case study of the Neighborhood Housing Services of Chicago (NHSC), documents the forces that prompted the early growth of what has emerged today as one of the largest community-based direct lending operation.[27] NHSC began its revolving loan fund in 1984 by making small home improvement loans targeted to borrowers unable to secure a bank loan. At first, the effort was supported by foundation grants and funds from the Illinois Housing and Development Agency, but later utilized federal Community Development Block Grant funds. In 1995, a pledge of $41 million in below market rate loan capital from Continental Bank (later a part of Bank of America) pushed the program into high gear, and enabled NHSC to expand its loan operations to include both home purchase loans, as well as second mortgages to help meet closing costs, downpayment requirements, or fund needed home rehabilitation.[28]

These programs not only helped expand access to capital in underserved communities, they also became a significant revenue source for the sponsoring CBOs. For example, in making what they called a Chicago Family Fund loan, in the mid 1990s the NHSC typically received a

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[26] For more complete description of these organizations see Neighborhood Reinvestment website at www.nr.org

[27] Howard Husock, "Seeking Sustainability: Neighborhood Housing Services of Chicago Faces Financial Challenge," Kennedy School of Government, Harvard University Case C16-02-1658.0, August, 2002.

[28] For further description of the effort see the Neighborhood Reinvestment web site at www.nr.org

three percentage point origination fee paid by the borrower, a fee of $200 per loan charged to participating banks, and a loan servicing fee of 50 basis points per year per loan. Reflecting the views of many CBOs engaged in the direct lending activities, NHSC director Bruce Gottschall observed that you have to "figure out how you actually get paid for what you're doing," and use these funds to help subsidize other organizational activities. [29]

Predictably, many lenders described the partnership between the NHSC and Continental Bank as "CRA-led extortion." Even so, when faced with activism that could delay planned mergers and or damage their reputation in the market, many bankers reluctantly entered into negotiations with community groups and began to aggressively expand their outreach to low-income and/or minority neighborhoods. According to the National Community Reinvestment Coalition, since 1977 banks and CBOs have entered into some 400 commitments to provide over $1 trillion in loans, investments and services to minority and low-income households. While most early commitments were limited in scope, with the emergence of inter-state banking the number and scale of CRA commitments increased dramatically. Indeed, one analyst estimated that there has been almost $1 trillion dollars committed by banks for CRA activities since 1992, a figure that includes several multi-billion dollar commitments made by national scale lenders.[30]

In addition the creation of local lending programs, another common approach was for community groups and banks to join forces to promote homebuyer education. Homeownership counseling, along with related efforts to promote financial literacy, are particularly important for low-income and minority homeseekers, two groups that in the past lenders have had difficulty serving. Over time the efforts of counseling and financial literacy networks operated by the Neighborhood Reinvestment Corporation, the National Community Reinvestment Coalition, ACORN, and others have enabled thousands of potential buyers to realize their dreams of homeownership. Homebuyer education and counseling programs have also emerged as an important revenue source for CBOs. What started out as opportunities for lenders and community groups to work together, has grown to a nationwide network of community-based homebuying counseling and education groups, and has become good business for both banks and community groups.

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[29] Husock, pages 5 and 6.
[30] NCRC, 2000.

The Changing Nature of CBO Negotiating Power

Though CRA, HMDA, and related fair lending legislation continue to play a significant role in expanding access to credit to underserved communities, it does appear that the ability of CBO's to this nearly 25 year old regulatory framework to extract concessions from the banking industry is on the wane. Several bankers conceded that as they have grown in scale and their lending operations became more sophisticated, there was less need to work with community groups. Community groups used to help banks identify 'good borrowers' with limited or no credit history living in distressed neighborhoods. Now, advocates and lenders alike acknowledge that with today's automated systems, banks now possess so much data about potential borrowers that their need for assistance in marketing and outreach is steadily eroding.

Furthermore, over the years, the legislative and regulatory framework has failed to keep pace with the marketplace, especially with respect to the lower-income and minority segments. Even as Congress, through the Gramm-Leach-Bliley Act of 1999, focused on financial services modernization, little was done to bring CRA into conformance with the rapidly evolving world of mortgage banking and financial services.[31] For example, the decoupling of mortgage lending from branch-based deposit-taking has severely diluted the impact of CRA's mandated intensive review of lending in 'assessment areas' (defined as areas where banks maintain deposit-taking branches). Instead, an increasingly large share of all loans are not subject to intense CRA scrutiny as mortgage banking organizations not covered by CRA regulations together with banking organizations operating outside of their CRA assessment areas now represent the fastest growing segment of the residential mortgage market. For example, by 2001 only 28.4 percent of all home purchase loans were made by CRA-regulated institutions lending in their assessment areas, down from the 36.0 percent share recorded in 1993 and the more than 80 percent share recorded in the early 1980s.

This changing regulatory and market environment has had a noticeable impact on the ability of CBOs to extract concessions from lenders in support of their mission. One manifestation of this phenomenon is the decline of locally-specific lending agreements negotiated between banking institutions and CBOs. Once the "bread and butter" of community

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[31] For further discussion see William C. Apgar and Mark Duda, "The 25th Anniversary of CRA" New York Federal Reserve Bank, 2002.

organizing efforts, these “bilateral agreements” are increasingly being replaced by highly visible unilateral commitments made by larger regional and national scale lenders.

For many community leaders, the growing number of unilateral commitments represents what they fear is a shift in the balance of power toward large lending institutions.

This is not to say that banks are ignoring community groups or that community groups have stopped advocating for expanded lending. However, Chicago area advocates acknowledged that even banks with a long history of partnering with local community groups are pulling back. “Chicago is a special case, and banks have more reason to deal with us, given the high visibility role that Chicago area advocates play in the national arena. But even the same banks that are renewing CRA commitments here in Chicago are refusing to sign comparable agreements in other cities.”

The decline of “bilateral agreements” also has implications for the ability of community groups to secure funding and technical assistance from the new breed of larger, more sophisticated mortgage banking organizations. Historically, locally-based institutions were a major source of both funding and guidance for community-based organizations. Little wonder that CBOs lamented the decline of locally-based lending organizations. These shifts not only substantially reduced the leverage local CBOs used to gain concessions from lending organizations, they also disrupted personal relationships between lenders and advocates, and threatened core organizational funding.

For example, the executive director of one Baltimore based CBO watched financial support for his organization dwindle as a direct result of industry consolidation due to the acquisition of a local bank by a national mortgage banking operations. For twenty years before this consolidation, the locally-based bank was not only a major financial supporter of this community organization, but also “walked the neighborhood with us and helped us craft some innovative programs.” While funding from the new national organization continued (at reduced levels), this executive director perceived that his area also suffered from losing the close personal relationships, and the various forms of technical assistance, support and guidance exchanged between the locally-based lending organization and the group.

Many CBOs believe that they have no choice but to continue to work with the locally-based CRA-regulated entities that remain. When asked to provide an example of a mortgage lending organization with an outstanding record of meeting local neighborhood credit needs one

Boston area advocate provided the name of a small local bank that made less than 50 loans each year. This institution does have a solid record, but they are a relatively minor player in the market. When pressed to discuss the lending record of others active in the market, this advocate admitted that he had limited interaction with or even knowledge of some of the largest mortgage lenders operating in their area. Similar comments were made by other advocates in other cities. Faced with industry changes, many CBOs continue to focus their advocacy and outreach on a dwindling number of locally based banks and thrifts and demonstrate showing surprisingly little knowledge about the new participants in the rapidly changing mortgage banking landscape.

At the same time, recent actions demonstrate that CBOs' experiences in negotiating CRA agreements, at least in certain circumstances, can be adapted and successfully applied to the changing business behavior of non-CRA regulated financial institutions. For example, in the absence of adequate consumer protection laws, CBOs and their national networks have worked to persuade individual subprime lenders to discontinue certain abusive mortgage practices, such as the sale of single-premium credit life insurance (SPCI). SPCI is low-value product that is financed completely up-front into the loan and is considered by advocates to be a particularly egregious example of predatory lending. CRA does not extend to most lenders that were offering SPCI, so CBO activism took other forms. They convinced the two secondary market entities -- Fannie Mae and Freddie Mac -- not to purchase loans containing this product, and encouraged the Federal Reserve Board of Governors to make changes to existing Home Ownership and Equity Protection Act regulations that had the effect of requiring lenders offering this product to abide by additional consumer protections for high-cost mortgages. The major subprime lenders eventually got the message and one-by-one agreed to stop offering the SPCI.

Impact on Community Loan Programs

As noted earlier, in their efforts to expand access to capital, many CBOs developed what appeared to be highly successful programs that originated loans to underserved neighborhoods either directly or in partnership with CRA-regulated lending institutions. Facing limited private sector competition, even the smallest and most inefficiently operated program could succeed simply by being ‘the only game in town.’

As private entities expanded their capacity, many communities once constrained by a decided lack of mortgage lending were now awash with lenders seeking to provide capital.

CBOs face new competition that challenges both the need for their presence in the market, and the efficiency of their operations. Exhibit 3 depicts the number of loans, the number of lenders, as well as the number of the largest national lending organizations (Top 25 Lenders) operating in census tracts of varying income and racial characteristics. Exhibit 3 shows that in 1993, there were 32.6 home purchase loans made on average in predominately minority, lower-income census tracts. These loans were made by an average number of 11.9 lenders operating in these tracts, including an average of 2.9 of the nation's top 25 lenders for 1993.

The data in Exhibit 3 confirm the transformation of the mortgage lending landscape in communities across the country. In addition to rapid growth in the number of home purchase loans made in lower-income communities, there was also an increase in the number of lenders vying to make loans in these same areas. While there remains a clear tendency for more lenders (including top 25 lenders) to seek out lending opportunities in higher income and largely white areas, the growth in the number of lenders serving lower-income areas has nevertheless been impressive. From 1993 to 2001, the number of loans made to predominately minority lower-income census tracts almost doubled, as did the number of total lenders and top 25 lenders active in these areas. Moreover, by 2001, top 25 lenders accounted for close to half of all loans made in predominately minority, lower-income areas – a figure that reflects the growing share of activity of these mortgage giants in neighborhoods across the country.

The arrival of well capitalized lenders, aided by the outreach efforts of literally thousands of mortgage brokers and loan correspondents posed several challenges to community- based lending operations. First, in this increasingly competitive lending environment, banks that were once active partners in locally crafted lending initiatives either abandoned their mortgage lending operations entirely, or now serve as a loan correspondent to a larger national lender.

Next, even banks with a strong commitment to CRA activities confirmed that the increasing competition among banks for CRA-eligible loans made it difficult to deal with 'special cases.' One banker said, "We continue to work with local groups to identify new potential borrowers and work on individual case files, but we lose money on this part of our business. Today, you have to be an automated, high-volume lender to make money in the residential mortgage business."

As a result, several advocates interviewed expressed concern at how automated underwriting and computer-based loan processing were making it more difficult to establish

programs tailored to meet local needs, as was done with Chicago's Family Loan Fund Program. One neighborhood advocate from Chicago observed that many banks no longer had the time or interest to sit down with community group representatives and go through specific loan files. "To be profitable, loan decisions have to be made in a matter of minutes, not days," said one. "There is just too little room to discuss how to serve those borrowers who don't conform with standard underwriting guidelines."

Together these trends challenge the effectiveness of community-based lending programs. Even highly successful organizations such as the NHSC found themselves losing borrowers to aggressive subprime lenders and their network of highly motivated brokers. Despite its lower interest rates – as much as 900 basis points lower than prominent subprime lenders such as Household Finance Corporation –NHSC still lost business to for-profit competitors. In part their inability to compete reflected their commitment to quality lending. For example, the Chicago program insisted that borrowers complete rigorous, and often time consuming, home buyer education. In contrast, most subprime lenders had no such requirements, but instead offered fast decisions that appealed to families anxious to purchase a home of their own.

But the NHS of Chicago faced other challenges linked to the diseconomies associated with their relatively small scale operations. By operating through a flexible network of brokers and correspondents, subprime lenders could use their marketing savvy and state of the art mortgage origination technology to reach a broad segment of the NHSC target markets in a cost effective manner. Although well know in the Chicago area, the NHSC was no match for the sophisticated use of direct mail, billboard, radio and television advertising. Nor could they match the speed (and low costs) at which the well capitalized subprime lenders using state of the art technology could originate loans. As a result, many potential home buyers in Chicago areas neighborhoods ended up securing more costly subprime loans, even though they might have qualified for a less expensive NHS loan. Worse still, the NHSC found that its counselors might spend weeks advising families on the intricacies of home mortgage finance, only to lose these potential customers and associated fee income to a subprime lender.

Unfortunately, the Chicago situation has been repeated around the country. ACORN reported that many members of its national lending network were now experiencing difficulty in placing their loans in the highly competitive market place. Participants in Neighborhood Reinvestment's Campaign for Homeownership also noted the increased competition. Indeed in

establishing their goals for 2003 to 2007, the Campaign noted that today, "almost anyone can get a mortgage," but often at "higher rates and more restrictive terms." As a result, to better address the new competition in the market, the Campaign's new strategy has added a renewed focus on the "pricing of credit," and more extensive monitoring of the "rates special populations actually receive.[32]"

Today's Complex Mortgages Challenge CBO Advocacy and Education Efforts

The changing industry structure also challenges the ability of community based organizations to ensure that borrowers are treated fairly in the mortgage market. A decade ago, HMDA data on the presence or absence of loans in particular neighborhoods was sufficient to mount a persuasive anti-redlining campaign. With mortgage lending growing rapidly in lower-income and minority neighborhoods, today community advocacy must focus less on whether lending is taking place at all, and more on whether the lending that is taking place is being done at the best rates and terms for which borrowers would qualify. Unfortunately, HMDA data do not reflect the changed structure of the industry nor do they capture in detail the characteristics of new mortgage products. More information on loan rates and terms is needed to clearly understand the full implications of the explosion of low-income and minority lending that has occurred over the past decade.[33]

The growing complexity of mortgage products, combined with the rise of broker originated loans also presents new challenges to home buyer education programs. The national focus on home buyer education builds on the fundamental proposition that consumer education should enhance the fairness and effectiveness of mortgage market. A recent study on counseling suggests that the impact of counseling depends, as should be expected, on the details of the counseling effort.[34] The study found that less expensive forms of counseling – including telephone and shorter one-day group counseling sessions -- had limited impact, at least when compared with more extensive (and expensive) one on one counseling efforts.

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[32] For further description of the effort see the Neighborhood Reinvestment web site at www.nr.org

[33] Beginning in January 2004, lenders will be required to report the mortgage interest rate for "higher-cost" mortgages. While this will enable researchers to better identify the presence or absence of subprime loans in the marketplace, regulators have been reluctant to require lenders to report data on credit scores or other factors required to assess whether this higher rate is appropriate given the creditworthiness of the borrower.

[34] Abdighani Hirad and Peter Zorn, "Purchase Homeownership Counseling: A Little Knowledge Is a Good Thing," in Nicolas Retsinas and Eric Belsky, Low-Income Homeownership: Examining the Unexamined Goal, 2002.

This finding raises serious questions about the effectiveness of current counseling operations. Groups interviewed for this study reported that all too often even those completing a home buyer counseling program were victimized by misleading mortgage marketing pitches of subprime lenders. The head of a Boston based counseling group noted that in the past, most of their counseled borrowers were able to obtain "good loans" through one of the area's community loan programs, but today that was often not the case. "It breaks our heart," he observed, "that people graduate from our program, only to end up in a high cost mortgage that could bankrupt them."

These comments suggest that while general mortgage counseling may help, borrowers must have access to the type of loan specific and trusted advice currently available to higher-income borrowers – advice that helps them to evaluate any current loan offer against the best terms available in the market. While in principal, the 'let the buyer beware' approach could limit abusive pricing in the market, the complexity of current mortgage instruments suggests that consumer education alone will not address the problem. Today, counseling programs must not only arm potential borrowers with basic information about mortgage loans, but also provide them with the capacity to select the best loan available from the bewildering array of products marketed by brokers that have strong incentives to place the borrower in the most expensive mortgage possible.

Enhancing the Efficiency and Effectiveness of Community-Based Efforts to Expand Access to Mortgage Capital

The concerns about predatory lending, rising foreclosures, and persistent disparity in access to conventional prime loans has led some CBOs to re-evaluate their role in expanding access to capital. Some CBOs are partnering with private sector mortgage companies to establish new automated mortgage lending or loan servicing operations, while others are developing their own state of the art mortgage lending and servicing systems. Other new approaches – including efforts to increase the effectiveness of homeownership counseling and foreclosure avoidance initiatives -- are just now in their early phase. This section examines whether there is potential for community groups and national non-profit financial intermediaries to make better use of emerging technologies to enhance the operations of their community lending, mortgage counseling, and foreclosure avoidance initiatives.

Using Automated Lending Tools to Widen the Reach of Community Loan Programs

Historically, hundreds of local groups have engaged in what at best can be described as low volume and relatively inefficient home lending operations which have failed to take full advantage of the best available technology. Despite having access to subsidized money and better pricing, many community-based lending operations find it difficult to compete with the extensive marketing tactics and fast turn around times of the more sophisticated and technologically proficient subprime players.

Even so, there are a number of remarkably successful lending initiatives that apply state of the art program design and operations to reach credit-impaired low-wealth and low-income borrowers. The Community Advantage Program of the Self-Help Credit Union is one leading example. Under the program, banks around the country deploy best available technology to originate loans to "high risk" borrowers according to flexible lending guidelines developed in partnership with Self Help. Banks in turn sell these loans to Self Help which assumes the default risk. Using grant funds provided by the Ford Foundation, Self Help retains a portion of the default risk sufficient to enable them to sell the loans into the secondary market through Fannie Mae. In turn, the participating banks are required to use the proceeds of these loan sales to fund new loans to low-wealth families, and the process starts all over again.

The results of the Community Advantage Program are impressive indeed. As of 2002, Self Help has provided $1.5 billion in financing to 22,000 low- and moderate-income buyers in 46 states and the District of Columbia. In exchange for helping participating banks meet their CRA obligations and Fannie Mae achieve its federally mandated affordable lending goals, Self Help is not only able to help thousands of families, it also gains access to an effective mortgage delivery system with nationwide reach.

Though few programs can match the scale of the Community Advantage Program, there are other programs that demonstrate equally sophisticated use of best available technology and program design. For example, Chattanooga Neighborhood Enterprises (CNE) first deployed automated underwriting technology nearly a decade ago. The efficiency gains not only enhance the quality and speed of its underwriting decisions, it also has lowered the cost of loan origination and has turned into a stable source of revenue for the organization.

Despite the success of these ventures, many CBOs resist use of automated underwriting and other technologically advanced systems. One common explanation expressed by CBO

leaders interviewed for this study was that automated underwriting systems would limit their ability to tailor loan products to meet the specific needs of their customers. Fearing that these systems place undue weight on what he considers to be inaccurate or in complete credit bureau reports on credit histories, one of these respondents disparagingly described the use of automated systems as “technological redlining.”

These concerns have some merit. First and foremost, many advocates are concerned that the automated underwriting systems utilize what is widely perceived to be flawed credit reporting data. Noting the significant discrepancy in credit scores as reported by the three major credit repositories – Equifax, Experian, and Trans Union – a recent study conducted by the Consumer Federation of America and National Credit Reporting Association concluded that one in five consumers is at risk of being mis-classified into the subprime market due to inaccurate information in credit reports. Common reporting errors include the failure to report a revolving charge account that was in good standing or a mortgage account that had never experienced a late payment.[35]

While acknowledging the limitations of the underlying credit reporting data, proponents of automated underwriting systems argue that well designed systems not only improve the ability to correctly evaluate and price mortgage risk, they have also enabled many lenders to reach out and extend credit to borrowers with less than perfect credit records, limited capacity to make a down payment, or other characteristics that previously have limited access to credit. Moreover, the best automated underwriting systems seek to offset the limitations of credit reporting by combining data generated by all three of the major credit repositories, and by including in their evaluations not only aggregate credit scores, but other specific measures of consumer behavior (such as a recent bankruptcy) likely to be more accurately estimated. Even so, with the exception of HUD’s fair lending review of the automated underwriting systems of Fannie Mae and Freddie Mac, there has been limited independent review of automated underwriting systems. Moreover, the fact that the HUD’s review was conducted in extreme secrecy, and that the results have yet to be released has only heightened the suspicions of some advocates.

In any event, many CBOs argue that some lenders have used automated underwriting systems as an excuse to deny loans to credit worthy borrowers, while others contend that this

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[35] Consumer Federation of America and National Credit Reporting Association, Credit Score Accuracy and Implications for Consumers, Washington, D.C., 2002

need not be the case. One official at CNE observed that while many borrowers present unique lending challenges or face problems with inaccurately reported credit, other applicants simply lack the downpayment or income required to qualify for a conventional loan product, but could easily fit standard automated underwriting parameters. According to this official, use of automated underwriting enables CNE to quickly fund the "easy cases," allowing them to devote additional staff time and effort serving those borrowers with more substantial credit blemishes, or those with "thin or inaccurately reported credit histories." In short, for CBOs with the capacity to monitor their use, automated underwriting systems can be structured to reflect the underwriting criteria, the values and norms of CBOs, while at the same time substantially improving operational efficiency.

Undoubtedly, more could be done to properly evaluate the credit quality of low-income people living in low-income communities. For example, work remains to insure that steady payment of rent and utilities is accurately included as a factor in credit scoring. Even so, as technology improves, there will be further improvement in the ability of credit bureaus to gather needed data and to translate that data into meaningful mortgage evaluation tools. The result is likely to be a growth in the ability of lenders to tailor automated underwriting systems to better serve the needs of "so-called" nontraditional borrowers. Indeed, many individuals interviewed for this study noted that there already was a "bewildering array" of mortgage products available. In short, while tailoring mortgage programs to meet local needs remains a challenge, there appears to be ample opportunity to fashion a diverse set of loan products that meet community needs while still adhering to whatever elements of standardization are required to tap into the efficiencies of risk-based pricing, automated underwriting, and state of the art mortgage servicing.

Contracting Out: The Make or Buy Decision

Self-Help's Community Advantage Program is a good example of the ability of a CBO to combine market rate capital with socially motivated funds to expand access to capital. Many community loans funds have amassed sizable pools of "socially motivated money" tapping CDBG and other government funds, as well as securing below market rate funds from foundations and charitable organizations. Starting with a below market capital base, a CBO

should be able to offer "below market rate mortgages," assuming that they are able to operate their loan programs in a cost effective manner.

In deciding how best to structure their operations, CBOs face what public finance experts term a 'make or buy' decision. Neighborhood Housing Services of Chicago (NHSC) once again provides a useful example of the issues surrounding this decision. Even as one of the nation's largest community-based loan programs, the NHSC lacked the internal organizational capacity to take full advantage of the latest loan origination and servicing technology, and was unable to sell loans into the secondary market in a cost effective manner. As result, some share of the subsidy present in its below market capitol pools was increasingly being diverted to cover the costs of program operations.

To address these issues, NHSC recently decided to outsource their loan servicing operations to MB Bank, a move that both improved the quality and lowered the costs of its mortgage servicing operations. Similarly, working in partnership with Chicago area banks, the NHSC created a $100 million loan facility that enables them to sell loan pools to Chicago area banks. This arrangement not only allows the NHSC to replenish funds available to make new loans, it dramatically reduces the interest rate, credit and collateral risk associated with originating and holding loans in portfolio. In combination, this outsourcing should not only improve program operations, but also should help to place their programs on a more sound financial footing.

While the NHSC opted to "buy" access to technology through its partnership with MB Bank, other groups choose to "make" or create their own in house mortgage lending and servicing capacity. This tendency to keep functions in house reflects, in many ways, a legacy of conditions that prevailed when these programs first appeared on the scene. For example, until recently, many CBOs were the only entities willing to lend in distressed inner city communities. Absent the availability of other potential partners with knowledge of lending in their target area, they had little choice but to "go it alone."

Yet the world today presents CBOs with a richer set of options. At noted, there has been a rapid growth in private sector lending in most low-income and minority areas, and equally substantial growth in the number of organizations – especially well capitalized large financial services organizations -- making loans in these areas. Recognizing the expanded array of potential new partners, the "buy approach" enables smaller community groups to tap into state of

the art loan origination, servicing and packaging, by outsourcing these functions to an existing mortgage lender. The premise is that the larger players in the mortgage industry have considerable economies to scale, and the ability to update their technology regularly. In addition, by outsourcing some or all of aspects of mortgage lending, a CBO can focus its attention on activities that take advantage of its presence in the neighborhood, such as home buying counseling, neighborhood outreach, and foreclosure avoidance.

Some CBOs interviewed for this project, expressed fear that partnering with private sector entities would not be cost effective and/or would leave them with little or no control over their mortgage lending operations. This need not be the case. For example, one Boston area CBO is considering hiring a large mortgage lender to originate and service a loan product that they would design and fund with low-cost money obtained from foundation grants. The CBO would continue to provide home counseling and engage, when needed, in foreclosure avoidance efforts, two areas where they perceive their presence in the community adds value. At the same time, they recognize they may be able to achieve greater efficiency in their overall lending operations by outsourcing some mortgage origination and servicing functions to a private sector partner.

Of course, to develop an effective partnering relationship may require that a local CBO reach out to potential partners from beyond their own metropolitan area. For example, having contracted with a local bank to service their loan portfolio, one small Midwest CBO had to terminate the contract and take back "in house" this servicing function. Yet it is important to observe that the private sector partner here was a local lending institution that agreed to take on the task as a "favor" to the CBO and quickly discovered that the job of servicing a portfolio of community loans was more difficult than first imagined.

As this last example suggests, contracting obviously requires identification of a willing and able partner. Yet such potential partners exist. For example, based on its successful assumption of servicing activity for the NHSC, MB Bank is exploring the possibility of providing similar services to other CBOs, while the Boston based group discussed earlier solicited the advice of a leading financial services expert to identify a list of qualified potential partners. Intervention by a national networks of community loan programs or a major national foundation could accelerate the move to outsourcing key elements of community loan programs by developing a pre-screened list of potential qualified partners, and/or by assisting local CBOs

with the often difficult task of conducting the due diligence required to select a suitable outsourcing partner.

Creating New Sources of Fee Income

Many CBOs have grown to rely on their direct lending efforts as a source of fee income. Yet lacking the scale economies of larger, well capitalized players, this is a difficult business proposition. Even so, many small CBOs still attempt to earn a profit from originating and servicing a handful of mortgages. Some claim to actually make money, but frequently these statements are more a product of their failure to accurately account for the total costs of their operations, than a carefully honed estimate. In too many instances, this situation diverts subsidy dollars that should go to reduced mortgage rates into dollars to compensate for inefficient lending operations.

Of course, one way to address problems associated with operating small scale lending programs is for a CBO to expand the scale of their operations. Today, there exist a limited number of CBOs that do in fact possess the capacity to run a state of the art mortgage banking operation. Chattanooga Neighborhood Enterprises (CNE) is a standout example. Offering a variety of mortgage products, CNE has developed in-house systems and expertise to turn a small profit from their mortgage operations. CNE is now considering offering their services to other CBOs in the region, groups that would benefit from contracting for more cost effective loan origination or loan servicing services, but are reluctant to secure these services in the open marketplace.

Similarly, the Phoenix NHS is looking to translate its success at servicing their own loan portfolio into a new business opportunity for their organization. Though their own loan portfolio far is smaller than CNE's, the Phoenix group already has contracts in place to service loans for several local government funded revolving loan funds, as well as the loan portfolio of several local Habitat for Humanity groups. Having mastered the intricacies of adapting an off the shelf loan servicing software package to meet their own mortgage servicing needs, the Phoenix NHS is able to service additional loans at a relatively low marginal cost, and earn a small profit in doing so.

Others interviewed for this study were considering making the investment in the technology and staff to develop replicate the CNE or Phoenix approach. Yet recognizing the

relatively small scale of community loan programs overall, this can be a tricky proposition. Indeed one California based CBO noted that they could easily ramp up their own capacity to sell mortgage services to others, but were reluctant to invest the time and energy to develop what they perceived to be a potentially cyclical business. As was discussed earlier, what is needed is for a national organization – such as Neighborhood Reinvestment – to step forward and support the growth of a limited number of entities that specialize in selling services to small scale CBO loan programs. As the CNE and Phoenix examples illustrate, by aggregating the volume from a number of smaller community loan programs, there is the potential for a non-profit entity – or a community minded for-profit player—to create a profitable business outsourcing mortgage banking services.

Of course, many smaller CBOs currently lack the scale and capacity to take advantage of these new technologically driven business opportunities. For these entities, it will be important to identify those aspects of the homebuyer process where they do have a strong competitive advantage. For example, several CBOs have identified real estate brokerage as a potential source of revenue. The NHS of the Inland Empire now has several real estate brokers on staff to handle the marketing and sales of homes that it builds and rehabs. The Santa Fe NHS is planning to extend this process, by building a full service company that provides real estate brokerage, as well as mortgage origination and servicing. In this way, it hopes to capture some fee income from graduates of its home buyer counseling programs, as well as earn additional fees from the sale and financing of its single-family construction programs.

Though these examples differ in many details, they share the common thread of the search by CBOs for fee income to support overall program operations. While this can be a worthy goal, care must be exercised to carefully select those business ventures suitable for small scale operations and that take advantage of having a visible and trusted presence in their community. To the extent that this is the case, for example, even relatively small scale CBOs may be able to develop a profitable real estate brokerage business. At the same time, name recognition and community savvy is no guarantee that a small scale organization will ever be able to efficiently service a small loan portfolio, or package and sell loans into the secondary market – two tasks that exhibit substantial scale economies often lacking in all but the largest of CBO programs.

The ability of smaller CBOs to adapt to the changing lending environment has important ramifications not only for individual CBOs, but also the future of organizational structure of the non-profit housing industry. If, as seems likely, scale economies enable a few non-profit organizations to expand the scale and scope of their loan origination and loan servicing operations, the non-profit housing industry will face the challenge of maintaining the strong "community" ties that are a critical element of their ability to serve diverse neighborhoods. Fortunately, as will be described in the next two sections, there are important roles that smaller CBOs can play – including providing homebuyer education and counseling and participating in foreclosure avoidance efforts -- that benefit from their extensive knowledge of local market conditions and the trust they have engendered as a result of years of neighborhood service.

Yet even if these new opportunities develop, there is no assurance that local CBOs will be able to master the required transition. National organizations will need to step-up their capacity to train and provide technical assistance to CBOs seeking to exploit these new niche opportunities. Absent this assistance, many CBOs – along with the special knowledge of neighborhood conditions – may be either rendered ineffective, or disappear altogether from the scene.

Helping Homebuyers Get the Best Mortgage Available.

In a world where many brokers have incentives to "sell" mortgages, the task of insuring nondiscriminatory pricing in the marketplace falls to regulators and to consumers themselves. Unfortunately, many consumers are not up to this task. As previously discussed, many consumers do not shop for mortgages, and instead rely on brokers for information, believing incorrectly that they have an incentive to get them the best terms available. Indeed, many consumers falsely believe that approval of their mortgage application by a broker is an indication that they can handle the mortgage payments.

It also seems unlikely that the current regulatory setup is not well structured to address the problems associated with the mispricing of mortgage credit. Current consumer protection regulations generally focus on ensuring that the information provided by the mortgage broker is accurate, that the appraised value of the home is a fair representation of current market value, and that the terms and cost of the loan are provided in advance of closing for the borrower to review. Indeed, there could and should be more aggressive enforcement of laws and regulations

governing deceptive marketing practices, or failure to accurately disclose the terms to the borrower prior to the closing. Yet under the doctrine "let the buyer beware," there is limited regulatory recourse for a borrower who simply overpays, or limited regulatory requirements that a broker offer the best price or terms in the marketplace.

Of course, the complexity of pricing of the current array of mortgage products can pose challenges to even the most knowledgeable borrower. Yet for many borrowers, the consequences of this knowledge gap may be less severe than others. For example, many higher-income borrowers have access to financial or legal advisors to guide them through the intricacies of the borrowing process, and in doing so help them evaluate whether they are obtaining credit on the best terms available. In communities where homeownership is the norm, other borrowers obtain useful advice from family and friends. Even in situations where such advice is not forthcoming, borrowers with more extensive financial resources suffer fewer negative consequences from paying too much for their mortgage credit, and have greater capacity to stave off mortgage default and foreclosure.

In contrast, in the current system less sophisticated borrowers are more likely to suffer the adverse consequences of being over charged for their mortgages. And in many instances they have little knowledge of the pitfalls associated with specific mortgage transactions. For example, at the time of closing, the broker, the lender and the investor may have good information about the likelihood that the borrower has an above average probability of defaulting on the loan and losing their home to foreclosure. Similarly, each of these parties has limited incentive to reveal whether the loan is being made on the best terms available. Lacking this knowledge, many less financially sophisticated borrowers willingly enter into transactions that may require them to pay too much for their mortgage and/or expose them to relatively high risk of future foreclosure, and in doing so enter into a transaction that may impose serious financial and emotional costs on themselves and their neighbors.

What is needed is the creation of a system of "buyer's brokers" to help potential borrowers identify the best loans for them. Unlike mortgage brokers, these "buyer's brokers" would work on behalf of the borrower. Like the trusted advisors available to many higher-income borrowers, a "buyer's broker" would provide lower-income income and/or less knowledgeable borrowers access to information on available mortgage terms and pricing.

Fortunately, there is a growing awareness of the importance of providing better pricing information to potential borrowers. As noted early, in their strategic plan for the period 2003 to 2007, the Campaign for Homeownership added a renewed emphasis on assisting borrowers to obtain better information on terms and prices. This will be no easy task. One approach is to expand the capacity of CBOs to work with buyers one-on-one to search for the best mortgages. Indeed, some CBOs are already gearing up to develop a mortgage brokerage business with the explicit goal of using their good standing in the neighborhood to become a "buyer's broker," while at the same time earn a small fee for offering this service.

To do this efficiently, CBOs will need to acquire automated tools to evaluate the risk profile of individual borrowers, but also develop capacity to identify the best products available in the market. Again, this is achievable, but difficult. Today, mortgage pricing and terms are largely determined by credit history, income, and a limited number of other factors. Indeed, most brokers receive daily "rate sheets" that specify the additional payments or terms required to compensate lenders for risk associated with a particular set of borrower/loan characteristics. Using software similar to that developed by large-scale mortgage originators or secondary market players, CBOs could help cut through the current complexity that now works to the detriment of many borrowers.

Fortunately, there are other ways, short of opening full scaled mortgage brokerage operations, that CBOs can help borrowers search for better mortgage. Just as is the case with the automobile "blue books," CBOs could periodically make "rate sheets" available to recent graduates of its home buying courses or fairs. Armed with knowledge of their credit score, income, and other characteristics, these rate sheets could help borrowers shop for the best terms in the market, as well as better evaluate unsolicited offers.

Of course, for such a service to be helpful, the CBO has to keep abreast of mortgage market trends for credit, and be recognized by potential borrowers as a trusted source of information. In this regard, CBOs have to be mindful of the actual or even perceived conflict of interests inherent in assuming the role of "buyer's broker." For example, to the extent that a particular CBO receives funding from a particular lending institution, they may be pressured to recommend this institution's products even in situations where more advantageous products exist in the market place. Needless to say, a CBO's failure to provide proper safe guards to avoid

either a perceived or actual conflict of interest would quickly erode the trust that community residents have placed in their organization.

Expanding Outreach to Potential Homebuyers

To enhance their capacity to move to a "buyer's broker" approach, CBOs must expand their capacity to reach out and help buyers review the terms of an imminent mortgage transaction. Yet today, many CBOs struggle to maintain their visibility in the marketplace. Historically real estate brokers would refer credit-impaired customers to CBOs in hopes that they would be able to identify an appropriate loan product. While many real estate brokers continue to make these referrals, in the increasingly competitive mortgage environment, real estate brokers now have the option of referring potential customers to any one of a number of mortgage brokers operating in their area. Indeed, several respondents noted that referrals by real estate brokers had "dried up."

Not only do shifting patterns of referrals limit the capacity for CBOs to identify potential customers, they also pose other policy challenges. Several studies suggest that in some instances the referrals offered by real estate brokers may not be in the best interest of the borrower. In the most benign cases, these referrals may simply reflect the interest of the real estate broker to sell the property in question in the fastest way possible. More ominously, a referral may reflect illegal collusion or racially discriminatory practices on the part of the real estate and mortgage broker. Yet as with mortgage brokers, regulations in this area require that real estate brokers fully disclose their relationship (if any with mortgage broker) and behave in a non-discriminatory manner with respect to racial minorities. Regulations recognize that real estate agents represent the seller of a home, and as a result are under no particular obligation to help the borrower secure "the best available mortgage."

Recognizing the need to reach out and help borrowers obtain useful information to guide them through the mortgage application process, many local CBOs are ramping up their outreach to potential borrowers. In one common approach, a CBO will host a homebuyer fair and invite a prescreened group of mortgage brokers and lenders to participate. While falling short of a full scale referral or buyer's brokers service, these homebuyer fairs not only seek to educate prospective buyers, but also help them identify specific mortgage products and providers that are best suited to meet their needs.

Other organizations have mounted campaigns to challenge the activities of lenders operating in their community in what they perceived to be a particularly abusive manner. For example a Des Moines CBO reviewed "Court House records" to identify households facing foreclosure in their target areas and to identify the lender that appeared to be responsible for making loans at inflated terms. Through skillful use of the media, they obtained restitution for the borrowers who apparently "paid too much" for their credit, and encouraged others to avoid this particular lender. In addition, by involving the office of the Iowa Attorney General, the CBO was able to extract a pledge from the lender to fund more appropriately priced loans in Iowa in the future.

Clearly casting a spotlight on abusive brokers and lenders can be an effective tool in increasing the likelihood that potential borrowers do fall victim to truly abusive lending practices. For example, working in cooperation with national campaigns such as Freddie Mac's 'Don't Borrow Trouble,' CBOs are redoubling their efforts to help low-income families avoid predatory lending practices or take on more mortgage debt than they can repay. At the same time, the airwaves and advertising media are now saturated by the outreach efforts of mortgage brokers and lenders targeting the low-income market. Again, while the ads are required to be factually correct, it still remains up to the borrower to identify the best mortgage available for them.

While such efforts to distribute pricing information could help, there is also a need to review and strengthen existing regulations in the mortgage lending arena. As long as brokers are able to use the complexity of the current array of available mortgage products to conceal the true extent of fees associated with any given mortgage, borrowers can be easily misled. Further work needs to be done on how best to arm borrowers with the information required to improve their capacity to shop for good loan terms. Absent such detailed advice on best available terms and rates in the market, the dual mortgage structure is not likely to disappear soon.

New Focus on Foreclosure Avoidance

Whatever factors sustain the dual mortgage market, there can be little doubt that foreclosures are on the rise in many neighborhoods across the country. The National Training and Information Center (NTIC) estimated that the foreclosure rate in Chicago stood at 4.7 percent in 2001 -- over ten times the national average foreclosure rate for prime conventional

loans. In the nine low-income neighborhoods served by Neighborhood Housing Services of Chicago (NHSC), the foreclosure rate reached 7.7 percent. Overall, some 40 percent of all completed foreclosures in the City of Chicago were in these nine targeted neighborhoods. Yet, these communities represented only 5 percent of all mortgage originations in 2001 and account for just 18 percent of Chicago's population.[36]

Unfortunately, high foreclosure rates are found in many low-income communities across the country. The recent surge in foreclosures appear to stem in large measure from the growing presence of subprime lending in these communities, and in particular the extension of loans to borrowers with limited capacity to repay, or at rates that are priced above market. As reported by the HUD/Treasury Task Force on Predatory Lending, from January 1998 through September 1999, delinquency rates (total loans past due for at least 30 days) in the subprime market averaged 13.5 percent and foreclosure rates averaged 2.6 percent. Over the same period, delinquency rates for prime mortgages averaged 2.8 percent and foreclosure rates averaged 0.24 percent[37]

To date there have been over ten separate studies of foreclosure activity in specific metropolitan areas. Though they differ in terms of the quality and extent of available data, they paint a remarkably consistent picture of the rising incidence of foreclosure, especially in lower-income and minority neighborhoods. For example, in Atlanta, Abt Associates examined loans entering into foreclosure between 1996 and 1999 and found that the share of foreclosures attributable to subprime lending increased from 5 percent in 1996 to 16 percent in 1999[38]. Moreover, Abt noted that almost half of the foreclosed subprime loans were "high-cost," that is they had mortgage interest rates more than 4 percentage points higher than the 30-year Treasury rate at the time of origination. Another common finding is that a relatively large share of subprime foreclosure occurred within two years of origination, suggesting that many of the borrowers probably lacked the ability to repay the loans at the time of origination. [39]

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[36] Michael Collins, 2003. "Chicago's Homeownership Preservation Challenge," Presentation to the Federal Reserve Bank of Chicago.

[37] HUD/Treasury Task Force Report citing default and delinquency data gathered from various sources including the Mortgage Bankers Association, Inside Mortgage Finance, the Mortgage Information Corporation, and FHA program data.

[38] Abt Associates Inc., Analyzing Trends in Subprime Originations and Foreclosures: A Case Study of the Atlanta Metropolitan Area, February, 2000.

[39] For other studies, see for example Debbie Gruenstein, and Christopher E. Herbert, Analyzing Trends in Subprime Originations: A Case Study of the Boston Metro Area, a paper prepared for the Neighborhood Reinvestment Corporation, 2000. See also The Housing Council, Residential Foreclosure in Rochester, New York, 2000

Clearly, the extension of loans to borrowers with limited capacity to repay has contributed to the rise in foreclosures. This imposes hardships on individual families, but also threatens to limit home sales, dampen home price appreciation and destabilize communities. Recognizing this, some CBOs are focusing their efforts on foreclosure avoidance. CBOs that once only offered pre-purchase counseling are expanding their operations to better serve the many thousands of households who have fallen behind on their mortgage payments and are facing foreclosure. Advocacy groups are pressuring lenders, particularly subprime lenders, to fund loan products that help delinquent borrowers remain in their homes.

Rising foreclosures are also of concern to the mortgage banking industry, particularly large mortgage servicers that handle mortgages in default that they didn't originate. Over the past five years, servicers have developed sophisticated models to sort borrowers by the likelihood that loss mitigation efforts will generate a favorable outcome. Yet despite the fact that such efforts could benefit the lender/investor and the borrower, servicers report that they often have trouble reaching lower-income borrowers in a timely fashion. This can be especially problematic in situations where the decision to fund a broker initiated loan was based on limited, or even false or misleading documentation.

Aware of both the financial and reputation costs of foreclosures, many large lender/ servicers are partnering with CBOs to develop more effective foreclosure avoidance efforts. In general, these partnerships seek to take advantage of the extent to which CBOs may be closer to borrowers than the lender/servicer and benefit from situations where CBOs can offer credit counseling or in other ways assist the borrower and avoid the costly foreclosure process.

The Home Ownership Preservation Initiative (HOPI) of the NHSC represents one such emerging partnership between a CBO and large servicing organizations. HOPI correctly notes that is the mortgage servicer (not the lender or investor) who is the key player in the foreclosure process. Working with NTIC, the NHSC first identified those servicers handling most of the foreclosure actions in low-income areas of Chicago. Working with the Mayor's Office and Federal Reserve Board officials, HOPI is challenging large servicers to create new foreclosure avoidance tools. Concerned about their ability to conduct business in the city, as well as the reputational risk of being associated with Chicago's growing foreclosure problem, representatives of several large mortgage servicers are now working with the HOPI initiative to see if they can create mutually beneficial alternatives to current foreclosure practices.

Though just in its early stages, the HOPI initiative is already bearing fruit. For example, Chicago is now considering augmenting it's non-emergency "311" call system to provide information to borrowers in risk of default. Recognizing the high costs of taking a foreclosure action, most large scale mortgage servicers have at their disposal, a wide array of "loan modification" and other "loan loss mitigation tools" designed to help borrowers avoid foreclosure. Moreover, as is true in many cities, the City of Chicago supports a variety of community-based to programs to help finance workouts for borrowers in the early stages of default. By expanding its public service advertising campaign, the City hopes to encourage borrowers to call the "311" number where they can obtain assistance in handling past due mortgage debt, including referring these borrowers to a special "help desk" created to link specific borrowers with available foreclosure avoidance resources.

New Approaches to Industry Outreach and Advocacy

The changing mortgage structure poses difficult challenges for low- and moderate-income communities. CBOs working in this area must confront a series of complex considerations related to industry trends, the limitations of the existing regulatory framework and the marketplace, and the preferences and choices of individual consumers. This is leading some community leaders to take a hard look at the effectiveness of their organization's current activities and to consider ways of adapting to the new lending environment. As a result, new paths of work are emerging.

One approach recognizes that the growing concentration of mortgage lending and the increasing market domination by a comparative handful of large lending institutions necessitates changes in the way CBOs relate to these mega-institutions. Consequently, CBOs are increasingly looking for ways to connect with other local, regional, and national organizations and to join forces to address matters of common concern. The response by CBOs to the explosion in predatory lending in their communities reveals how they are adapting to this new concentrated lending environment. Working through their support organizations and networks, CBOs have joined forces with banks and the secondary mortgage market entities to fund financial education and counseling efforts managed by a single community partner that serves as a conduit for numerous smaller participating groups. Such arrangements can be particularly important in those areas lacking a significant community-based capacity. For example, as an

outgrowth of a region-wide planning effort, Region 2020, a Birmingham, Alabama based non-profit is working to form a CDFI that could serve as a conduit for the charitable contributions and CRA-related investments of locally based banks.

CBOs are also aware that bank support for their work may be declining and therefore have mounted campaigns to diversify their funding bases. One Executive Director noted: "CRA gave community groups access to bank resources, but times are changing. We have to convince other major corporate players that the health of our communities is not just important to the mortgage and banking sector – it affects all business." Consequently, some CBOs are turning to other private sector institutions and trying to get corporate leaders from the health care, manufacturing, service, and other sectors to "walk the neighborhoods with us," and learn first hand what effective CBO approaches can accomplish.

Another emerging approach seeks to refocus CBO advocacy toward finding new ways to improve the regulatory framework for mortgage lending and provide underserved households with better access to fundamental banking services. Thus, CBOs have formed alliances with consumer, civil rights, labor, and other interests to build broad based support for public policies and other efforts aimed at preventing predatory lenders and fringe bankers from exploiting low-income consumers.

For example, despite a hostile federal policy environment, CBOs continue their efforts to adapt or "modernize" CRA so that it covers a greater share of mortgage market and other lending activities. These advocates seek to convince banking regulators to update the present geographically-based assessment area definitions for CRA reviews so that examiners can take into account the growing share of bank lending that occurs outside of these areas. They also are looking for ways to apply CRA rules to subprime affiliates of banks to prevent these institutions from engaging in predatory and other exploitative lending practices. Some CBOs also are contemplating strategies to get states to do more to patch the holes in regulation. In Massachusetts, CBO advocates have already won passage of a 'CRA-like' regulation for mortgage companies and a community reinvestment requirement for insurance companies.

Similarly, in light of recent events surrounding Fairbanks Capital Corporation, including allegations that they engaged in abusive subprime mortgage servicing practices, advocates are now encouraging federal regulators to take a hard look as this important segment of the mortgage banking industry. While awaiting the release of new FTC guidelines on what constitutes fair

approaches to mortgage servicing, Ameriquest -- one of the nation's largest subprime issuers and servicers -- was first to release a comprehensive set of "best practices" for subprime mortgage servicing. Under the leadership of the Mortgage Bankers Association of America, other subprime mortgage servicers are now hard at work creating their own set of "best practices" in mortgage servicing. While in its early stages, to the extent advocates can pressure both regulators and industry participants alike to weed out predatory practices in the subprime servicing arena, the result can only serve to enhance ongoing CBO efforts at foreclosure avoidance.

Advocates are also forging coalitions with the capacity to prompt regulatory changes at the state and local level. CBOs and their allies have pushed for the passage of tough new state anti-predatory lending standards and have succeeded in a number of states including North Carolina, New Jersey, New York, New Mexico, and Georgia. Meanwhile, in Los Angeles, a broad coalition of grassroots organizations and lenders successfully convinced local elected officials to commit to fund a major new housing trust fund. Even in Alabama, which has a relatively weak non-profit infrastructure, there is an promising effort by local CDCs to join forces on a statewide basis to share experiences and to advocate about issues of common concern.

Others are seeking to expand advocacy beyond mortgage lending, and have begun to develop a variety of community-based responses to the problems created by the two-tiered financial system that imposes unreasonably high costs for consumers without access to mainstream banking services. For example, community groups have convinced the federal bank regulators to adopt policies to prevent banks from "renting their charters" to payday lenders in an effort to circumvent state limits on the interest that can be charged consumers for these short term, extremely highly priced loans. Further, one welfare rights organization challenged a major national banking operation to offer direct deposit accounts for families participating in a welfare-to-work program. In Birmingham, a church-based group worked in partnership with local banks to fund a financial literacy campaign in a local housing development that included efforts to teach young adults how to manage credit card debt and to start to save for future needs.

Conclusion

The initiatives discussed in this paper suggest that CBOs are beginning to respond to the challenges posed by the new lending and financial services environment. In the process they are undertaking new programmatic activities. Some are utilizing new lending tools available to them to widen the reach of community loan programs. Others are partnering with larger entities, exploring new ways that they can assist homebuyers in obtaining suitable mortgage products, or providing foreclosure avoidance services. CBO advocacy and outreach is also taking new forms.

These efforts suggest a series of important questions that community groups, national non-profit support and intermediary organizations, and funders who support their work must address. Among these questions are the following:

- What is the optimum scale of operations and structure for CBOs taking on these new challenges? The strength of the non-profit community organization sector traditionally has been its ties and connections to the communities in which they operate. Achieving larger economies of scale for CBOs has proven difficult. Does the increasing concentration of the mortgage lending industry dictate a similar need for CBOs and their support systems to ramp up and consolidate their operations?

- What new institutional infrastructure and technological innovations are needed to enable more CBOs to undertake these new responsibilities?

- What will it take for local community groups to connect better with other local and national organizations to provide the additional capacity they will need to relate to national financial institutions?

- What is an appropriate public policy agenda for CBO advocacy that addresses market abuses and the need for better regulatory oversight, while not interfering with what can be accomplished through marketplace innovations?

Adapting to the dramatic shifts that are transforming the financial services industry is clearly the central challenge facing so many CBOs today. The answers to these questions will go along way in determining how well these organizations are able to respond.

Exhibit 1
Top 25 Originators Dominate Mortgage Lending

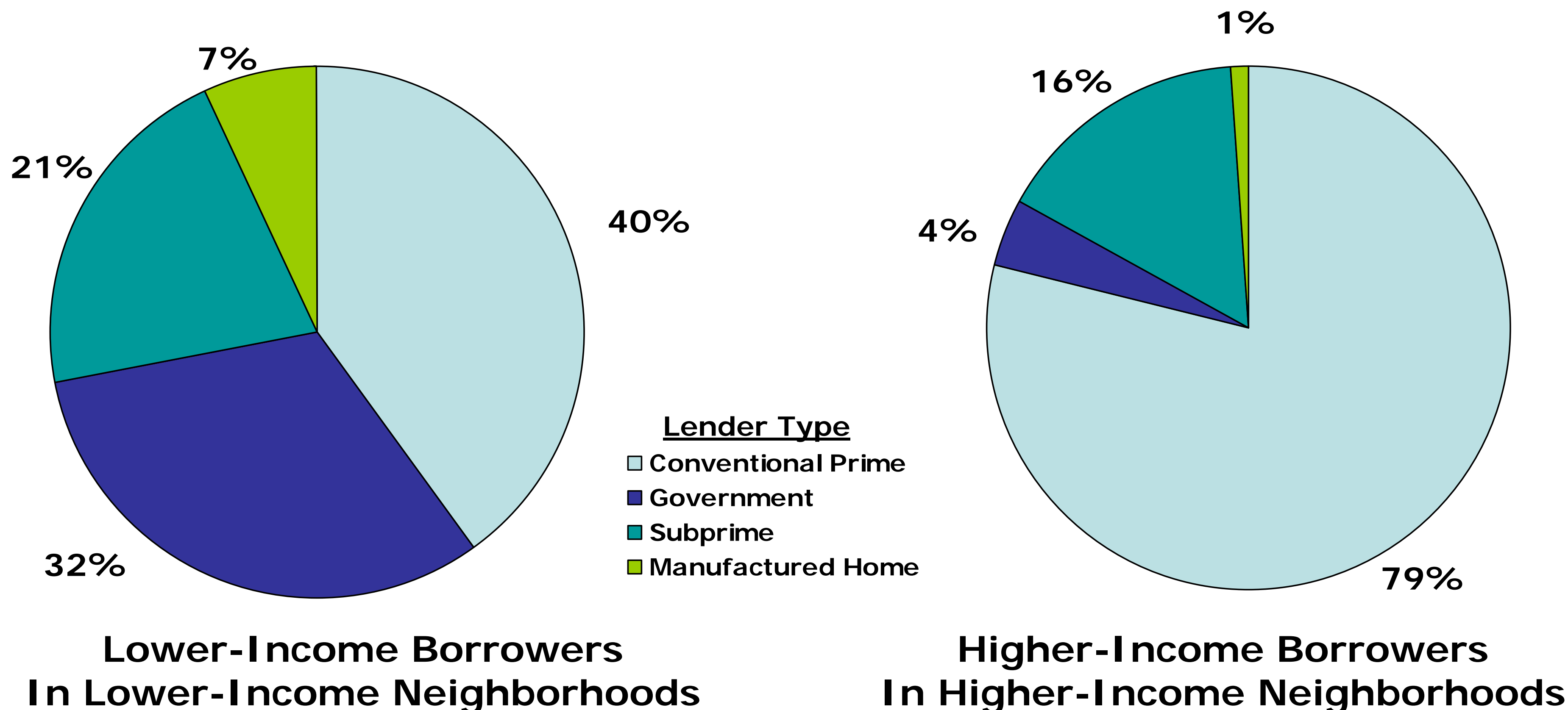
Home mortgage originations

Year	Total ($billions)	Total for Top 25 Originators ($billions)	Share Top 25 (Percent)
1989	453	118	26.1%
1990	458	130	28.4%
1991	562	151	26.8%
1992	894	272	30.5%
1993	1020	373	36.6%
1994	773	259	33.4%
1995	639	252	39.4%
1996	785	317	40.4%
1997	859	384	44.6%
1998	1450	780	53.8%
1999	1310	732	55.9%
2000	1048	637	60.8%
2001	2058	1458	70.8%
2002	2510	1971	78.5%

Source: Inside Mortgage Finance, 2003 Mortgage Market Statistical Annual

Exhibit 2
Expanded Lending to Lower Income Borrowers Has Fostered a Dual Mortgage Market

Share of Growth in Home Purchase Lending, 1993-2001



Note: Lower (higher) income borrowers have income of less than (at least) 80 percent of area median in that year. Lower (higher) income neighborhoods have income of less than (at least) 80 percent of area median as of 1990.

Source: Joint Center for Housing Studies, The 25th Anniversary of the Community Reinvestment Act: Access To Capital In An Evolving Financial Services System, March 2002.

Exhibit 3
Mortgage Lending Expands in Neighborhoods of Varying Income and Racial Composition

	Number of Home Purchase Loans		Number of Lenders		Number Top 25 Lenders		Share of Loans by Top 25 Lenders (Percent)	
Income < 80% AMI	**1993**	**2001**	**1993**	**2001**	**1993**	**2001**	**1993**	**2001**
Predominantly White	32.6	52.2	11.9	19.7	2.9	7.4	25.4	46.8
Predominantly Minority	15.7	30.3	8.4	15.1	2.4	5.9	32.3	49.7
Income 80-120% AMI								
Predominantly White	60.9	90.1	19.4	28.5	4.9	10.4	26.2	47.8
Predominantly Minority	42.0	72.5	17.9	26.2	5.0	9.8	33.3	51.7
Income >120% AMI								
Predominantly White	90.8	117.3	26.0	32.2	7.0	12.1	30.0	51.3
Predominantly Minority	64.9	106.5	21.8	28.5	5.6	10.3	32.8	54.9

Source: Joint Center for Housing Studies enhanced HMDA Database